



INTERNATIONAL LAW
JOURNAL

**WHITE BLACK
LEGAL LAW
JOURNAL
ISSN: 2581-
8503**

Peer - Reviewed & Refereed Journal

The Law Journal strives to provide a platform for discussion of International as well as National Developments in the Field of Law.

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EVOLUTION AND MEANING OF CORPORATE GOVERNANCE IN INDIA

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ABSTRACT

Corporate governance is the system of structural, procedural and cultural safeguards designed to ensure that corporation is run in the „best“ long-term interests of its shareholders, as well as, other stakeholders. This alignment requires a commitment to sustained interactions between a company and principal stakeholders.

According to the OECD,

“Corporate Governance comprehends that structure of relationship and corresponding responsibilities among a core group consisting of shareholders, board members, corporate managers designed to „best“ foster the competitive performance required to achieve the corporation “s primary objective.”

Corporate governance is concerned with wider accountability and responsibility of the directors towards „key“ stakeholders of the corporations: employees, consumers, suppliers, creditors and the wider community. Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. Corporate governance denotes to that blend of law, regulation, and appropriate voluntary private-sector practices which allow the companies to fascinate financial and human capital, while respecting the interests of other stakeholders and society as a whole. The fundamental principles of good corporate governance are transparency, protection and enforceability of the rights and prerogative of all shareholders; and directors capable of independently approving the corporation“s strategy and major business plans and decisions, and of independently hiring management, observing management“s performance and truthfulness and replacing management when necessary.

KEY WORDS: Corporate Governance, Company Etc

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INTRODUCTION

Corporate governance can be interpreted as placing power and authority in the hands of stakeholders of the corporate entity. This definition brings stakeholders to the forefront but is still too general to properly understand the term. In 1996, the governance working group of the International Institute of Administrative Sciences said that Governance is the process whereby elements in society wield power and authority and influence and enact policies and decisions concerning public life and economic and social development. In India, the Kumar Mangalam Birla Committee Report recognized that the “fundamental objective of corporate governance is the enhancement of the long-term shareholder value, while at same time protecting the interest of other stakeholders”. The 2003 SEBI (Narayanamurthy) Committee on Corporate Governance was even more specific in its references to the need to include stakeholders as major contributors to the development and prosperity of the country. There seems to be no single definition that neatly ties up the term because corporate governance means different things to different people. It is an interdisciplinary subject of interest to people as diverse as law-makers, business people, accountants, economists and even historians. To attempt a definition, corporate governance is the system within company, of bridging the expectation gap between promised returns and actual returns. However, this seems to tilt towards owners and shareholders of businesses and ignores the existence of other stakeholders.³

The corporate governance practices are perceived and dealt as tool to achieve healthy relationship between corporate managers, directors and shareholders who invest their savings in the corporate. These practices improve corporate performance and attract investment. Corporate governance practices enable corporates to achieve their corporate objectives, protect shareholders right, meet legal requirements and demonstrate to the shareholders their efficiency to conduct business.

1.1 MEANING OF ‘CORPORATE GOVERNANCE’

Corporate Governance has succeeded in attracting a good deal of public interest because of its importance for the economic health of corporations and the welfare of society in general. However, the concept of corporate governance is defined in several ways because it potentially covers the entire gamut of activities having direct or indirect influence on the financial health of the corporate entities. As a result, different people have come up with different definitions,

³ N Balasubramanian, “Corporate Governance and Stewardship”, ed. 1st, Vol. I, (2010), 8.

which basically reflect their special interest in the field. The best way to define the concept is perhaps to list a few of the different definitions rather than mentioning just one or two. Before attempting to do this, it would be useful to first understand the literal meaning of both „corporate“ and „governance“, separately⁴.

1.2 EVOLUTION AND GROWTH OF CONCEPT OF ‘CORPORATE GOVERNANCE’

Issues related to corporate governance have been hotly debated in the United States and Europe over the last two decades. The debates and discourses in India have been heavily drawn on British and American literature on governance. It is evident from the fact that the corporate governance proposed by the Confederation of the Indian industry is modeled on the lines the Cadbury Committee of the United Kingdom. It is the increasing role of foreign institutional investors in emerging economies that has made the concept of corporate governance a relevant issue today. The need for corporate governance was felt after corporate scams came to the forefront of public knowledge. Over the last decade and a half corporate governance has become a central issue globally. Modern-day business is beset with changing operating paradigms. With corporations growing larger and larger and the need for capital multiplying manifold, the need to enter foreign capital markets and access them for their capital requirements has given rise to new challenges in the governance of international business. The pre-transition era was justified by the need to protect domestic markets, but with corporations growing in gargantuan proportions, the need to open up domestic markets for the entry of foreign business became a necessity. After the Second World War, when economies needed to be rebuilt the world over, increased cooperation amongst countries became indispensable for international movement of goods and services. Capital lying idle in some countries had to move out to lubricate the economies of other countries. This sowed the seeds for growing internationalization of business. Prior to this, protectionist regimes seldom allowed any foreign intruder into their national business scene.

The growth of organization that led to the demand for more and more capital, prodded the protectionist regimes to open up their economies and enabled more foreign investment to flow into the domestic business. Control and command-based structures had to be done away with. Instead a new form of governance structure, which was led by market based economic systems

⁴ Vasudha Joshi, “Corporate Governance- The Indian Scenario”, 1st ed., (2004), 7-8.

primarily dominated by the private sector had to be embraced. Now most governments the World over, are relinquishing State control over industry and the private sector is given incentives to accept the new challenges of globalization. This is evident from the transition efforts made by the East European and some Asian countries, including India, following the Russian reform process (perestroika) which was initiated by the change in leadership in the mid-1980s. Economies with efficient economic policies and stable political systems are a big draw amongst the investors. Countries that have opened themselves to world markets and that have good legal systems in place providing protection to investors, have attracted more capital in the process of globalization. As the demand for capital is growing in both the developed and the developing economies, the need for establishing good governance practices has gained momentum. Thus, corporate governance has become a pressing problem⁵.

1.3 IMPORTANCE OF CORPORATE GOVERNANCE TO A COUNTRY

There are several reasons why corporate governance is considered an inseparable element of a country's economic. Just as it is the government's responsibility in a civilized nation state to provide clean water and air, efficient communications, and so on, it is also, arguably, its responsibility to provide for an orderly and transparent business environment that would inspire confidence and trust on the part of domestic and international investors. Research suggests that overseas investors shy away from poorly governed companies in countries with relatively Weak shareholder protection and related legal institutions since the investor's information and monitoring costs could be overly taxing. Similarly, in countries with Weak laws or their poor implementation, permitting overseas investments by their nationals, domestic investors may prefer to invest overseas in countries where corporate governance standards and the legal protection framework are perceived as more favorable, unless domestic stock returns are considerably more attractive to cover poor governance risks adequately. Because of their resilience and competencies (as we shall note later), corporations have grown enormously in the last century and a half to a position of pre-eminence, such that in many cases their assets and revenues exceed the GDP of several countries put together. In the ultimate analysis, corporations are run by individuals. Human nature being what it is, often aided by greed is good exhortations and apparently successful role models, there is a real possibility of expropriation of created Wealth and wealth-creating assets by those in operational control of the enterprise. It is in a country's national and economic interest to contain such devious

⁵ Ed. Klaus J. Hopt and Hideki Kanda, "Corporate Governance in Context". 1st ed. (2005), 50.

practices, though governments generally are quite loathe to and tardy in proactively intervening in such matters.

Another important reason for ensuring good corporate governance is the inevitability, in case of large corporations, of involvement of other people monies in financing their operations. Equity capital and debt capital, including various hybrid forms of credit, constitute the sources of funding of any corporation as normally displayed in their financials. There is nothing strictly private about the corporation to the extent that large proportions of a corporations funding are thus traceable to other people"s monies.\ When such large proportions of money were infused into the corporate sector by people who were in effect absentee owners and absentee lenders, a great deal of trust and public confidence was automatically brought into play. It was the duty of the state to protect and respect that confidence as the entire superstructure of the all-powerful corporate edifice rests on this frail foundation. The slightest hint of erosion of that confidence can lead to disastrous consequences-eventual demise in the case of banks and financial institutions, and alarming downside in the case of equity markets. Ironically, the states devolved responsibilities include protecting orderly and transparent governance of the corporate sector, as well as intervening to minimize and control damages to the economy through pre-emptive bailouts, especially in case of banks and financing institutions, in order to contain the contagion effects of entity failures⁶.

1.4 OBJECTIVES OF CORPORATE GOVERNANCE AROUND THE GLOBE

There are numerous diverse forms of corporate governance around the world. These vary according to the variety of capitalism in which they are rooted. The substantial form that is common in Anglo-American nations tends to give importance to the interests of shareholders. The harmonized form that one finds in continental Europe and Japan also recognizes the interests of workers, managers, suppliers, customers, and the community. Both forms have separate competitive benefits, but in different ways. In the USA, a company is administered by a board of directors who are technically appointed by shareholders. Board of directors has the authority to select an executive officer, known as the Chief Executive Officer (CEO). The UK has established a flexible form of regulation of corporate governance, known as the

⁶ Pawan Aggarwal, "Corporate Governance- Is the Business of Business only Business?", Vol. 56, SCL [2004], 143.

„comply or explain“ code of governance. This is a principle based code that lists practices, such as the separation of CEO and Chairman of the Board, the introduction of a time limit for CEOs“ contracts, the introducing of a minimum number of the non- executive directors, of independent directors, the designation of a senior non- executive director, the formation and composition of remuneration, audit and nomination committees. The Securities and Exchange Board of India (SEBI) describes corporate governance as the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. The definition drawn by the SEBI is from the Gandhian principle of trusteeship and the Directive Principles of the Constitution of India, Corporate Governance is viewed as ethics and a moral duty⁷.

Corporate governance is a set of processes, customs, policies and laws by which an institution or the corporation is administered, controlled and governed in the best interest of all stakeholders. Good Corporate Governance also includes the relationship between the stakeholders involved and the goals for which the corporation is governed. In corporate governance, principal stakeholders are the shareholders, management and the board of directors. Other stakeholders include employees, suppliers, customers, banks and other lenders, regulators, the environment and the community at large. In other words, good corporate governance means good business. It ensures:

- a) Adequate disclosures and effective decision making, to achieve corporate objectives;
- b) Transparency in business transactions;
- c) Protection of shareholder interests;
- d) Commitment to values and ethical conduct of business;
- e) Statutory and legal compliances;

1.5 DEVELOPMENT OF THE CONCEPT OF CORPORATE GOVERNANCE

Across a broad spectrum of countries like Australia, Canada, UK and the US to developing Countries like Brazil, Malaysia, Korea, Kyrgyz, corporate governance codes recognize and emphasize that the duty of the board is to maximize shareholders value. In other countries for example, France, Japan and South Africa more emphasis is placed on a broader range of

⁷ Arvind Kumar Agarwal, “Corporate Governance and Latest Development in Companies Act 1956”, [2003] 57 CLA (Mag) 19, 20.

stakeholders. In May 1999, ministers representing 30 governments, which comprise the OECD, voted to endorse the OECD Principles of Corporate Governance. These principles are non-binding and are intended to serve as a reference point for various countries efforts to evaluate, develop or improve their own legal, institutional and regulatory frameworks. They also provide guidance for stock exchanges, investors, corporations and others that have a role in the process of developing good corporate governance. These form the bedrock of good corporate governance and most countries both OCED and Non OCED- recognize them as a declaration of minimum acceptable standards. Since endorsement in 1999, the principles have become a benchmark for policy makers, corporations and stakeholders in many countries. These principles have been identified as a key standard deserving of priority implementation by Financial Stability Forum, which is an initiative of G-7 finance ministers and central bank governors in order to promote international financial stability and, inter alia, reduce the tendency of shock to propagate from country to country.⁸

The basic principles adopted in 1999 are:

- a) Protection of shareholder rights.
- b) Equitable treatment of shareholders.
- c) Protection of stakeholder rights.
- d) Timely and accurate disclosure and transparency.
- e) Diligent exercise of the board of director's responsibility.

Considering the sweeping changes and turmoil that have taken place in the years following the adoption of the aforementioned principles, a revised set of principles has been adopted in May 2004. The revised principles remain nonbinding but adopt a tougher approach on many governance matters. They still do not intend to become a substitute for any detailed best practice initiatives or laws that may be enacted by organizations within a country. The revised principles read as:

- a. Ensuring the basis for an effective corporate governance framework.
- b. Rights of shareholders and key ownership functions.
- c. Equitable treatment of shareholders.
- d. Role of stakeholders in corporate governance.
- e. Disclosure and transparency.

⁸ Ramesh Chandra Sinha, "Corporate Governance in India", VOL 64, Jan (2) 2005, 38.

- f. Responsibilities of the board⁹.

1.6 REGULATIONS AND CORPORATE GOVERNANCE

Most regulations are guided by the assumption that more information is better than less. Most regulations are also aimed at making companies disclose information. The more information a company discloses about activities within the organization, the greater is the comfort level of investors and regulators. But how this information is going to be used by users is often overlooked. Another way that regulation does a dis-service to companies is that it tends to throttle business itself. If a company or directors have to constantly worry about being within the grid prescribed by regulations, they will not have much time or energy left to conduct real business in a real world. For example, if a research analyst has to temper his analysis with caveats and riders, such research may be inconclusive and useless. Companies that voluntarily practice good governance expect markets to reward them but if regulation absorbs much of the discretionary governance practices and makes it compulsory for everyone across the board, it is hard to see how markets will reward individual companies. Regulation has the effect of taking away any extra points that companies may reasonably expect. Regulation applies to all companies falling in a certain band, regardless of whether all of them actually need reforms. This raises costs for the entire industry and the high price of reforms will have to be paid by all users of financial markets. As markets mature and become more reliable and trustworthy, in large part due to enforced reforms, the gains may well be worth the additional costs. Much more needs to be done apart from legislating governance norms, for instance, accounting reforms, tightening audit procedures or reducing conflicts of interest. According to Ira Millstein, Chairman of OECDs Business Sector Advisory Group on Corporate Governance, regulation in the area of corporate governance is likely to be most effective if it focuses on attracting capital by promoting four simple and essential principles namely, fairness, transparency, accountability and responsibility.

- (i) Fairness means ensuring the protection of shareholder rights including the rights of minority and foreign shareholders and the enforcement of contracts.
- (ii) Transparency means requiring timely disclosure of adequate, clear and comparable information concerning corporate financial performance, corporate governance and mission.
- (iii) Accountability concerns the role of the corporate board in providing independent board

⁹ James Allen, "As a Man Thinketh", ed. 2nd, (2006), 8.

oversight of management performance and holding managers accountable to shareholders.

- (iv) Responsibility means ensuring that corporations comply with other laws and regulations that reflect that particular society's values.

Corporate governance happens inside an organization and depends on the collective ethics of management and boards to make it happen. It is naive to think that by enacting regulations, we can build safe and secure institutions. Ultimately, nothing can replace voluntary adoption of good governance procedures-and markets respond by rewarding such companies. Self-governance, as in other issue, is most effective, but we have seen little evidence of that these past few years. So we end up with more regulation.¹⁰

1.7 DEVELOPMENT OF CORPORATE GOVERNANCE CODES IN THE WORLD

The first major work in formulating a corporate governance Code came from the Cadbury Committee Report of the UK. Corporate governance as a subject got serious consideration by regulators, in the aftermath of corporate excesses and failures of late 1980s. The Cadbury Committee Report of December 1992 (Cadbury report) proposed a code of best practice, which became compulsory for companies and who wished to list on UK stock exchanges. The report became very influential in improving the standards of corporate governance in UK and is considered a fore runner of later reports like Greenbury, Hambel and Turnbull, each of which improved some component of the standard. In July 2003, the Financial Reporting Council that supersedes and replaces the Combined Code of 1998 issued a combined code, following major reviews, among others, of the role and effectiveness of non-executive directors and audit committees. The revised code seeks to bring various works and regulations on the subject under one umbrella and embraces Cadbury and Greenbury reports and contains elements of the Higgs report. It provides guidance on complying with the Turnbull Committee provisions on internal control and the Smith Group provisions on audit committees and the auditor.

The revised code applies the „comply or explain“ approach and assigns to the board a central role for governance of the company rather than the management as traditional trading

¹⁰ M.M. Blair,“Corporate Governance”, Neil J. Smelser and Paul B. Batles (ed.-in -chief), International Encyclopedia Of The Social And Behavioral Sciences, Vol. IV, ed. 1, (2001), 2797.

companies of United Kingdom. It aims to enhance board effectiveness and improve investor confidence by raising standards of corporate governance. There are concessions to smaller companies in complying with the provisions, recognizing that not all provisions will be proportional or relevant to them. The major changes on companies as consequence of this Code are¹¹:

- (i) An increase in the size of the boards, more open and rigorous procedures for appointment of directors.
- (ii) Increase in the chairman's role in many more aspects and reinforcing separation of the roles of chairman and chief executive.
- (iii) Greater time and commitment will be required of non-executive directors, formal evaluation of the structure and performance of boards.
- (iv) Increase in legal liability of non-executive directors and greater potential reputational risk.
- (v) Strengthened role for the audit committee in reviewing financial performance and reinforcing the independence of auditors.

In late 2000 and 2001, the US capital markets were rocked by some of the biggest accounting scandals in recent times, which impacted the lives of, many ordinary US investors and sent shockwaves across the entire globe. The SarbanesOxley Act (SOX) came into existence following a clamoring for the US government to do something to restore investor confidence in capital markets. Very few laws have had such a wide- ranging and far-reaching impact on public accounting, financial disclosure and general corporate governance than this law. Passed into law in July 2002, SOX had a deep influence on the corporate world, more so because it contains some of the toughest corporate governance rules anywhere in the world. Besides, a new body called Public Company Accounting Oversight Board (PCAOB) has been set up to police the accounting industry and this body, along with the Securities and Exchange Commission (SEC) is responsible for interpreting the provisions of this Act.

The focus of SOX is very much on directors and the senior management team. For example, it calls for:

- (i) A statement of responsibility on the part of the management regarding establishing and

¹¹ Vibha Mahajan, "Improving the efficiency of Corporate Governance", P.P. Arya, B.B. Tandon and A.K. Vashisht (eds.), Corporate Governance, (2003), 45.

maintaining internal controls and procedures of financial reporting.

- (ii) A statement regarding the effectiveness of such internal controls, etc.
- (iii) Signing off on any financials issued by a company by the CEO and CFO.
- (iv) A certificate from the external auditors attesting managerial assertions.
- (v) Disclosure of code of ethics for the company's senior financial officers.
- (vi) Stringent independence norms for directors.
- (vii) Definition of financial expert on audit committees and requiring companies to disclose the name of such expert.
- (viii) Strict conditions on loans to directors¹².

1.8 EMERGING TRENDS AND ISSUES

After the initial years of nurturing the concept of corporate governance, this concept of law also saw its branches coming out. Initially concentrating on role of „Board of Directors“ only for a long time, till now the system of corporate governance has expanded its realm to study of part played by management, secondary market, institutional investors, other stake holders especially employees, whistle blower policy and the latest addition are corporate citizenship and corporate social responsibility. While concentrating on the role which the directors could play is keeping a watch on corporate fraud and abuse, the thinkers suggested the „independence“ of directors as the panacea to the problem of improper governance. Later finding the independent directors without the specialized knowledge handicapped in the case of proper monitoring; the independent people with specialized knowledge of financial accounts were asked to be preferred over others for bare minimum number. This was necessitated with the formation of special committee called the Audit Committee constituting of Directors to look over the auditing system of the company is in line with the standard accounting practices. The real scrutiny is possible only by a financially literate person. Further the concept of various other committees evolved worldwide like Remuneration Committee, Nomination Committee etc. to make the work of the directors (especially the independent directors) like a watchdog in the best interest of the stakeholders. The emphasis on financial and other liability disclosure has been prominent in the near past, as the main reason for the major corporate failures have been embezzlement in their financial statements. The emphasis on the whistle blower policy which is gaining momentum each year, though still most of the nations“ system do not provide the desired level of protection to whistle blower, yet the growing emphasis on the same is good

¹² Bryan A. Garner (editor- in chief), “Black“s Law Dictionary”, ed. 8, (2004), 364.

sign.¹³

The emerging perception of corporate governance rating Credit Rating Agencies is also picking up, giving the corporations a constant evaluator for their performance. Further the stress is on Scrutiny of Media especially the financial press has been suggested in India by the Narayan Murthy Committee (2003) to ensure that the true picture must be shown by media on the corporate affairs as they are the major sources of information to the general public. The latest addition to the construction of corporate governance is the concept of „Corporate Social Responsibility“ wherein it is desired that the corporations pay to the society what they have taken from it, in the form of education, healthcare, shelter, fair income opportunity etc. This concept is very close to the idea of „Sustainable development“ which requires the development only in a manner which can be sustained for a longer period of time due to its compatibility not competition with the society it is working in. All these various facets have developed at their own pace in different national systems of corporate governance as developed as per the need of their respective capital markets. Academics studied them under the different models categorized under broadly defined prominent theories of corporate governance. But the globalization has brought the change in everyone’s lives, so did it to this ethical concept of business too. As international trade made its presence felt in the near-end part of the 20th century, and multinationals spread their wings almost all over the world.¹⁴

CONCLUSION

The idea of corporate governance has developed marvelous significance in contemporary corporate law. Corporate governance is apprehensive with direction and control of corporate bodies. These activities are very basic as compared to efficiency and performance of the companies. Corporate governance is the outline that ensures responsibility. When it is in place, the companies are permitted to go about their own way in generating shareholder value and registering progress. In the developing nations, corporate governance is a precondition of capital market development. The investors may only be encouraged to participate in corporate securities only when there is a trustworthy corporate governance is effective. Lacking in it, stakeholders will not appear to stake their money in companies and also private limited companies shall not appear to list its shares on stock exchanges. It is occasionally contended

¹³ Robert A. G. Monk and Nell Minow, “Corporate Governance”, ed. 1, (2001), 249.

¹⁴ Melvin Avon Eisenberg “The Structure of Corporation Law”, 89 Column. L. Rev. 1461

that corporate governance instrument is a substitute to competitive markets. The consequence is that competition in product and capital markets may frame for in corporate governance. However, this is a wrong notion. Markets might take insufficient time to react; they may be intentionally misinformed and their curative action might be very drastic. Previous evidence shows that well-organized, advanced markets do not promise good governance. Therefore, whether markets are developed or underdeveloped, corporate governance rests a priority area. Because of the developments in the last two decades, it is now increasingly found that retail investors, banks, mutual funds and other institutional investors base their investment decisions not only on the future outlook of a company but also its governance. Good governance is becoming a source of competitive advantage among economies for attracting international capital. As mentioned above, it is necessary also to broaden and deepen local capital markets by attracting local investors. It is found that a poor corporate governance system results not only in under-performance in the corporate economy but also in vulnerability of the entire financial system. The growing need to access all types of financial resources and to harness the power of private sector for economic and social progress has brought corporate governance in prominence the world over¹⁵.

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¹⁵ Gordon Hobbs, B.A. (ed.), "Halsbury Laws of England", ed. 4th (reissue) 1998, vol. 9(2), para 1001.