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Enforcement of Corporate and Securities Laws in India

The Arrival of the Class Action?

VIKRAMADITYA KHANNA

1 Introduction

Corporate governance in Asia has garnered a great deal of recent scholarly attention.[1] One topic that permeates discussions across countries is the enforcement of corporate and securities laws – with some countries

[1] The literature is vast, for a sampling, see e.g. Stijn Claessens and Joseph P.H. Fan, 'Corporate Governance in Asia: A Survey', 3 *International Review of Finance* 71–103 (2002); Donald C. Clarke, 'Corporate Governance in China: An Overview', 14 *China Economic Review* 494–507 (2003); Hideki Kanda, Kon-Sik Kim and Curtis J. Milhaupt, *Transforming Corporate Governance in East Asia*, (Routledge, 2008); Vikramaditya Khanna, 'Corporate Governance Ratings: One Score, Two Scores, or More?', 158 *University of Pennsylvania Law Review* 39–51 (2009); Vikramaditya Khanna, 'Corporate Governance in India: Past, Present & Future?', 1 *Jindal Global Law Review* 171–196 (2009); Vikramaditya Khanna and Umakanth Varottil, 'The Rarity of Derivative Actions in India: Reasons and Consequences' in *Derivative Actions in Major Asian Economies: Legislative Design and Legal Practice*, Harald Baum, Michael Ewing-Chow and Dan W. Puchniak (eds.), (Cambridge University Press, 2012); Vikramaditya Khanna and Umakanth Varottil, 'Board Independence in India: From Form to Function?' forthcoming in *Independent Directors in Asia: A Historical, Contextual and Comparative Approach*, Harald Baum, Souichirou Kozuka, Luke Nottage, and Dan W. Puchniak (eds.) (2016); Curtis J. Milhaupt and Benjamin L. Liebman, *Regulating the Visible Hand? The Institutional Implications of Chinese State Capitalism*, (Oxford University Press, 2015); Curtis J. Milhaupt and Wentong Zheng, 'Beyond Ownership: State Capitalism and the Chinese Firm', 103 *Georgetown Law Journal* 665–722 (2015); Organization for Economic Co-operation and Development (OECD), *White Paper on Corporate Governance in Asia* (2003); OECD, *Corporate Governance in Asia – Progress and Challenges* (2011); OECD, *Public Enforcement and Corporate Governance in Asia – Guidance and Good Practices* (2014); Daniel W. Puckniak, Harald Baum and Michael Ewing-Chow, *The Derivative Action in Asia: A Comparative and Functional Approach*, (Cambridge University Press, 2012). Umakanth Varottil, 'A Cautionary Tale of the Transplant Effect on Indian Corporate Governance', 21 *National Law School of India Review* 1–49 (2009).

relying primarily on public enforcement (i.e. enforcement by government) while others rely on some combination of public and private enforcement (i.e. enforcement by private shareholders). Further, understanding how enforcement is operationalised and its concomitant strengths and weaknesses enables us to better appreciate the actual corporate governance situation in many countries.[2] In light of this, the enforcement of corporate and securities laws in India is examined in this chapter with special attention paid to the recent reforms that allow for class actions, for the first time, under Section 245 of the Companies Act 2013 of India.

To explore this issue in greater depth, this chapter examines the likely value of private enforcement against the background of India's ownership structure and institutional context. This involves laying out what the pre-existing methods of enforcement are and how, if at all, the class action provision builds on their edifice. It also involves a general assessment of how successful this incarnation of the class action is likely to be in the Indian corporate governance space. The overall conclusion is that class actions are likely to be of limited value because of: (1) the glacial speed of the Indian courts, (2) the lack of contingency fees, (3) the limited availability of monetary remedies under the class action provision, and (4) the interaction between ownership structure in India – virtually all

[2] This literature is also voluminous, for a sampling see, e.g. John C. Coffee, Jr., 'Law and the Market: The Impact of Enforcement', 156 *University of Pennsylvania Law Review* 229–311 (2007); Robert Daines and Charles Jones, 'Mandatory Disclosure, Information Asymmetry and Liquidity: The Effect of the 1934 Act', *Draft* (2012); Dhammika Dharmapala and Vikramaditya Khanna, 'Corporate Governance, Enforcement, and Firm Value: Evidence from India', 29 *Journal of Law, Economics, and Organization* 1056–1084 (2013); Howell E. Jackson and Mark J. Roe, 'Public Enforcement of Securities Laws: Preliminary Evidence', 93 *Journal of Financial Economics* 207–238 (2009); Vikramaditya Khanna, 'Law Enforcement & Stock Market Development: Evidence from India', No. 97, Center for Democracy, Development, and the Rule of Law, Freeman Spogli Institute for International Studies, Stanford University (2009). Available at: http://cddrl.fsi.stanford.edu/publications/law_enforcement_and_stock_market_development_evidence_from_india; Vikramaditya Khanna, and Umakanth Varottil, 'The Rarity of Derivative Actions in India: Reasons and Consequences' in *Derivative Actions in Major Asian Economies: Legislative Design and Legal Practice*, Harald Baum, Michael Ewing-Chow and Dan W. Puchniak (eds.), (Cambridge University Press, 2012); Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer. 'What Works in Securities Laws?', 61 *Journal of Finance* 1–32 (2006); Curtis J. Milhaupt and Katharina Pistor, *Law and Capitalism: What Corporate Crises Reveal About Legal Systems and Economic Development Around the World*, (University of Chicago Press, 2008); Mark J. Roe and Jordan I. Siegel, 'Political Instability: Its Effects on Financial Development, its Roots in the Severity of Economic Inequality', 39 *Journal of Comparative Economics* 279–309 (2011).

firms are controlled – and the absence of fiduciary duties owed by controllers to minority shareholders. The last point suggests that the class action in India is a procedural device that is only weakly tethered to an underlying duty.

This, however, does not mean that significant reform of enforcement should not be pursued in India. Indeed, quite the opposite – this chapter suggests some reforms that are likely to be more useful than the current class action regime in light of the institutional context and ownership structure in India. In particular, reliance on early warning signals provided by regulators and perhaps a version of arbitration that has been tried with measured success in other jurisdictions are worthy of greater consideration.

Section 2 begins by describing the enforcement terrain prior to the enactment of the Companies Act 2013. Public enforcement in India was, until fairly recently, plagued with lengthy delays in obtaining a remedy due to the well-known delays in the Indian judicial system. Indeed, public enforcement only began to move at a *relatively* faster speed in the last few years as the Securities and Exchange Board of India (SEBI) – the securities market regulator – started to take a more active role in examining the governance concerns animating the Indian business context (e.g. controller–minority conflicts). On the private enforcement side, derivative suits were not common (and took a long time to deliver any result), statutory oppression and mismanagement actions were also heavily delayed (perhaps around fifteen years), there was no easy way to aggregate shareholders claims (or to pay attorneys contingency fees)[3] and the remaining causes of action (e.g. contract or tort) had difficult-to-satisfy requirements and lengthy delays as well. Moreover, when SEBI became more active in enforcement, it operated to reduce the scope of private enforcement because of how courts interpreted certain statutory provisions on their jurisdiction once SEBI was involved. Overall, the state of both public and private enforcement in corporate governance in India prior to 2013 was quite ineffectual. This sets the stage for considering whether it might be valuable to enhance private enforcement in the Indian context and what measures might be considered (such as class actions).

[3] There are other ways to potentially aggregate claims (some discussed in this section) that could conceivably be useful in corporate cases. India allows 'public interest litigation' as well, but that is unlikely to be used in the corporate context. On PIL, see generally Surya Deva, 'Public Interest Litigation in India: A Critical Review', 28 *Civil Justice Quarterly* 19–40 (2009); S.P. Sathe, *Judicial Activism in India* (Oxford University Press, 2002).

Section 3 lays out the arguments usually put forward for why private enforcement may add value to a system relying primarily on public enforcement.[4] Two of the key reasons are that private enforcement may incentivise private individuals (i.e. shareholders) to come forward with their corporate governance related information because they stand to gain from it. Moreover, private enforcement – because it holds out the prospect of recovering money for investors – may also aid in deepening liquidity in a market. Both of these features may be particularly important in emerging markets, which frequently suffer from poor public enforcement and thinly traded markets.

Section 4 then examines some of the key features of the Indian context that are relevant for our inquiry. In particular, it discusses the ownership structure in India where virtually all firms are controlled – whether by a family business house, the state, a foreign multinational, or the founders of the firm (who do not belong to the same family or kinship group). This means the key agency problem is not the separation of ownership and control per se, but rather the conflict between the controller and the minority shareholders which should then in turn animate much of the discussion in the Indian context. Second, the other key feature of the Indian landscape relates to the legal system – very long delays in addressing commercial and civil matters and the absence of a contingency fee system (often thought to be valuable in the class action context). This suggests that reliance on timely judicial resolution of corporate governance disputes in India may not be realistic in the current environment.

Section 5 examines reforms that might enhance private enforcement. Section 5.1 starts with the class action provision (Section 245 of the Companies Act 2013) and examines how its structure, the absence of contingency fees, and the absence of fiduciary duties owed by a controller to minorities undermines the value of such an action. Investors may then need to rely on other methods to assuage their governance concerns such as reputation, large holdings, cross holdings, and so forth. Section 5.2 explores some alternatives to class actions that might prove to be useful supplements. Given the institutional conditions and ownership structure

[4] See William Landes and Richard A. Posner, 'The Private Enforcement of Law', 4 *Journal of Legal Studies* 1–46 (1975); Stephen J. Choi and Adam C. Pritchard, *Securities Regulation: Cases and Materials*, 4th ed., (Foundation Press, 2015); Vikramaditya Khanna, 'Law Enforcement & Stock Market Development: Evidence from India'; and George Akerlof, 'The Market for 'Lemons': Quality Uncertainty and the Market Mechanism', 84 *Quarterly Journal of Economics* 488–500 (1970).

in India, it would appear that reliance on non-judicial methods of dispute resolution is going to be important (e.g. arbitration). Moreover, with a respected and more active regulator in the mix (i.e. SEBI) perhaps greater reliance on it as an enforcer or facilitator of enforcement (e.g. through early warning signals) might be very useful.

Section 6 concludes with comments on how even though the changes suggested here may be useful, one should also inquire more deeply into how investors are currently protecting their interests in Indian firms. This is important because when devising enforcement structures and systems, it will be useful to acquaint oneself with the existing structures to examine how they may also prove useful for enhancing investor protection and corporate governance in India.

2 Pre-2013 Enforcement

It is generally well understood that law and enforcement are important for the growth of stock markets. This is because investors are more likely to invest, all else equal, in firms based in jurisdictions that provide investors with some sense of protection so that they are more secure in investing in entities where they have limited control.[5] Investor protection laws (e.g. corporate and securities laws) and their enforcement are ways in which some measure of security may be obtained (as are other sorts of private ordering mechanisms (reputation, reliable intermediaries)).[6]

Prior research has indicated that enforcement of the law is important in a number of spheres ranging from signalling government attitudes to governance issues,[7] providing assurances to investors on the credibility of anti-expropriation measures and firm disclosures,[8] and letting investors know that their concerns can be addressed in some manner.[9]

[5] Daines and Jones, 'Mandatory Disclosure, Information Asymmetry and Liquidity'; Jackson and Roe, 'Public Enforcement of Securities Laws'; Khanna, 'Law Enforcement & Stock Market Development'; La Porta et al., 'What Works in Securities Laws?'.

[6] John C. Coffee, Jr., 'The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control', 111 *Yale Law Journal* 1–82 (2001).

[7] Milhaupt and Pistor, *Law and Capitalism*.

[8] La Porta et al., 'What Works in Securities Laws?'; Daines and Jones, 'Mandatory Disclosure, Information Asymmetry and Liquidity'.

[9] Coffee, 'Law and the Market'; Jackson and Roe, 'Public Enforcement of Securities Laws'; Khanna, 'Law Enforcement & Stock Market Development'; Roe and Siegel, 'Political Instability'. For a broader discussion of how these factors interact in the development of active stock markets in India, see Khanna, 'Law Enforcement & Stock Market Development'. For a discussion of important conceptual issues related to corporate law, see Reinier H. Kraakman, Paul Davies, Henry Hansmann, Gerhard Hertig, Klaus Hopt,

In light of this, examining the various kinds of enforcement options available in India becomes critical. This part engages in that inquiry by dividing the discussion into two parts – Section 2.1 addresses public enforcement in India and Section 2.2 discusses private enforcement in India before 2013.

2.1 Public Enforcement of Corporate and Securities Laws in India

Enforcement of corporate and securities laws by the government occurs in multiple ways in India. The two primary methods are enforcement by the securities market regulator – the Securities and Exchange Board of India (SEBI) – and enforcement via the Ministry of Company Affairs and the Registrar of Companies. This is supplemented by occasional reliance on the criminal law.[10]

2.1.1 Securities and Exchange Board of India

SEBI has a broad mandate – to protect 'the interest of investors or orderly development of securities markets'[11] – but for the purposes of this chapter our discussion is limited to its power to impose penalties, grant other remedies (e.g. delisting), and initiate criminal prosecution for violations related to corporate governance requirements under the Securities and Contracts (Regulation) Act 1956 (SCRA), the Securities and Exchange Board of India Act 1992 (SEBI Act), and any rules and regulations promulgated thereunder. SEBI's jurisdiction includes listed firms and their directors, officers, or controlling shareholders, and it has developed a reputation over the years for moving matters rather expeditiously to resolution.[12]

Hideki Kanda, and Edward Rock, *The Anatomy of Corporate Law: A Comparative and Functional Approach*, 2nd ed., (Oxford University Press, 2009).

10 One might treat stock exchange enforcement as a form of quasi-public or quasi-private enforcement (see Paul G. Mahoney, 'The Exchange as Regulator', 83 *Virginia Law Review* 1453–1500 (1997) and Adam C. Pritchard, 'Self-Regulation and Securities Markets', 26 *Regulation* 32–39 (2003)), but in India stock exchange listing requirements are often enforced by SEBI.

11 Securities and Exchange Board of India Act 1992, Section 11B.

12 G. Sabarinathan, 'Securities and Exchange Board of India and the Regulation of Indian Securities Market', Working Paper No 2010-06-309, Unpublished working paper, Indian Institute of Management, Bangalore (2010); Ajit Dayanandan, Sarat Malik and Sneha Nautiyal, 'Effectiveness of SEBI's Complaints Redress Systems (SCORES) in India' (2015), available at: www.sebi.gov.in/cms/sebi_data/DRG_Study/DRG_II_Scores_150920. Praise for SEBI has not been uniform, especially recently – see Dev Chatterjee, 'GIFT to create regulatory crisis for RBI, SEBI: Mistry', *Business Standard*, 23 February

The primary corporate governance provision is Clause 49, promulgated by SEBI in 2000, which bears substantial similarities to the OECD's best practices from around that time.[13] Clause 49 is a mandatory part of the Stock Exchange Listing Agreement, and violations of it can result in SEBI imposing large financial and criminal penalties on firms and directors under Section 23E of the SCRA (1956).[14]

In spite of this, active enforcement in this area has taken some time to get started. Although it was fairly well known that many firms were not in compliance with Clause 49's requirements,[15] SEBI only started investigating violations in September 2007 (SEBI Press Release, 2007) – seven years after Clause 49 came into operation – and to date no sanctions have been imposed.[16]

There are, of course, other regulations that are of import, such as the prohibition of insider trading (and unfair trading), the 'takeover' regulations (relevant in share acquisition cases), and regulation on the failure of firms to address grievances by investors[17] where SEBI enforcement has been more active. However, the issues addressed in these regulations are not at the core of governance concerns in India.[18] Nonetheless, proof that SEBI can be an active enforcer in some areas holds out hope that it could also be an important player in the governance context. Indeed, the increasing breadth of SEBI's powers and its willingness to use certain remedies makes approaching SEBI a popular course of action for investors.[19]

2016, www.business-standard.com/article/economy-policy/gift-to-create-regulatory-crisis-for-rbi-sebi-mistry-116022200637_1.html.

13 Khanna, 'Corporate Governance in India'.

14 SEBI decisions may be appealed through various layers of the Indian administrative and judicial apparatus and all the way to the apex court – the Supreme Court of India.

15 N. Balasubramaniam, Bernard S. Black, and Vikramaditya Khanna, 'The Relation Between Firm-Level Corporate Governance and Market Value: A Study of India', 11 *Emerging Markets Review* 319–340 (2010).

16 A number of these actions were against government owned firms, and to date, only three of these proceedings have been resolved (leading to no sanctions) (SEBI Press Release. 2007. 'SEBI initiates adjudication proceedings against 20 companies for non-compliance of Clause 49 norms'. SEBI PR No.257/2007 (11 September, 2007). Available at: www.sebi.gov.in/Index.jsp?contentDisp=Section&sec_id=1).

17 See Section 23C of the SCRA (1956), Sections 12A, 15C and 15G of the SEBI Act (1992), Sections 3 and 4 of the Securities and Exchange Board of India (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Market) Regulations 2003 and Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, as amended in 2010 ('Takeover Code') Sections 45(5) and 45(6).

18 SEBI Annual Report. 2008–09, www.sebi.gov.in/annualreport/0809/annualrep08-09.pdf.

19 G. Sabarinathan, 'Securities and Exchange Board of India and the Regulation of Indian Securities Market; Ajit Dayanandan, Sarat Malik, and Sneha Nautiyal,

Having said this, it is noteworthy that private enforcement is usually precluded where SEBI is empowered to act or issue orders because the operation of sections 15Y and 20A of the SEBI Act prohibits civil courts from taking jurisdiction and entertaining a suit in such situations.[20] Thus, the enhancement in public enforcement comes at the cost of limiting private enforcement in this context.

2.1.2 Ministry of Company Affairs

Along with SEBI enforcing India's securities laws, the Ministry of Company Affairs (MCA) administers India's Companies Laws.[21] The MCA primarily investigates matters through its investigations divisions, regional directors, registrars of companies, and more recently the serious fraud office, and promulgates rules under certain statutes (e.g. the corporate social responsibility rules under the new Companies Act 2013). Although the MCA has broad investigatory authority, the cases it could bring are limited to only certain provisions (which are discussed shortly) and have been subject to significant delays leading to MCA's having a substantially weakened ability to play an important and timely enforcement role.

2.1.3 Reserve Bank of India

The Reserve Bank of India (RBI) has the power to regulate a number of things under the Foreign Exchange Management Act 2000 (FEMA 2000) that can have an impact on governance (e.g. acquisitions using foreign currency).[22] Although these might be important in specific cases, they are not generally considered core governance concerns and thus I refrain from discussing the RBI's enforcement role in any greater detail.

'Effectiveness of SEBI's Complaints Redress Systems (SCORES) in India'; Pankaj Vaish, 'Sebi: A Watchful and Efficient Regulator', LiveMint, 22 February 2016. Available at: www.livemint.com/Opinion/isaido0Fv2QYHTBkOCAj3M/Sebi-A-watchful-and-efficient-regulator.html; Anirudh Laskar and Vyas Mohan, 'Sebi's 25-Year Journey', LiveMint, 21 May 2013. Available at: www.livemint.com/Industry/xer1j7wBRbQH1UTOBVrRaL/Sebis-25year-journey.html.

[20] Both the courts – in *Kesha Applicances P. Ltd* v. *Royal Holdings Services Ltd* (2006) 130 Comp. Cas. 227 (Bom.), para. 43 – and the Reserve Bank of India (see Report of Committee on Financial Sector (2009) at para. 4.3.4)) – have held that the civil jurisdiction of the courts is excluded in such instances.

[21] Ministry of Company Affairs Annual Report (2005), www.mca.gov.in/MinistryWebsite/dca/report/annualreport2005.html.

[22] For details, see www.rbi.org.in/scripts/Fema.aspx.

2.1.4 Criminal Liability

Governance concerns can rise to the level of criminal liability in India. In particular, the Indian Penal Code (IPC) makes it a crime to engage in a criminal breach of trust (Section 406) or cheating (Section 420).[23] These provisions have been used at times to police governance issues,[24] but they are generally not used with high frequency. Moreover, conviction rates are fairly low in India,[25] which is likely to weaken the deterrent effect of such laws.[26]

Based on this brief overview, the impression one gets is that, except for SEBI in the last few years, public enforcement in the area of corporate and securities laws in India has been quite lacklustre. That then leads to the discussion on private enforcement.

2.2 Private Enforcement

Although there are multiple bases for private civil enforcement in the corporate governance space in India (e.g. derivative suits, oppression and mismanagement, fraud and so forth) they all largely suffer from lengthy delays in the judicial process and unclear bases for liability. This creates a weak form of private enforcement. This section begins its discussion with derivative suits and then proceeds to examine the other forms of private civil enforcement.

2.2.1 Derivative Suits

Although derivative suits are available in India, they are quite rare for a number of reasons.[27] First and foremost is that India's derivative suit

[23] See *Tristar Consultants* v. *VcustomerServices*, AIR2007 Delhi 157; *Nanalal Zaver* v. *Bombay Life Assurance*, AIR 1950 SC 172.

[24] Vikramaditya Khanna and Shaun J. Mathew, 'The Role of Independent Directors in Controlled Firms in India: Preliminary Interview Evidence', 22 *National Law School of India Review* 35–66 (2010).

[25] Bibek Debroy and Aditya Singh, 'Justice Delivery in India: A Snap Shot of Problems and Reforms', in C. I. Herman (ed.), *Economic Developments in India* (Academic Foundation, 2009); Khanna, 'Judicial Reform in India'.

[26] India's criminal justice system tends to have low conviction rates but fairly relaxed arrest practices (i.e. it is fairly easy to arrest individuals even though convicting them is difficult – see Vikramaditya Khanna and Kartikey Mahajan, 'Anticipatory Bail in India: A Novel Way to Address Misuse of the Criminal Process', in Jacqueline Ross and Steven Thaman (eds.), *Research Handbook on Comparative Criminal Procedure* (Edward Elgar, 2016). This raises concerns for a number of reasons including creating a breeding ground for corruption; Khanna, 'Judicial Reform in India'; Khanna and Mahajan, 'Anticipatory Bail in India'.

[27] Khanna and Varottil, 'The Rarity of Derivative Actions in India'.

system is based on common law, not statute, and is subject to the limitations that come with that.[28] In particular, the rule in *Foss* v. *Harbottle* applies in full force in India.[29] The holding of this case (i.e. that a derivative action belongs to the company) means that if shareholders ratify the complained of activity then the suit becomes infructuous, as the company has effectively said it approves of the underlying activity. This presents an almost insurmountable hurdle for minority shareholders trying to sue controllers, because the controlling shareholder can usually manage to get a majority of the shareholders to ratify the complained about action (e.g. by voting the controller's shares).[30] Although there are exceptions to *Foss*, they are rather limited (e.g. suits based on violations of the charter or underlying legislation, such as *ultra vires* acts, illegal acts, and acts obtained without a required special resolution) or require the minority shareholder to meet difficult burdens (e.g. showing that the controller obtained some benefit at the expense of the *company* (not the minority per se)).[31]

In addition, minority shareholders would face challenges in identifying the underlying fiduciary duties that were violated. Controlling shareholders do not owe fiduciary duties to minorities in India, making a derivative suit on this basis a non-starter.[32] Further, although directors do owe duties to the company in India, these duties are determined by reference to the very thin case law present in India.[33] Moreover, courts can protect directors from liability under Section 633 of the Indian Companies Act 1956 if it is shown that the directors acted honestly and reasonably.[34] This, when combined with the weaker explication of duties and likely controller ratification, leaves the derivative suit mechanism in India with little power.

[28] Ibid. In an earlier study, a co-author and I could only find ten derivative suit cases that reached the High Courts or Supreme Court in India over the last sixty or so years, with only three being permitted to continue.

[29] (1843) 2 Har 461. Indian cases relying on *Foss* include *Nagappa Chettiar* v. *The Madras Race Club* (1949) 1 MLJ 662 (Mad) and *Nirad Amilal Mehta* v. *Genelec* Ltd (2008) 146 Comp. Cas. 481 (Bom).

[30] *See MacDougal* v. *Gardiner* (1875) 1 Ch. D 13.

[31] See *Nagappa*, above note 29; Arad Reisberg, *Derivative Actions and Corporate Governance*, (Oxford University Press. 2007).

[32] See *Rolta India Ltd.* v. *Venire Industries Ltd.* (2000) 100 Comp. Cas. 19 (Bom).

[33] For a more detailed discussion see above note 27.

[34] See above note 27. This is quite frequently used.

2.2.2 Order I, Rule 8, CPC 1908

Another route through which a shareholder may try to initiate private enforcement is through a 'representative' suit under Order I, Rule 8, of the Civil Procedure Code 1908, which states:

> One person may sue or defend on behalf of all in same interest.
> (1) Where there are numerous persons having the same interest in one suit,
> (a) one or more of such persons may, with the permission of the Court, sue or be sued, or may defend such suit, on behalf of, or for the benefit of, all persons so interested.

Generally, a representative suit under this order is thought to be similar to a motion for claim joinder – where similar suits are brought together in one proceeding to avoid duplicative litigation.[35] This is different than the standard background for a derivative suit – where the concern is that most shareholders would not bring a suit unless some form of claim aggregation was permissible. Indeed, the optics are a little stranger still because a derivative suit is permitted when the board is *unwilling* to initiate a suit (perhaps they are conflicted) and thus shareholders are permitted to bring suit, whereas in a representative suit the issue is that all litigants are *keen* to bring suit and for judicial economy these claims will be joined in one proceedings.

In spite of these differences, some courts seem to have allowed what looks like a derivative suit to be conducted as a representative suit with some unusual modifications. Generally, a representative suit requires the permission of the court and notice to be provided to all parties (at plaintiff's expense). The company is included as a defendant (pro forma) and in case the plaintiffs win then the recovery goes to the company (which is again the defendant).[36] Although this results in an awkward fit, it is somewhat understandable given the challenges in bringing a successful derivative suit in the Indian context. Nonetheless, only recently have courts in India begun to discuss the differences between derivative suits and representative actions.[37] In any case, the number of representative suits in the corporate context in India is still vanishingly thin.

2.2.3 Oppression and Mismanagement: Company Law Board

The Company Law Board (and its soon to be successor – the National Company Law Tribunal (NCLT)) is another player in the enforcement

35 Prasad, Mulla, *The Code of Civil Procedure*.
36 See *Jaideep Halwasiya* v. *Rasoi Ltd* (2009) 150 Comp. Cas. 1 (Cal).
37 See *Nagappa Chettiar*, above note 29.

landscape in India. The Company Law Board's (CLB's) governance mandate, for our purposes, is limited to oppression and mismanagement claims under Sections 397 to 399 of the Companies Act 1956 (now replaced by Sections 241 to 244 of the Companies Act 2013).[38] Under the 1956 Act the oppression and mismanagement action was not seen as being too important because the most common remedy available was an injunction and because the CLB, under section 633 of the 1956 Act, could protect directors from liability.[39] Finally, although the CLB may move somewhat faster than the civil courts on commercial matters, it has still been subject to lengthy delays so that any recovery probably has a substantially reduced real value to a litigant.[40]

2.2.4 Contract or Tort?

It is conceivable that a shareholder might initiate a fraud action (under Section 17 of the Indian Contract Act 1872), a misrepresentation claim (under Section 62 of the Companies Act 1956), or a Common Law tort claim for deceit. In all these cases the chances of recovery are slim (because their core elements are difficult to show in modern transactions) and because the endemic delays in litigation would make any judgment worth quite a bit less.

For example, under the tort for deceit the plaintiff must show a fraudulent misrepresentation related to a material fact and that the plaintiff received the shares directly from the company.[41] Thus, secondary market transactions would largely be outside the purview of this tort. Similarly, the cause of action under Section 17 of the Indian Contracts Act 1872 requires that the fraud have been conducted by a party to the transaction thereby exempting most secondary market transactions where the alleged fraud is by the issuing firm.[42]

2.2.5 Impact of Securities Laws on Private Enforcement

India's securities laws might provide for potential causes of action, but as noted earlier, if SEBI is empowered to act on a matter or issue an order

[38] For details, see Companies Amendment Act 2002; *Union of India* v. *R. Gandhi*, in the Supreme Court of India Civil Appeal No. 3067 of 2004 & Civil Appeal No. 3717 of 2005, 11 May 2010.

[39] A. Ramaiya, *Ramaiya's Guide to the Companies Act* (18th edition) (Nagpur: Lexis Nexis Butterworths Wadhwa India, 2014).

[40] Khanna and Varottil, *The Rarity of Derivative Actions in India*.

[41] Avtar Singh, *Company Law* (Eastern Book Company, India 2007).

[42] Avtar Singh, *Company Law*.

then the civil courts are not to entertain jurisdiction for private suits. Thus, as a practical matter these statutory and regulatory provisions do not generate any scope for private enforcement unless SEBI is not empowered to act on a matter – which is fairly rare.

This general overview of public and private enforcement in India leads one to conclude that India has limited public enforcement and almost no effective private enforcement of corporate and securities laws. Indeed, prior surveys of enforcement in India have suggested that it is quite weak.[43] Given these weak protections, one might expect that it would be difficult for dispersedly held firms to develop, and investors might then need to rely on other methods (taking larger stakes, relying on business and social norms) to secure their investment.[44]

This then leads to the key question animating this chapter: What steps can be taken that might enhance enforcement in India? The next two sections begin an inquiry into that question by examining the theoretical case for private enforcement and then examining how it might be operationalised in the Indian business and institutional context. Following that is a discussion of the class action mechanism described in the Companies Act 2013 and other potential enforcement reforms.

3 Potential Value of Private Civil Enforcement

For purposes of obtaining a more thorough understanding of private enforcement in India, this chapter assumes that public enforcement is available and then inquires how might private civil enforcement be a useful supplement.[45] This issue is pursued in two steps – first, examining how private civil enforcement is likely to enhance the availability of information on wrongdoing by incentivising private individuals to come

[43] CII Report (2009), 'Corporate Governance: Recommendations for Voluntary Adoption'. *Report of the CII Task Force on Corporate Governance*, www.mca.gov.in/Ministry/latestnews/Draft_Report_NareshChandra_CII.pdf.; ICSI Report (2009), 'ICSI Recommendations to Strengthen Corporate Governance Framework'. *Institute of Company Secretaries of India*, www.mca.gov.in/Ministry/latestnews/ICSI_Recommendations_Book_8dec2009.pdf); KPMG Report (2008), '*The State of Corporate Governance in India: A Poll*', www.kpmg.com/IN/en/ThoughtLedership/The%20State%20of%20Corporate%20Governance%20in%20India%202008.pdf.

[44] Coffee, 'The Rise of Dispersed Ownership'; Mark J. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (Princeton University Press, 1996).

[45] For a discussion on public enforcement see A. Mitchell Polinsky and Steven M. Shavell. 'The Economic Theory of Public Enforcement of Law', 38 *Journal of Economic Literature* 45–76 (2000).

forward with their information, and second by examining how the potentiality of recovery for individual investors might aid in deepening the liquidity of stock markets.

3.1 Obtaining Enforcement Relevant Information

Individuals might possess information that is relevant to enforcement efforts (e.g. on wrongdoing) that government agents may not be able to easily access or assess.[46] An example might be when victims of wrongdoing have information about who harmed them and how that government agents would find either difficult or costly to obtain.

By providing these individuals with the prospect of monetary recovery (or the prospect of having the wrongdoer's behaviour adjudged negatively) we provide them with an incentive to bring their information to the attention of authorities thereby increasing the likelihood that the wrongdoer will be punished (and hence deterring her). There are of course other ways in which to incentivise private parties to bring information to light (e.g. bounties, whistleblower duties), but I limit my discussion to private civil enforcement for now.[47]

In the context of corporate governance one can easily see the value of private enforcement. There are likely to be many things related to fiduciary duties about which the putative victim is more likely to have information than the government. Similarly, a shareholder is likely to have a better understanding of the contractual and other relationships between the parties as compared to the government.

3.2 Liquidity Enhancing Features?

Another likely benefit of private enforcement is that by providing an avenue in which investors can obtain monetary remedies for governance wrongdoing, it reduces the downside risk faced by investors when

[46] Landes and Posner, 'The Private Enforcement of Law'.

[47] On bounties and whistleblowing see A. Mitchell Polinsky, 'Private versus Public Enforcement of Fines', 9 *Journal of Legal Studies* 105–127 (1980), Michael Rich, 'Prosecutorial Indiscretion: Encouraging the Department of Justice to Rein in Out of Control Qui Tam Litigation under the Civil False Claims Act', 76 *University of Cincinnati Law Review* 1233 (2008), David F. Engstrom, 'Whither Whistleblowing? Bounty Regimes, Regulatory Context, and the Challenge of Optimal Design', 15 *Theoretical Inquiries in Law* 605–633 (2014). For discussion on the closely associated notion of self-reporting, see Louis Kaplow and Steven Shavell, 'Optimal Law Enforcement with Self-Reporting of Behavior', 102 *Journal of Political Economy* 583–606 (1994).

investing and should attract more investors to the market (compared to if such recovery was unlikely or not timely and no insurance was available), thereby enhancing its liquidity.[48] Of course, the risk of governance wrongdoing or fraud is a risk that investors might also reduce via diversification and thus not require recovery to attract them to the market. Although certainly plausible for some risks, one must keep in mind that systemic risk associated with fraud (that affecting the market) cannot be easily diversified away. If a market is thought to have rampant fraud, then people are likely to simply stay away and that would hurt market development and capital formation.[49] Moreover, if diversification is difficult or costly then that too might hurt market development.[50] This leaves space for private enforcement to play a role in enhancing liquidity by reducing some of the downside risk investors might face.

In the context of India and other emerging markets, if a goal is to encourage the entry of individual investors at the retail level or even to attract them to invest via intermediaries (e.g. mutual funds) then the possibility of recovery for governance wrongdoing might well be an attractive option. India is estimated to have around two million retail investors,[51] but one must keep in mind that the population is over 1.2 billion. Moreover, foreign investors are quite likely to pay close attention to governance issues (as has been observed in the past), and attracting them may involve some measure of private enforcement.[52]

Of course, assessing the value of private enforcement in India will require some understanding of how it might fit within the business and institutional structures in India. It is to those issues that I now turn.

[48] Choi and Pritchard, Securities Regulation: Cases and Materials; Khanna, 'Law Enforcement & Stock Market Development'.

[49] Akerlof, 'The Market for "Lemons"'; Choi and Pritchard, *Securities Regulation: Cases and Materials.*

[50] If there are very few publicly traded firms, then the prospect of diversification is similarly reduced.

[51] Rahul Chhabra, Sankar De, Naveen R. Gondhi and Bhimasankaram Pochiraju, 'Is Zero Return a Natural Benchmark for Investors? An Investigation with Individual Trading Records' (20 January 2012). Available at SSRN: https://ssrn.com/abstract=1846474 or http://dx.doi.org/10.2139/ssrn.1846474; For further discussion see 'Indian Retail Investors Tend to Lose in Stock Markets: Study', *Economic Times*, 29 November 2012, available at http://articles.economictimes.indiatimes.com/2012-11-29/news/35433105_1_retail-investors-trade-data-study.

[52] Vikramaditya Khanna and Roman Zyla, 'Survey Says. . .Corporate Governance Matters to Investors in Emerging Market Companies', *International Finance Corporation Publication*, World Bank Group 2012. Available at: www1.ifc.org/wps/wcm/connect/dbfd8b004afe7d69bcb6bdb94e6f4d75/IFC_EMI_Survey_web.pdf?MOD=AJPERES.

4 Indian Business and Institutional Context

India's business and institutional structures share some similarities with those in the US and Western Europe, but there are also important differences that will likely influence the desirable structure of enforcement for corporate and securities laws. In this section, I focus on two of the most prominent differences – ownership structure and institutional architecture (i.e. judicial and legal system).

4.1 Ownership Structure: Controlled Firms

India has, depending on how one counts, somewhere around 4,000 publicly traded firms on two major stock exchanges, Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE). However, virtually all these firms are controlled firms. Some are controlled by family business houses (e.g. Birla, Ambani, Adani), some by the State (e.g. Oil and Natural Gas Corporation), some by foreign multinationals (e.g. Nestle India), and others by Indian founders who are neither family nor part of a kinship network (e.g. Infosys). There are few truly dispersedly held firms in India.[53]

This means that the predominant form of governance concerns in India are not the typical concerns between shareholders and management (seen in countries with more dispersedly held firms), but rather the conflict between controlling shareholders and minority shareholders.[54] This conflict raises standard concerns about expropriation of the minority rather than pure executive compensation, about freeze outs rather than hostile takeovers and so forth. In light of this overarching governance concern, what value might private enforcement provide?

First, it seems likely that minority shareholders in a controlled firm (especially larger minority shareholders) are likely to have enforcement relevant information. This is for a number of reasons. First, like shareholders in a dispersedly held firm, minorities are the likely victims of governance wrongdoing and are likely to have useful information about it. Second, some firms may have minority shareholders who are not entirely dispersed – that is, some minorities may have sizeable stakes in

[53] George S. Geis, 'Can Independent Blockholding Really Play Much of a Role in Indian Corporate Governance?' 3 *Corporate Governance Law Review* 283 (2007); Tarun Khanna and Yishay Yafeh, 'Business Groups in Emerging Markets: Paragons or Parasites?', 45 *Journal of Economic Literature* 331–372 (2007).

[54] Lucian A. Bebchuk and Assaf Hamdani, 'The Elusive Quest for Global Governance Standards', 157 *University of Pennsylvania Law Review* 1263–1317 (2009). Khanna, 'Corporate Governance Ratings'; Kraakman et al., *The Anatomy of Corporate Law.*

the firms. These larger positions provide them with the incentive to get informed about the firm – something seen less often in dispersedly held firms – which in turn suggests they should often have enforcement relevant information (because they are monitoring). Moreover, minorities may find it easier to know who to monitor in a controlled firm (i.e. the controller) rather than in a dispersedly held firm (e.g. management, the board, large institutional shareholders, and so forth). This may be even more likely if the minority has other connections with the controller (e.g. belonging to similar business communities (or caste), having intermingled business interests).

Second, even though minority shareholders may have enforcement relevant information, it is likely that their access to and use of it may vary across the different types of controlling structures – whether by controller type (e.g. family business, state-owned) or by how control is maintained (e.g. pyramids, cross-holdings).[55] For reasons of expositional brevity, I do not discuss these variations here, but note it is an interesting area for future research.

Finally, one expects that the potential liquidity enhancing features of private enforcement are likely to be useful in controlled firms in India too. This is especially likely if the government is trying to increase market liquidity (which India's government seems keen to do) by attracting dispersed investors and foreign investors who may not have the other methods of policing governance that larger minorities may possess (e.g. interlinked business, similar business and social networks, and so forth).[56]

In spite of all these benefits of private enforcement, one should be cognizant of the limitations on private enforcement in the Indian business context. The importance of business families, founders, and powerful bureaucrats running most major firms in India may create an atmosphere of reticence in challenging these controllers in open court and may lead to a preference for less visible challenges or for resolutions that keep disputes out of the public view.[57]

4.2 Institutional Architecture

Another key issue in assessing the likely value of private enforcement is appreciating the institutional architecture within which it might be

[55] Khanna and Varottil, 'Board Independence in India'.
[56] See Coffee, 'The Rise of Dispersed Ownership'.
[57] Khanna and Varottil, *The Rarity of Derivative Actions in India.*

utilised. This requires us to gain a deeper understanding of the current reality of India's judicial and legal system.

One of the well-known concerns associated with India's legal system is the lengthy delays faced by litigants. Indeed, many judgments occur so long after the alleged wrong that they hardly provide any real recovery.[58] Although there are specialist courts for addressing corporate law matters in India (first the CLB and then the soon to be formed NCLT), they have thus far also suffered from lengthy delays. Moreover, plaintiffs bringing private cases in India must bear court fees (i.e. fees for bringing a civil suit seeking recovery), and these fees can be substantial and may reduce the attractiveness of suit.[59] This makes reliance on private enforcement in the standard court system less attractive as a means to either obtain enforcement relevant information, enhance liquidity, or police governance wrongdoing.

However, even if delays were not endemic, there are other concerns. In particular, it is key to understand who the likely litigants are and what their incentives might be. In the Indian context (as noted earlier), these are primarily minority shareholders in controlled firms. If the minority is composed of shareholders with sizeable stakes in the firm (e.g. 5 per cent), then the minority may consider it worthwhile to bear the costs of bringing suit (including getting informed) and that may make private enforcement more plausible, holding all else equal. However, these larger minorities may also have other extra-legal methods of influencing the controlling shareholder in India making private suits less likely or less likely to lead to a judgment (as opposed to settlement).[60]

On the other hand, if the minority is composed of small dispersed shareholders, then they are unlikely to consider it worthwhile to bear the costs of bringing an individual suit. Simply put, if most minority shareholders own \$100 worth of shares, then none of them are likely to hire attorneys (who charge more than \$100 for such suits) to initiate litigation. This situation is one in which a typical class action with a

[58] Law Commission of India Report. 2008. *Reforms in the Judiciary: Some Suggestions.* Report No. 230. Law Commission of India; National Mission for Delivery of Justice and Legal Reform. 2009. 'Towards Timely Delivery of Justice to All: A Blueprint for Judicial Reforms'. Available at: http://lawmin.nic.in/doj/justice/National_Legal_Mission-7NOV2009.pdf

[59] Ibid. In addition to the certainty of paying court fees, if the plaintiff loses, he may have to pay some part of the defendant's legal costs (India follows the English rule on legal costs – 'loser pays'), which may be a substantial cost for some retain investors.

[60] See Coffee, 'The Rise of Dispersed Ownership'; and Symposium on Norms and Corporate Law (2001).

contingency fee structure might prove useful. However, in India contingency fees are not permitted.[61]

Finally, even if minority shareholders were willing to sue and the courts provided more timely decisions, private enforcement still faces another hurdle in India – lack of clarity on what the underlying wrong is. Given that most firms in India are controlled, the minority would need some action against the controller (or an action the controller cannot dismiss easily). India does not, at present, provide for fiduciary duties owed by the controller to the minority. Absent the development of such fiduciary duties, any suits against controllers would need to overcome this issue.

In light of the business structures and institutional conditions in India, it seems that private enforcement in the corporate governance space is likely to be quite quixotic. However, that does not mean that reforms might not improve upon the situation.

5 Reform Alternatives?

Many reform efforts have been pursued in India, but with little substantial effect. In this part, I explore the most recent reform effort – promulgating a class action mechanism for corporate law issues – along with other reform efforts that might be pursued. First I explore the attempts to create a class action in India, and then I discuss alternatives to the class action that may generate greater net benefits in India.

5.1 Class Actions Under the Companies Act 2013

Against this background of fairly limited enforcement, the Companies Act 2013 introduced the class action via Section 245, which is reproduced below:

Section 245. Class Action

(1) Such number of member or members, depositor or depositors or any class of them, as the case may be, as are indicated in sub-section (2) may, if they are of the opinion that the management or conduct of the affairs of the company are being conducted in a manner prejudicial to the interests of the company or its members or depositors, file an application before the Tribunal on behalf of the members or depositors for seeking all or any of the following orders, namely: –

[61] See Bar Council of India Rules (Part VI, Chapter II, Section II, Rule 20).

(*a*) to restrain the company from committing an act which is *ultra vires* the articles or memorandum of the company;

(*b*) to restrain the company from committing breach of any provision of the company's memorandum or articles;

(*c*) to declare a resolution altering the memorandum or articles of the company as void if the resolution was passed by suppression of material facts or obtained by mis-statement to the members or depositors;

(*d*) to restrain the company and its directors from acting on such resolution;

(*e*) to restrain the company from doing an act which is contrary to the provisions of this Act or any other law for the time being in force;

(*f*) to restrain the company from taking action contrary to any resolution passed by the members;

(*g*) to claim damages or compensation or demand any other suitable action from or against—

(*i*) the company or its directors for any fraudulent, unlawful or wrongful act or omission or conduct or any likely act or omission or conduct on its or their part;

(*ii*) the auditor including audit firm of the company for any improper or misleading statement of particulars made in his audit report or for any fraudulent, unlawful or wrongful act or conduct; or

(*iii*) any expert or advisor or consultant or any other person for any incorrect or misleading statement made to the company or for any fraudulent, unlawful or wrongful act or conduct or any likely act or conduct on his part;

(*h*) to seek any other remedy as the Tribunal may deem fit.

(2) Where the members or depositors seek any damages or compensation or demand any other suitable action from or against an audit firm, the liability shall be of the firm as well as of each partner who was involved in making any improper or misleading statement of particulars in the audit report or who acted in a fraudulent, unlawful or wrongful manner.

(3) (*i*) The requisite number of members provided in sub-section (1) shall be as under: –

(*a*) in the case of a company having a share capital, not less than one hundred members of the company or not less than such percentage of the total number of its members as may be prescribed, whichever is less, or any member or members holding not less than such percentage of the issued share capital of the company as may be prescribed, subject to the condition that the applicant or applicants has or have paid all calls and other sums due on his or their shares;

(*b*) in the case of a company not having a share capital, not less than one-fifth of the total number of its members.

(*ii*) The requisite number of depositors provided in sub-section (1) shall not be less than one hundred depositors or not less than such percentage of the total number of depositors as may be prescribed, whichever is less, or any depositor or depositors to whom the company owes such percentage of total deposits of the company as may be prescribed.

(4) In considering an application under sub-section (1), the Tribunal shall take into account, in particular—

(*a*) whether the member or depositor is acting in good faith in making the application for seeking an order;

(*b*) any evidence before it as to the involvement of any person other than directors or officers of the company on any of the matters provided in clauses (*a*) to (*f*) of sub-section (1);

(*c*) whether the cause of action is one which the member or depositor could pursue in his own right rather than through an order under this section;

(*d*) any evidence before it as to the views of the members or depositors of the company who have no personal interest, direct or indirect, in the matter being proceeded under this section;

(*e*) where the cause of action is an act or omission that is yet to occur, whether the act or omission could be, and in the circumstances would be likely to be—

(*i*) authorised by the company before it occurs; or

(*ii*) ratified by the company after it occurs;

(*f*) where the cause of action is an act or omission that has already occurred, whether the act or omission could be, and in the circumstances would be likely to be, ratified by the company.

(5) If an application filed under sub-section (1) is admitted, then the Tribunal shall have regard to the following, namely: –

(*a*) public notice shall be served on admission of the application to all the members or depositors of the class in such manner as may be prescribed;

(*b*) all similar applications prevalent in any jurisdiction should be consolidated into a single application and the class members or depositors should be allowed to choose the lead applicant and in the event the members or depositors of the class are unable to come to a consensus, the Tribunal shall have the power to appoint a lead applicant, who shall be in charge of the proceedings from the applicant's side;

(*c*) two class action applications for the same cause of action shall not be allowed;

(*d*) the cost or expenses connected with the application for class action shall be defrayed by the company or any other person responsible for any oppressive act.

(6) Any order passed by the Tribunal shall be binding on the company and all its members, depositors and auditor including audit firm or expert or consultant or advisor or any other person associated with the company.

(7) Any company which fails to comply with an order passed by the Tribunal under this section shall be punishable with fine which shall not be less than five lakh rupees but which may extend to twenty-five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to three years and with fine which shall not be less than twenty-five thousand rupees but which may extend to one lakh rupees.

(8) Where any application filed before the Tribunal is found to be frivolous or vexatious, it shall, for reasons to be recorded in writing, reject the application and make an order that the applicant shall pay to the opposite party such cost, not exceeding one lakh rupees, as may be specified in the order.

(9) Nothing contained in this section shall apply to a banking company.

(10) Subject to the compliance of this section, an application may be filed or any other action may be taken under this section by any person, group of persons or any association of persons representing the persons affected by any act or omission, specified in sub-section (1).

Section 245 is largely concerned with restraining the behaviour of the firm and its members rather than compensating shareholders (Sections 245(1)(a) to (f)). The only provisions allowing for monetary remedies are Section 245(1)(g) and (h). However, even here the remedies might be viewed as limited, given that none of the provisions explicitly mention the controller. For example, Section 245(1)(g) allows for monetary remedies primarily against the firm, its directors or advisors for fraudulent, illegal or wrongful behaviour. It is conceivable that controllers might be included in the 'any other person' language in Section 245(1)(g)(iii), but given the general tenor of the Section and the context of this language it does not appear that controllers are the targets. Moreover, because controllers do not owe fiduciary duties to minority shareholders in India, it is not clear whether their behaviour would trigger a class action under Section 245. Indeed, the focus on whether the company has ratified the complained of activity (Sections 245(4)(e) and (f)) and the provision requiring the company to pay for plaintiff's legal expenses (Section 245(5)(d)) appear poorly suited for a typical suit brought by a minority shareholder against a controller and instead seem more suited to a typical derivative action.

However, we are left to speculate on how far Section 245 might go because, as of this writing, no cases have been initiated under Section 245.

This is largely due to the fact that the NCLT has not yet been formally set up. Consequently, it is unclear how the class action mechanism will be operationalised, but given the absence of fiduciary duties owed by the controller and the language in Section 245, it seems unlikely that it would be a very effective tool for generating monetary recoveries to minority shareholders. Indeed, there is no provision permitting contingency fees, which makes Section 245 less appealing for smaller minority shareholders.

Even if the current version of a class action does not provide much solace to shareholders, one could consider alternative reforms. Many might be discussed (e.g. bounties, stock exchange enforcement),[62] but this chapter discusses two reforms that may pay bigger dividends than the current class action regime.

5.2 *Regulatory Early Warning System*

Prior research has suggested that ex ante measures may be particularly valuable in contexts where large harm may be generated from wrongdoing (e.g. the Satyam Fraud).[63] One such measure might be a regulatory early warning system where regulators (such as SEBI) put out information on factors that might be correlated with greater wrongdoing risk so that investors are aware of this and can adjust their behaviour (or initiate litigation and so forth). This may be particularly valuable where wrongdoing is difficult to detect (even with private enforcement) because when regulators provide information on factors correlated with wrongdoing, that may trigger responses by investors and others that might reduce the potential harm or prevent further wrongdoing, if any.

Of course, for such an early warning system to be effective, one must be able to identify some factors correlated with wrongdoing and the current surveillance systems should be able to detect these signs. Although such a list is difficult to provide with finality, below are a list of factors that

[62] On bounties, see Polinsky, 'Private versus Public Enforcement of Fines'; Rich, 'Prosecutorial Indiscretion', 1233; and Engstrom, 'Whither Whistleblowing?'; and on stock exchange enforcement, see Pritchard, 'Self-Regulation and Securities Markets'; Mahoney, 'The Exchange as Regulator'; and Stephen Craig Pirrong, 'The Self-Regulation of Commodity Exchanges: The Case of Market Manipulation', 38 *Journal of Law and Economics* 141–206 (1995). Note that bounties have an additional advantage in that even non-shareholders may receive the bounty, providing them with an incentive to bring forth relevant information. This of course comes with costs as noted in the literature on bounties.

[63] See Steven Shavell, 'Liability for Harm Versus Regulation of Safety', 13 *Journal of Legal Studies* 357–374 (1984) for more discussion of regulation and liability.

Table 16.1 *Proposed list of possible early warning signals*

Early Warning Signals
If some directors (especially independent directors) resign unexpectedly.
If there are recent off-balance-sheet transactions.
If there was a decision to withdraw an offering of stock or debt.
Any restatement of financial or other important results.
Related-party transactions that exceed some threshold (e.g. 5 per cent of net profit).
If the controller has been selling down her stake in the firm in an unanticipated manner.

would seem useful to someone concerned about potential wrongdoing at a firm (some of these factors arise from studies discussed in previous writings by Khanna).[64]

For an early warning signal system to be effective, we must believe that investors will rely on that system in deciding where to invest or whether to sue. There is little evidence in India about whether either is likely, but in other countries where disclosure based systems have been tried (e.g. 'comply-or-explain' rules in parts of Europe), they have met with some measured success.[65] It is conceivable that if there is sufficient analyst coverage, something similar may occur in India.

5.3 Arbitration

Another potential reform is that firms that are publicly traded be allowed (or perhaps required) to have shareholders pursue corporate governance claims in arbitral proceedings rather than in judicial or tribunal proceedings. This has advantages in terms of obtaining expertise in decision making as well as procedural efficiency and speed.[66] Such an approach

[64] Khanna, 'Judicial Reform in India'; Khanna, 'Law Enforcement & Stock Market Development'.

[65] Sridhar Arcot,Valentina Bruno and Antoine Faure-Grimaud, 'Corporate Governance in the UK: Is the Comply or Explain Approach Working?', 30 *International Review of Law and Economics* 193–201 (2010).

[66] Roger S. Haydock, 'Civil Justice and Dispute Resolution in the Twenty-First Century: Mediation and Arbitration Now and for the Future', 27 *William Mitchell Law Review* 745–778 (2000–2001); Keith N. Hylton, 'Agreements to Waive or to Arbitrate Legal Claims: An Economic Analysis', 8 *Supreme Court Economic Review* 209–263 (2000); Steven Shavell, 'Alternative Dispute Resolution: An Economic Analysis', 24 *Journal of Legal Studies* 1–28 (1995).

has been tried in some other jurisdictions. For example, arbitration provisions are available in Brazil for firms listed on the Novo Mercado,[67] and in China for firms domiciled in China issuing stock overseas.[68] Moreover, in India too there are firms that offer arbitration as a method of resolving disputes with shareholders.[69] Under a functioning arbitration system, one expects that the enforcement relevant information and liquidity enhancing effects of private enforcement would both be present because of the prospect of monetary recovery for those providing relevant information (who are most likely to be shareholders). Although conclusive results of these experiments in China and Brazil are not yet available, there is little evidence that arbitration has made the situation any worse than the status quo ante.

6 Conclusion

Enforcement of corporate and securities laws is generally acknowledged to be important to the growth of capital markets, and this may be especially so in emerging markets. In the Indian context, the pre-existing state of both public and private enforcement of corporate and securities laws was fairly weak, and thus attempts to revamp the area via the class action device in Section 245 of the Companies Act 2013 were greeted with some enthusiasm. Indeed, there are good theoretical reasons to think that private enforcement could be beneficial in India, although there may be some limitations in light of India's institutional and business climate.

However, the version of class actions drawn by Section 245 seems constrained in its likely effectiveness. Monetary remedies do not seem to be the primary aim of the provision, and it is not accompanied by other changes that would make it more likely to work in the Indian context. In particular, the prohibition on contingency fees and the absence of

[67] Ira M. Millstein, G. N. Bajpai, Erik Berglöf, and Stijn Claessens, 'Non-Traditional Modes of Enforcement' in *Enforcement and Corporate Governance: Three Views*, 1–17 (2005).

[68] Nicholas Calcina Howson, 'The Doctrine that Dared Not Speak its Name: Anglo-American Fiduciary Duties in China's 2005 Company Law and Case Law Intimations of Prior Convergence', in Hideki Kanda, Kon-Sik Kim, and Curtis Milhaupt, eds., *Transforming Corporate Governance in East Asia* 193–254 (Routledge, 2008).

[69] Balasubramanian, Black, and Khanna, 'The Relation Between Firm-Level Corporate Governance and Market Value'; Francis G.X. Pileggi, 'New Rules Allow for 'Lightning Fast' Adjudication of New Cases Filed in Delaware Court of Chancery'. Litigation Department Alert, Fox Rothschild LLP. (2010). Available at: www.foxrothschild.com/newspubs/newspubsArticle.aspx?id=13596.

fiduciary duties owed by controllers to minorities would appear to hamstring the effectiveness of the class action provision in India. Thus, it appears that the opportunity to enhance investor protection in India is unlikely to be much furthered by Section 245.

Nonetheless, there may be some measures that can be taken that would be beneficial in the Indian context, such as regulatory early warning signals and the increased use of arbitration to resolve shareholder disputes. Early warning signals may help to trigger shareholder monitoring and avert large-scale harms and arbitration helps to address a perennial problem in the Indian legal system – the lengthy delays in the courts and tribunals. Some mix of these measures appear more likely to benefit investors interested in the Indian markets than the current version of class actions exemplified by Section 245.