
ANALYSING THE EFFECT OF TRANSPLANTATION ON CORPORATE GOVERNANCE NORMS IN INDIA

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ABSTRACT

The question whether the transplantation of corporate governance norms from jurisdictions like U.K. and U.S. has been efficient and sustainable in Indian corporate structure still does not have concrete answer. These jurisdictions follow the outsider model of governance which is different from the insider model as the latter is more prevalent in Indian settings. With several years being passed after the concrete standardized efforts for the enhancement of corporate governance, the review of the impact of enforced corporate governance norms on the Indian corporate sector must be checked and if such policies are adequate or any mid- course action is required. Apart from this, the efficacy in former has been in doubt after large scale corporate failures in these jurisdictions.

This paper will deal with analysing the system of corporate governance existing in India in light of discussing the framework which exists in outsider model of governance, primarily focusing on U.K. and U.S. It will examine the working and outcome of transplants in the Indian corporate governance system in relation to other major changes and events happening around. The paper will also delve into the idea of enhanced shareholder protection, if adopted gradually, leads to effect on growth of the financial market, thus analysing the point of this entire dynamics being favourable for Indian model of corporate structure.

INTRODUCTION

There has been sustained efforts on the part of Indian regulators in order to strengthen and improve the norms related to corporate governance by formation of committees like “Narayana Murthy Committee”.¹ Corporate governance can be defined as a system through which companies are directed and controlled through the checks or balances which are provided in the corporate structure that leads to long terms enhancement in value for shareholders of the company. In India, corporate governance came into existence in 1990s and formulated into law only in 2000. The initiatives to strengthen corporate governance norms and apply stringent practices has been highly influenced by changes taking place worldwide. India’s corporate governance norms have been encapsulated under clause 49 of Equity Listing Agreement. These norms as well as revisions to the same are highly attributed from the reports and principles prevailing in U.K. and U.S as this was done keeping in mind, the need to attract foreign capital into India and thus several rules and concepts were taken from U.S. and U.K. which are two of the most developed economies.²

The model of governance which has been followed in these jurisdictions which is classified as ‘outsider’ model differs from the model which is usually followed in India namely ‘insider’ model.³ There has been gradual advancements in corporate governance norms worldwide which has shown a shift towards shareholder primacy model and many of the developing countries have amended and made changes to enhance the scope of shareholder rights which increases protection for foreign investors and shareholder that will lead to greater investment in capital market and overall financial market development.⁴ In India this was marked by liberalisation which showed shift from a tightly controlled welfare economy to one with more laissez faire in its working.

A PROLOGUE ON INDIAN CORPORATE GOVERNANCE

There have been two distinct phases witnessed by India in regards to corporate governance regime, that is symbolised in the company law which has been taken from English law. This

¹ Securities and Exchange Board of India, Report of the SEBI Committee on Corporate Governance (2003).

² N. Balasubramaniam, Firm Level Corporate Governance in Emerging Markets: A Case Study of India, *ECGI*, no. 199, p.5 (2008)

³ S.K. Guha, Evolution of corporate governance in India and its impact on the growth of the financial market: An empirical analysis (1995-2014), *EPL*, vol. 19, no.5, p. 947 (2019).

⁴ Henry Hansmann, Reinier Kraakman, The End of History for Corporate Law, *HLR*, p. 18 (2000).

company law was taken over by Companies Act, 1956 after independence. During this time, much emphasis was kept on manufacturing sector and the systems like “license raj” and “industrial capacity quota system” limited the number of businesses to survive.⁵ Thus, only certain groups were able to hold large chunks of capital in public companies where banking institutions played a major role. They held large shareholdings and nominated the board of directors. This showed high influence of certain groups over the companies and minority shareholders were kept at stake.⁶ The financial disclosure norms were not effective and the government structures did not pay much emphasis in this regards. In 1991, during the time of economic liberalisation, rapid changes started taking place and SEBI was formed in 1992 to monitor and regulate securities market in India.

In 1998, “Confederation of Indian Industry” (CII) constituted a national task force which proposed “Desirable Corporate Governance Code” that was voluntarily approved and adopted by few companies.⁷ After this SEBI, through Kumar Mangalam Birla committee provided for recommendation to raise the standards of corporate governance for the listed companies which resulted into formulation of Clause 49.⁸ It was inserted into Equity Listing Agreement in 2000 which was applied to all the listed companies of certain size. However, both, the Birla committee and CII had cautioned about import of forms of corporate governance from developed nations, specifically U.S. and U.K. Few among such concepts was of independent board⁹ and audit committee¹⁰.

SEBI started making efforts for building and strengthening of corporate governance in India especially in the light of global scandals like Enron. “Narayana Murthy Committee” was established for the same where it worked towards examining and recommending changes in the existing structure and Clause 49.¹¹ A revised form of Clause 49 was implemented in 2006 and the latest reform to these corporate governance norms was made in 2014. SEBI amended the norms under Clause 49 after understanding the need to make better governance practices for listed companies. The norms were amended to add more stringent conditions and in order

⁵ R. Chakrabarti, Corporate Governance in India: Evolution and Challenges, *GMIR*, no. 26, p.15 (2005).

⁶ V. Bhat, Corporate Governance in India: Past, Present and Suggestions for the Future, *ILR*, vol. 6, no.92, p. 1433 (2007).

⁷ Confederation of Indian Industry, Desirable Corporate Governance: A Code, *CII* (1998).

⁸ Securities and Exchange Board of India, Report of the Kumar Mangalam Birla Committee on Corporate Governance, *SEBI*, (2000).

⁹ Clause 49(I)(A) of the Listing Agreement.

¹⁰ Clause 49(II)(A) of the Listing Agreement.

¹¹ Securities and Exchange Board of India, Report of the SEBI Committee on Corporate Governance, *SEBI* (2003)

to bring them in line with Companies Act 2013. The factors which led to bringing in of such changes included- “i) internationalisation of Indian capital markets; ii) cross-listings by Indian companies.”¹² There was a pull towards attracting of foreign capital into Indian markets so that securities market can be made much more competitive among the emerging markets. Through economic liberalisation several investments came from offshore investors which compelled Indian companies to follow the governance norms which were being complied overseas. And since majority of these investments were from U.S. and U.K. the norms prevailing in these jurisdictions became more convenient and relevant to be followed. Indian companies also started getting listed overseas in order to raise capital and by 1990s, it was common for Indian companies to issue their securities through global depository receipts which was listed on London Stock Exchange.¹³

The great number of listings also made companies to adhere to the norms and practices of corporate governance which prevailed in these markets and gradually they also permeated into Indian scenario. Presently clause 49 of Equity Listing Agreement consists of mandatory and non-mandatory provisions. The disclosures regarding mandatory requirements and its compliance as well as non-mandatory requirements and their non-adoption must be made in the Annual Report. Clause 49 provides upon following key features-

- Mandatory provisions include- “i) Composition of Board and its procedure which also includes provisions regarding meetings, independent directors, code of conduct for board of directors and senior management; ii) the composition and role of Audit committee; iii) subsidiary companies and related provisions; iv) disclosure to audit committee, board and shareholders; v) CEO and CFO certification; vi) quarterly report on corporate governance; vii) annual compliance certificate.”
- Non-mandatory provisions- “i) Constitution of Remuneration Committee; ii) Despatch of half-yearly results; iii) Training of board members; iv) peer evaluation of board members; v) Whistle blower policy.”

Clause 49 also states that a separate section needs to be maintained on corporate governance in the annual reports of the company which should elaborate upon the compliance of the norms.

¹² J. Armour, P. Pele, Law, Finance and Politics: The Case of India, ECGI, no. 107 (2008)

¹³ T. Khanna, K. Palepu, Globalization and Convergence in Corporate Governance: Evidence from Infosys and the Indian Software Industry, *JIBS*, vol. 35, no. 6, p. 489 (2004).

It also requires companies to submit quarterly compliance reports within 15 days to the stock exchange in the form which has been prescribed and this must be signed and approved by company's CEO or compliance officer. Certain clauses as given under Equity Listing Agreement provides for the protection to minority shareholders. These include- "Disclosure of Shareholding Pattern; Maintenance of minimum public shareholding (25%); Disclosure and publication of periodical results; Disclosure of Price Sensitive Information; Disclosure and open offer requirements under SAST."¹⁴

MODELS OF CORPORATE GOVERNANCE

There are several concepts in corporate governance, for example, independent directors, CEO/CFO certification, audit committee and so on which have been taken from U.S. and U.K.¹⁵ This brings up the contention if these norms and concepts can be made applicable across several jurisdictions as the fundamental differences might exist across various jurisdictions. In order to understand this, an analysis of these differences in corporate governance needs to be done. The major two models which exist are in the form of outsider model and insider model which can help in dealing with the issue of convergence or divergence of certain corporate governance.

- **Outsider Model Of Corporate Governance**

This model is about dispersed ownership classified with large institutional shareholdings which shows the shift in position from active to passive agent.¹⁶ It, therefore, brings a distinction between ownership and control. In this, the shareholders are not much interested into the management of company and their relationship is limited to financial investments which shows clear demarcation of ownership and control. Apart from this. Outsider model is market centric which means that emphasis is given to market players than the State and regulators. Hence, it focuses on capital market, characterized by high disclosure standards and major investment related decision making with market players.¹⁷ This model is followed in U.S. and U.K. and

¹⁴ Vikramaditya Khanna, Corporate Governance, Enforcement and Firm Value: Evidence from India, MLE, no. 08-005, p. 19 (2008).

¹⁵ A. Cadbury, Report of the Committee on the Financial Aspects of Corporate Governance., *Gee & Co. Ltd.* (1992).

¹⁶ S. Nestor, J.K. Thompson, Corporate Governance Patterns in OECD Economies: Is Convergence underway, *OECD*, no.34, p. 8 (2001).

¹⁷ H. Hansmann, R. Kraakman, The End of History for Corporate Law, *GLJ*, no. 89, p. 443 (2000).

most of the corporations here are not family oriented but rather public. It is uncommon to find companies with controlling shareholder as the shareholding is diffused.

There are three kinds of agency problems that are faced by companies in general- “i) the conflict between managers (agent) and owners, being shareholders (principal); (ii) the conflict between controlling shareholders (agent) and minority shareholders (principal); and (iii) that between the company itself (agent) and other stakeholders with whom the company contracts, such as creditors, employees and customers (principal).”¹⁸ In this model, it is the first problem which is encountered. Thus, several mechanisms are employed to deal with the issue like employing more independent directors who can act as check on managers in order to protect the interest of shareholders. Certification of financial statements and internal controls are also other measures to control the powers of CEO and CFO to not let them be detrimental to shareholders.

- **Insider Model Of Corporate Governance**

Insider Model of Corporate Governance is characterised by group of people having long term relationship with the company that is present in private as well as listed companies.¹⁹ This group is the controlling shareholders and the remaining shareholding is diffused in public. These shareholders have major control in the company and mostly they tend to be the state or business family groups. This model is highly seen in the context of India where there is presence of concentrated stock ownership and a preponderance of family-controlled businesses while State-controlled businesses form an important segment of the corporate sector in many of these countries.²⁰ In this, minority shareholders do not have much say because of not holding sufficient number of shares to veto or outvote any decisions as made by controlling shareholders. These controlling shareholders influence the working and management of the company through the privilege which is provided to them. The senior managerial positions are taken up by family members or bureaucrats.

The companies here, do not have robust capital markets or sophisticated market players because of which state keeps on continuing the work of regulation of corporate activities by making regulations as there is great reluctance to depend upon market-based regulation because

¹⁸ R. Kraakman, *The Anatomy of Corporate Law: A Comparative and Functional Approach*, OUP, (2004).

¹⁹ S. Nestor, J.K. Thompson, *Corporate Governance Patterns in OECD Economies: Is Convergence underway*, OECD, no.34, p. 2-24 (2001).

²⁰ R. Chakrabarti, *Corporate Governance in India: Evolution and Challenges*, GMIR, no. 26 (2005).

of lack of organisational working.²¹ There are so many classic examples which makes India, the country following insider system as most public companies are either business family or state controlled.²²

Diffused ownership can be found only in some companies which makes it as exception rather than a rule. This can be proved by the study done on the basis of information present on the “Bombay Stock Exchange” and “National Stock Exchange”, where the shareholding pattern showed that the average BSE 100 company consist of promoter who owns 48 percent of the company.²³ There are only 10, out of these 100 companies, where promoters who hold shares below 25 percent exist. In this, the second agency problem is faced ie, between controlling shareholders and minority shareholders. Thus, the role of law over here is to control the powers of controlling shareholders in order to protect minority ones. This can be solved by instances which make it possible for meaningful involvement of them in decision making like appointment of board of directors. However, the proportional representation in directors’ appointment the controlling shareholders should also be given fiduciary duties so that they take the interests of minority shareholders into account. But Indian law does not owe fiduciary duties on shareholders towards anyone.

Apart from all this, minority shareholders must be provided with protection and remedies against any wrong. In india, it is given under Section (241- 246)³⁹⁷ and 398 of Companies Act 2013.²⁴ However, there are certain prerequisites and procedure which need to be fulfilled by them in order to make use of these sections. Hence, India needs to put greater emphasis on the existing system. but, as already mentioned there has been much more attention paid to requirements like independent directors, CEO/CFO, audit committee etc. as taken from the context of outsider model which shows a gap between the contextual and theoretical fundamentals of Indian Corporate Governance.

CORPORATE GOVERNANCE IN INDIA VIS-À-VIS LEGAL TRANSPLANTATION

As already seen, there are significant differences between the corporate structures of India and U.S. where the latter is highly based on concentrated shareholding structures and there is no

²¹ D.K. Denis, J.J. McConnell, International Corporate Governance, *ECGIF*, no. 38, p. 1-36. (2003).

²² S. Mohanty, Sarbanes-Oxley: Can One Model Fit All?, *NEJI*, vol. 1, no. 4, p 469 (2006).

²³ S.J. Mathew, Hostile Takeovers in India: New Prospects, Challenges and Regulatory Opportunities, *CBLR*, vol.7, no.3, p. 801-842 (2007).

²⁴ The Companies Act 2013 (No. 18 of 2013).

distinction or demarcation drawn between ownership and control as majority shareholders have say in management of the company as well. There is no overarching power given to directors and director primacy is not present unlike U.S.²⁵ They can be removed in case where they are not performing their functions. Also, unlike U.S. boards which are classified with independence, Indian boards are composition of inside and outside directors in order to maintain quality of discussions. Thus, this section will look into the principles and phenomenon of legal transplant in order to understand the impact of it over Indian corporate governance.

- **Concept Of Legal Transplantation**

Legal transplant refers to adoption of laws or principles from one nation to another which can be in entirety or in limited manner.²⁶ This became general in corporate governance due to globalization and capital markets export. Transplantation can help in setting common standards across various nations but however, the implementation of the same needs to be checked as every jurisdiction is different socially, politically and economically. If such transplanted rules are not fit to be implemented, that will result into failure either by not getting implemented at all or by failing its purpose. The same transplantation is open to contention in India as there are several instances where these concepts are not executed effectively thus, raising question on relevancy and viability of entire transplant. This can be looked at in reference to the concept of independent directors. as already mentioned, controlling shareholders in India get right in de jure as well as de facto and they play a major role in appointment and removal of directors.²⁷ It can also be extended to independent directors also, who are appointed to collectively look for the interest of shareholders and company but they also owe de facto allegiance towards controlling shareholders. However, it clearly defeats the purpose of creation of independent directors which is to solve the agency problem.

This have been partially looked into in U.S. by making a provision for “nomination committee of independent directors” where they recommend the appointment of independent directors.²⁸ Clause 49 does not make such a provision mandatory because of incongruence in appointment process. Apart from this, it is demonstrated that this concept has been taken from outsider

²⁵ Umakanth Varottil, Evolution and Effectiveness of Independent Directors in Indian Corporate Governance, HBLJ, vol. 6, no.2, p. 284 (2010).

²⁶ Hideki Kanda, Curtis J. Milhaupt, Re-Examining Legal Transplants: The Director's Fiduciary Duty in Japanese Corporate Law, AJCL, vol. 51, no. 8, p.887 (2003).

²⁷ Section 264 and 284, Companies Act, 2013.

²⁸ Rule 4350(c)(4), NASDAQ Stock Market Rules, 2003.

model without paying emphasis to differences which exist in the corporate structures. Both NSYE and NASDAQ (National Association of Securities Dealers Automated Quotations) is an American stock exchange based in New York City). in U.S., if it is controlled company there is no need to have board with majority of independent directors as it is not enough to accord protection anyways in such a case.²⁹

There has been a major two- fold argument made which sets the framework of present global corporate governance debate- “(1) American corporate governance has reached an optimally efficient endpoint by adopting the shareholder primacy and dispersed shareholding corporate model, and (2) the rest of the world will inevitably follow, resulting in a convergence of corporate governance around the world on the lines of the U.S. model.”³⁰ Although this has faced criticism but after certain instances the sustenance and success of such model has been questioned. The U.S. model of corporate governance has faced criticism in two frames of time. Firstly, after the Enron fraud that saw swift reaction by the regulators in the enforcement of SOX (Sarbanes-Oxley Act, The goal of SOX is to protect shareholders in public companies by ensuring the accuracy of these companies' financial reports).³¹ The other came when global financial crisis got its root along with collapse of big corporate structures like Bear Stearns, AIG, Lehman Brothers which poses serious questions regarding the viability of the regime.³² Issues like dispersed oversight and lack of oversight mechanism; managerial superiority giving haven to incumbent board and management; unaccountable and irresponsive Board and so on are some of the reasons for governance failures prevailing in the model.

IMPACT OF TRANSPLANTATION IN CORPORATE GOVERNANCE OF INDIA

In order to examine the impact of transplants in Indian Corporate Governance Reform, two empirical studies can be looked into. Black and Khanna, through the formation of “Mangalam Birla Committee”, studied the impact of corporate governance reforms which were brought.³³ It was seen that within two days of such reforms, the share prices of the large firms to which such rules were going to apply increased by 4% in relation to other small firms, that pointed towards the expectations of investors that these reforms will increase market value. In another

²⁹ New York Stock Exchange, Listed Company Manual § 303A (2003).

³⁰ W. Bratton, Comparative Corporate Governance and the Theory of the Firm: The Case against Global Cross Reference, *PCL*, vol. 38, no.67, p. 214 (1999).

³¹ C.M. Elson, The Enron Failure and Corporate Governance Reform, *WFLR*, vol. 38, no. 1, p.856 (2003).

³² Nell Minow, Blame Boards of Directors for Financial Mess, *CNN* (2008).

³³ B.S. Black, V.S. Khanna, Can Corporate Governance Reforms Increase Firms' Market Values? Evidence from India, *JELS*, vol. 4, p. 752 (2007).

study done by Dharmapala and Khanna who took sample of around 4000 firms and noted that positive impacts were seen largely and statistically for the reforms of clause 49 along with the sanctions which came in 2004 [Securities Contracts (Regulation) Act] which imposed penalties in case of non-compliance of listing agreement.³⁴

Although positive impact can be seen through this, still there are certain factors which are arguable here. Like considering the first study, it showed a very limited and short time to analyse the impact within which information regarding the reforms could have been well analysed and spread throughout the system in order to effect the prices. Although there might be high expectations regarding such reforms, but the details of such reforms would not have been understood clearly. This does not confirm the fact of acceptability of all the concepts which were about to get incorporated from outside into the system as it was the enhanced corporate measures which was awaited by the market. The other study which attempted showing the positive impact of stringent penalties coupled with the reforms, however it neglected the point of effective enforcement of these rules. The entire point lies on successful implementation of the rules, not their formation and any assessment made on the latter is not adequate.

Additionally, it took a lot of work to implement the changes in corporate governance where the revisions being done in years were met by cold reception from Indian industry. Even after clause 49 was implemented, there were several government companies violating the provisions and several cases were initiated against the same, but later dropped by SEBI. This showed the negative effect which would come in market place making the successful execution of corporate governance norms much more complex. Apart from this, non-government companies also showed inadequacies in the compliance where around thousands of companies did not file their compliance reports. Further the Satyam scam in 2009 also showcased the problem of implementation of transplant into Indian scenario.³⁵

The Satyam scam is considered as India's one of the biggest "corporate governance and financial accounting scandal." It highlighted the ambiguities regarding independent directors and promoters showing the failure of corporate governance model. In this, the chairman of the company Mr. Ramalinga Raju, who owned 5% of shares announced that there is falsification

³⁴ Dhammika Dharmapala, Vikramaditya Khanna, Corporate Governance, Enforcement and Firm Value: Evidence from India, *MLS*, no. 8, p. 9 (2008).

³⁵ Joe Nocera, Satyam Chief Admits Huge Fraud, *NYT*, Jan. 8, 2009.

in the financial statements which consisted of US\$1 billion on its books. Company's stock prices fell more than 70% which wiped off the resources of shareholders. This incident is also a matter of discussion as it necessitates to examine the number of misstatements which could be made even after complying with the provisions and requirements of not just clause 49 but also SOX because the company was enlisted on NYSE, Satyam had complied to all the important requirements as imposed by "clause 49 and SOX" like independent directors, audit committee, financial statements by audit but still such a big failure took place.

The failure of audit process which is evident through financial misstatements even after checks and balances which were provided in the form of internal, statutory audit along with audit committee. The independent directors of Satyam also failed in protecting the shareholders from such falsification. This showed as to how the independent directors were portrayed as protector of minority shareholders providing for a false sense of security. Rather they are which becomes hindrance in realising frauds even if they exercise due diligence in all their actions. Apart from this the issue of promoters also came into light as Indian law provides for distinct roles to promoters which holds good even in case of companies with controlling shareholders.³⁶ As in this case, the promoters of the company had only 5% of shares when the announcement was made. In general, a company with 5% of shareholding by promoters will be classified as under diffused shareholding which is within outsider model. But not having enough controlling shareholders complemented with the concept of promoters in Indian sense makes the demarcation between outsider and insider model blurry as in the present case. All this demonstrated as to how a company with a minimal shareholding can also be influenced by the promoters, giving rise to agency problems between controlling and majority shareholders. This also showed the inadequacy of existing governance norms to deal with family- controlled companies where even the promoter shareholding is low.³⁷ The reforms being undertaken should take note of the situation of minority shareholders in the companies which are in middle of insider and outsider model.

CONCLUSION

There have been constant measures taken from the side of SEBI for the betterment of corporate governance in India. The opening up of Indian market was influenced by globalisation and

³⁶ S. Mishra & R. Shinde, Satyam Esop-Holders in Deep Sea as Valuation Takes a Hit, *ET*, Jan. 8, 2009.

³⁷ Salil Tripathi, India Faces an 'Enron Moment', *WST*, Jan. 9, 2009.

liberalisation. Although there were certain changes which came through the reforms, however it did not distinguish between the system which existed in developed economies like U.S. and U.K. and the one which exists in India i.e., outsider model and insider model. Till the time these differences are not acknowledged and taken into account while framing rules and regulations for Indian corporate regime. These differences need to be identified and deliberated upon so that the concerned agency problems as faced in Indian scenario can be resolved.

The major issue which forms the centre of insider system is overarching influence of controlling shareholders on the governance of company which impacts the rights of minority shareholders, which needs to be resolved. Apart from bringing new regulations, certain modifications can be made to the existing ones to make them more suitable. This can include the improvement in external audit process and making audit system as totally out of controlling shareholders purview. The same should be done with regards to independent directors where keeping entire reliance on them for checks and balances need not be done unless and until their appointment is through effective process. The concept of promoter should also be looked into as it restricts the transition of corporate governance model along with looking into enforcing fiduciary duties on part of majority shareholders. Thus, rather than taking up laws from one jurisdiction and implementing them into other, without any regard to either of the structure will into a faulty foundation of corporate system, as it is already demonstrated as to how existing concepts engage themselves with agency problems between managers and shareholders which do not form the crux of Indian corporate governance.

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