

Overseeing and regulatory role of state over the corporate activities

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Abstract

The paper reviews the regulatory and overseeing role of the State over Corporate Activities. The State plays a very important role in ensuring that the corporate activities are conducted in an efficient and lawful manner. The State plays crucial role in providing a level playing field for the market participants. There have been suggestions that self-regulatory mechanisms should be adopted but during the course of our article we will observe that State Regulation proves to be a more advantageous mode than Self-regulation.

Keywords: state, regulator, management, self-regulation, state-regulation

1. Introduction

The State plays a very important role in regulating and overseeing the affairs of a corporate organization. The State has played a major role ever since the passage of the Bubble Act by the Parliament of Great Britain in the year 1720. The primary aim of the Act was to restrain practices that “manifestly tend to the prejudices of the public trade and commerce of the Kingdom”^[1]. The State oversees and regulates the corporate activities by means of three categories of rules, namely: permissive rules, presumptive rules and mandatory rules. The justification for state intervention can very well be understood by considering “efficiency” related factors and factors “other than efficiency” such as fairness, participation, morality etc^[2]. There are, however, a few arguments as to when “self-regulation” could also prove to be pivotal in the regulation of the corporate activities. Therefore, in the light of the above brief discussion we will discuss the major law governing corporate activities in India i.e. the Companies Act 2013 and also simultaneously consider the position in the United Kingdom.

In order to understand the regulatory role of the State, it is very important for us to analyse the historical background as to “why” did the State intervene in the very first place. In the Great Britain, during the first and second decades of the eighteenth century there was a growing concern about company promoters not obtaining charters^[2] and acting without legal authority. When such speculative enterprises were growing at a rapid rate, the State decided to intervene by passing the Bubble Act in the year 1720. The State, as a result of this, started instituting proceedings against such companies with the aim of forfeiting them. This action by the State created widespread panic which then also led to the collapse of the South Sea Company whose stock fell from a whopping 1000 % to 125%^[3]. According to Gower^[4], if the aim of the State, by enacting the Bubble Act, was to protect and safeguard the interests of the investors, then it had failed miserably in performing its role as a regulator. However, in my opinion the State had played its role adequately by suppressing the growth of companies who were acting without legal authority by obtaining obsolete charters.

2. How does the State Regulate

On an understanding as to “why” did the State intervene, it is now necessary for us to understand as to “how” the State performs its overseeing and regulatory role? The State performs its regulatory role by imposing three categories of legal rules namely: permissive, presumptive and mandatory rules. Permissive rules, as the name suggests, does not apply automatically and it is left up to the parties to opt for it. Mandatory rules, on the other hand, apply automatically and that the parties do not have an option to displace the rule. The State imposes mandatory rules in the form of S53 of the Companies Act 2013. The provision strictly prohibits a company to not issue shares, except for sweat equity shares, at a discount. Presumptive rules provide an option to the parties to opt out of the requirements. It is essentially important to understand that categorizing these rules is a very complicated task in the first place. For example, s310 of the Companies Act 1985 strictly prohibits any provision in the articles that exempts the directors from breach of duty. The ambit of this provision is quite uncertain because it may be possible under certain circumstances for the articles of a company to limit a certain range of situations where there is a conflict between the director’s personal interest and his duties towards the company^[5]. Upon considering the forms of rules that a State may impose, we will now proceed to consider the importance of the State as a regulator when imposing those rules.

3. Regulation to remove Information Asymmetry

The State plays a very important regulatory role when there is asymmetric information as between the market participants. An imbalance of information makes it very difficult for the party to assess if the transaction would lead to a beneficial outcome. In India, s129 of the Companies Act 2013^[6] makes it mandatory for the board to provide a true and fair view of the affairs of the company^[6]. The Act also now provides for a “consolidated financial statement” to be prepared when a company has one or more subsidiaries^[7]. The Cadbury Committee Report set up in the year 1991 also provides for the board of directors to provide a “balanced and understandable assessment” of the company’s position. The State also plays a very important

role in providing sanctions, an advantage that may not be adequately ensued in case of self-regulation. In the UK, S47 of the Financial Services Act ^[8] provides that an individual would commit a criminal offence if he makes a false or misleading statement with the intention of inducing the other party to make the investment. Therefore, the State as a regulator aims to ensure that the interest of investors/shareholders and creditors/prospective creditors are safeguarded.

In continuing with the issues that arise with asymmetric information, the State also imposes mandatory rules on the company to follow compulsory disclosure obligations when it is preparing to float its shares to the public for the first time. In India, under s25 and s26 of the Companies Act 2013, a public company is required to publish a prospectus that includes the offer of securities for sale ^[9]. G.A. Akerlof ^[10] rightly justifies this position by providing a scenario that is generally referred to as “market for lemons”. In this scenario, if the sellers were compelled to disclose all the facts with regards to the cars they sell, the buyers would feel more confident of purchasing cars of higher quality. Therefore, the State here plays a very important regulatory role in, firstly, ensuring that parties makes an informed decision prior to entering into a transaction and secondly, to help them yield mutually beneficial outcomes.

4. Regulation to remove Transaction Costs

The State also plays a very important role in reducing the transaction costs between the parties. Professional fees are a good example of transaction costs. In such a case, the State imposes a permissive rule in the form of Model Articles of Association under Schedule 1 (Table F-J) ^[11] of the Companies Act 2013. S5 (8) ^[12] of the Companies Act 2013 provides that these model rules would govern a company’s affairs unless the company excludes or modifies it. Furthermore, contractual gaps also tend to give rise to transaction costs. According to Brian Cheffins ^[13], the State can provide for “gap filling” rules that would provide for hypothetical scenarios as to how transactors would act under ideal conditions. However, it could also be argued that such “gap filling” rules in the form of regulation may create a tendency amongst the market participants to replicate the rules, thus, giving them lesser autonomy to formulate arrangement that would have left them better off.

5. Regulation to limit Negative Externalities

Furthermore, the Government as a regulator also plays an important role in limiting negative externalities by forcing companies to impose rules on taxes and liability. Negative externalities arise when a decision affects people who are not parties to a transaction. In the social context, if companies do not take externalities into account, they would be able to impose lower prices that they would have had they taken social costs into account. This would in turn lead to a higher demand and, therefore, over-production from the society’s point of view. Professor Ronald Coase ^[14] is of the opinion that market participants can reach utility-maximizing arrangements on their own at that the State does not need to intervene in such cases. However, he does not completely discard the importance of regulation and holds the opinion that in certain circumstances it would not be possible to reach a bargain that would be advantageous to everyone, for example in case of a factory polluting the air. In the corporate context, an area of law where externalities

might justify state interference would be “company names”. If companies were given the freedom to choose names of any sort, then duplication would become a common problem. People would then tend to use names of popular organizations. This would then impose externalities on people who are dealing with such companies. Rule 8 of the Companies (Incorporation) Rules 2014 ^[15] provides for a mandatory rule that before granting any name, it will be verified whether the name is identical or similar to any other name of a company/LLP. State Regulation, therefore, ensures that the public is protected from being misled or confused when entering into a transaction.

6. Regulations imposed on Management

In considering the role of State as a regulator, according to John Kay and John Vickers ^[16], there are two forms of regulation that State imposes namely: Structural Regulation and Conduct Regulation. Conduct Regulation plays a very important role in determining how the company performs its activities. These forms of regulations are important at a time when individual transactors generally tend to “free ride” and maximize their “self-interest”. Professor Brian Cheffins ^[17] applies the device of “game theory” beautifully to the relation between an entrepreneur and a manager. He rightly points out that a manager might tend to do better for himself by not adequately performing his role as expected by the entrepreneur. In such circumstances, an entrepreneur who is aware of the manager’s position might not want to invest in the very first place. This is where the lawmakers step in and provide for regulations that impose duties on the directors to perform their duties diligently towards the company.

In India, S184 of the Companies Act 2013 ^[18] provides for a mandatory rule where the director of a company must disclose the nature of his interest, whether direct or indirect, in a contract or arrangement with a body corporate where he holds more than two percent shareholding. The director shall also disclose his interest in case of a contract with a firm where he is a partner, owner or member. In addition to the regulations, Berle and Means ^[19] are of the opinion that “market for corporate control” would further incentivize inefficient managers to take steps to maximize the value of the shares of a company. If the directors don’t take beneficial steps then it exposes them to a “control opportunity” where a predator might acquire the control of a company and appoint a new management. However, according to Sally Wheeler ^[20], such threats of take over might lead to short-term profit-maximization by the management. However, interestingly, Professor Brian Cheffins states that regulation in such a case might not necessarily be the suitable option. According to him, managers have a reputation of being competent and trustworthy and, therefore, they would always want to remain loyal and act in the best interests of the company. This is, however, not an appropriate argument to deter the use of regulations imposed by the State. Sanctions imposed by the State for a breach of duties by the directors are of a very strict nature and this would nevertheless be the driving force behind encouraging the directors to not act in their self-interests.

7. Regulation to ensure Fairness

Legal Regulation also plays an essential role in ensuring fairness for major constituencies of a company, particularly shareholders. According to Adolf Berle Jr. ^[21] the directors

of a company are to act in the best interests of the shareholders. Keeping this in mind, it is very important for the shareholders to be given certain mechanisms to enforce their rights in cases when they have been victims of unfair prejudice or oppression. Under S241 of the Companies Act 2013 ^[22], any member of a company may apply to the Tribunal for a remedy in such circumstances. Furthermore, S245 of the Companies Act 2013 also provides a remedy to the shareholders to bring a class action suit when they are of the opinion that the management has conducted affairs in a manner that have been unfairly prejudicial to their interest. The roles of the directors are very important in safeguarding the interests of the shareholder. The English law has majorly considered the role of a director as a trustee. A director, as a trustee, is liable if he makes any personal profit while acting in his capacity as a director ^[23]. Furthermore, mandatory rules are also provided in order to ensure fairness towards shareholders. S213 of the Companies Act 2013 provides shareholders the right to launch investigation when they are of the opinion that the business of the company is being conducted with the intention to defraud its creditors or members or when affairs are conducted in an oppressive manner. The Government, therefore, plays a very important role in ensuring that directors abide to their duties and in the course of doing so, they shall not hinder the interests of the shareholders.

The roles of regulations are not just to provide for remedies when the shareholders are deprived of their rights. The shareholders must also be given adequate procedural rights to participate actively in the running of the business. S169 of the Companies Act 2013 ^[24] provides that a company may remove a director by a mere ordinary resolution, except in cases where the director is appointed by the tribunal under S242. This right, according to Berle and Means, is only effective theoretically. According to Berle and Means, in large public corporations shareholders/investors are generally passive in nature. They do not tend to attend general meetings and their primary aim is to receive “capital appreciation”. Therefore, in many cases it is the management themselves who appoint or remove directors. In addition to the power to appoint or remove directors, S47 of the 2013 Act ^[25] provides for a mandatory rule where every member of a company limited by shares shall have the right to vote in a general meeting. Furthermore, S136 of the Act ^[26] also provides for a mandatory rule where every member has a right to obtain a copy of the audited financial statements. These rights of participation to the shareholders certainly provide a useful check on managerial conduct and also helps that the company is governed suitably.

8. Regulation governing Interests of Employees

In addition, the State also imposes regulations on the directors to take into account the interests of the employees of the company. This is perhaps in consonance with Merrick Dodd’s ^[27] opinion that corporations need to undertake social responsibilities and that corporate managers must act in the interests of all the constituencies of the company. S166 of the Companies Act 2013 ^[28] provides for a mandatory rule that the directors of a company shall act in good faith for the benefit of the members as a whole, including “company”, its “employees”, the “shareholders”, the “community” and for the protection of “environment”. There is, therefore, a wider obligation on the directors of a company. However, according to Parkinson ^[29], the aim of

the provision, “despite its mandatory wording”, is to give the director’s discretion to act in the interests of the employees. This should rightly be the case too since, employees are under a contract of service and therefore, are entitled to their remuneration. Shareholders, on the other hand, are “residuary legatees” of a corporation and therefore, as according to Milton Friedmann ^[30] the primary focus of the directors should be maximize shareholder’s benefits.

The State has also imposed on the companies “Corporate Social Responsibility”. S135 of the Companies Act 2013 imposes a mandatory rule which provides that every company having net worth of rupees five hundred crores or more shall constitute a Corporate Social Responsibility Committee. The Committee shall ensure that the company shall spend at least two percent in pursuing its Corporate Social Responsibility Policy. According to Andrew Crane, this is a new management idea that is a little more than a recycled version ^[31] A similar analogy can be drawn as in the prior paragraph where we have argued that the directors shall act in the best interests of the shareholders of the company.

9. Further analysis of Categories of Rules

In our discussion above, we have therefore considered the forms of regulations that State imposes as a regulator. A very important “permissive” rule that companies choose to opt for is “limited liability”. The feature of this rule is that the shareholders are only liable to the extent of their investment and, therefore, are not obliged to pay the outstanding debts of the company. The Parliament first enacted the use of limited liability by enacting the Limited Liability Act 1855. Prior to 1855, the members of a company could be asked to raise funds to pay the debts of the company, a process termed as the “levitation” method. On the other hand, mandatory rules are obligatory and a company is bound to abide to it. S141 of the Companies Act 2013 ^[32] takes every step to ensure that the auditors are independent in performing their duties diligently. S143 ^[33] imposes duties on the auditors to examine the company’s account and financial statements and to certify that they provide a true and fair view of the state of the company. In case of any contravention of provisions the company shall be liable to imprisonment or fine or both. Furthermore, mandatory rules are also provided in order to ensure fairness towards shareholders.

10. State Regulation v Self-Regulation

Our discussion in this article has primary focused on the role of the State as a regulator. It would now be appropriate for us to consider the possibility of a self-regulatory mechanism in the corporate field. What are the advantages that a self-regulatory mechanism may have over State Regulation? John Kay and John Vickers ^[34] provide that in peripheral areas of Public Sector State regulation may be unnecessary. For example, the State has no advantage in controlling hotels, trucks, laundries etc. In these areas, privatization may lead to more effective and beneficial results. Professor Brian Cheffins is of the opinion that regulation may replicate steps that the company participants take in the course of business. Market participants generally tend to act on their own initiative by entering into arrangements that leave them better off. Therefore, the State may not have an important role by making regulations that

provide for strategies that the market participants would have anyways implemented. Furthermore, Professor Leonard Sealy also argues that the current legislation in the UK imposes unnecessary regulatory requirements and, therefore, it does not service the needs of the business. Passing a regulation is a time-consuming affair and it is the same in case when reforms are to be made to a regulation.

In considering the advantages of self-regulation, we must not overlook the disadvantages of self-regulation. A Regulatory Policy Program on the “Role of Government in Corporate Governance”^[35] outlines some of the disadvantages that self-regulations may possess. Firstly, having proper knowledge of the business industry does not make self-regulation effective. There is a possibility of a conflict of interest because of possessing more useful information about the market. Furthermore, there is also a possibility that self-regulation is used by older established entities to keep out new participants. Secondly, in several instances self-regulatory mechanisms impose lesser sanctions and, therefore, it is not the right mechanism to restrain violators. Thirdly, it is highly likely that as a result of the self-regulator’s conflict of interest and flexibility, the compliance with rules would not be sufficiently monitored. Therefore, on an overall understanding, it would be wiser to state that the benefits offered by “State Regulation” far outweighs the benefit offered by “Self-Regulation” and that regulation by the State is the right mechanism to maintain an overall balance in the corporate market.

11. Conclusion

The State has a very important role when overseeing and regulating the corporate activities. We have observed that the State imposes regulations by means of three categories of rules namely: permissive, mandatory and presumptive rules. The State by imposing such rules ensures that there is no information asymmetry between the parties. The Government also imposes rules to reduce transaction costs and negative externalities that may flow during the ordinary course of a business. Mandatory rules are imposed on the management so that they act in the best interests of the company. Adequate mechanisms are offered to the shareholders so that they are not victims of inadequate mismanagement on the part of the managers. We have also looked into the role of self-regulation as opposed to State regulation. On an overall analysis, it is clear to us that the benefits offered by “State regulation” far outweighs the benefits offered by “Self-regulation” and that regulation by the State is the right mechanism to maintain an overall balance in the corporate market.

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