THE AGENCY PROBLEM WITH REFERENCE TO REGISTERED COMPANIES UNDER THE COMPANIES ACT, 2013

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INTRODUCTION

According to Jensen and Meckling[1] the agency relationship is a contract under which one party (the principal) engages another party (the agent) to perform some service on his behalf. As part, the principal will delegate some decision-making authority to the agent. Applied to finance theory, the agency problem refers to the conflict of interest arising between creditors, shareholders and management because of differing goals.[2] The agency problem emanates from the arrangement where the interests of the agent differ substantially from those of the principal because of the impossibility of perfectly contracting for every possible action of an agent whose decisions affect both his own welfare and the welfare of the principal[3].

The agency problem arises due to the separation of ownership and control of business firms. In theory the shareholders, being the owners of the firm, control its activities. In practice, however, due to a diffuse and fragmented set of shareholders, the latter appoints a board of directors to direct the affairs of the company. The board would similarly delegate the duty of day to day running of the organisation to managers. In terms of this arrangement therefore, managers are the agents of the board whereas board members are also agents of the shareholders. On the other hand, Corporate Governance can be defined as the system by which corporations are directed and controlled in line with stakeholder expectations. Such task is placed upon the shoulders of directors and senior management. Corporate governance facilitates the attainment of common sense business objectives like effective business and risk management, establishing and maintaining good relations with shareowners, ensuring reasonable and sustainable returns, compliance with applicable laws and regulations among others.

[1] Meckling, William H. and Jensen, Michael C., Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure (July 1, 1976). Michael C. Jensen, A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS AND ORGANIZATIONAL FORMS, Harvard University Press, December 2000; Journal of Financial Economics (JFE), Vol. 3, No. 4, 1976, Pg.172

[2] http://www.investopedia.com/walkthrough/corporate-finance/1/agency-problem.aspx; Last visited on 23/10/2017

[3] Brennan, M. J., INCENTIVES, RATIONALITY, AND SOCIETY; Journal of Applied Corporate Finance, Vol.7, Issues 8, Pg.192(1994)

In light of the agency problem, corporate governance principles assist in lessening the worry among investors about the "professional manager" who wields excessive power.

CORPORATE GOVERNANCE IMPLICATIONS

Inherent in any principal-agent relationship is the understanding that the agent will act for and on behalf of the principal. The agent assumes an obligation of loyalty in the performance of the act. An agent cannot take personal advantage of the business opportunities the agency position uncovers. A principal, in turn, reposes trust and confidence in the agent. These obligations bring forth a fiduciary relationship of trust and confidence between principal and agent.

However, the principal-agent relationship that subsists between the shareholder and the directors on one hand and between the directors and managers on the other is fraught with some problems. The agency problem is compounded by the conditions of incomplete and asymmetric information as between the principal and the agent. Shareholders (as principals), expect directors/board members (as agents), to make decisions that will lead to the maximization of the value of their equity. In the same vein, directors (as principals) expects management (as agents) to pursue strategies and operations that contributes to the bottom-line and are in tune with the board's expectations. This scenario means that the shareholders who should stand to benefit from the profitability of the company do not have direct control over what management (who generate that profitability) does. This dilemma, which is a consequence of the separation of ownership and control, raises worries that the management team may pursue objectives attractive to them, but which are not necessarily beneficial to the shareholders. The distance that is created between the shareholder and management team therefore breeds the problem of a serious lack of goal congruence, i.e. where there is no alignment of the actions of senior management with the interests of shareholders.

Alleviation of discrepancies between shareholder and manager interests calls for strong corporate governance measures if shareholders are to be protected from financial losses resulting from corporate and market financial scandals.

Role of the Board:

Corporate governance bestows a variety of duties on directors. Bonazzi L.,[4] defines the function of the board as a collective responsibility to determine the company's purpose and "ethics"; to decide the direction, i.e. the strategy; to plan; to monitor and control managers and CEO; and to report and make recommendations to shareholders. To ensure that directors diligently discharge these duties, personal liability attaches to individual directors if the company can be shown to have been trading "wrongfully" or illegally carrying out

[4] Bonazzi,L., and Islam,S. Agency Theory and Corporate Governance: A study of the Effectiveness of Board in their Monitoring of the CEO. Journal of Modelling in Management Vol. 2 No. 1, Pg. 7(2007).

activities contrary to laws and regulations. This personal liability will help lessen the agency problem caused by directors pursuing their own personal interests.

Board Structures:

One mechanism of corporate governance that may be used to ensure that checks and balances are in place to minimise the agency problem would be to appoint independent non-executive directors to the board of directors[5]. It will ensure that management is monitored for operational performance. For example, in terms of the RBZ Guidelines on Corporate Governance[6], all banking institutions boards should have a minimum of five (5) directors, the majority of whom should be non-executive. In India, the board of director of a company should have both executive and non-executive directors. At least 50% of the board should have non-executive directors. If the chairman of the board is a non-executive director, then at least one-third of the board should comprise independent director. If the chairman is an executive director, then independent directors should make up at least half of the board. If an independent director resigns or is removed from the board, he/she has to be replaced by a new independent director within 180 days from the day of such resignation or removal.

Thus, a board more likely to protect shareholders from agency problems would be one with separate individuals controlling the firm and the board[7]. Such a board composition is important in ensuring that interests of minority shareholders are protected and given due consideration in the decision-making process. Effective directors are typically those that make the board more independent from the internal workings and individuals of the firm.

However, there are some boards which do not conform to codes of corporate governance like the Cadbury (1992) Report[8], hence are susceptible to manipulation by management to the detriment of the shareholders. Specifically, they find an inverse relationship between board strength and a number of board characteristics. A board which is dominated by directors who are also members of the executive employees of the company are not independent. Such a set up would mean that managers and board members may pursue goals which do not necessarily lead to the maximization of the value of the shareholder's equity. As Webb[9] observes, such a board would encourage “entrenchment” and “managerialism”. By entrenchment, management would be protecting themselves through reducing the monitoring power of the board.

Managers might be “satisfiers” rather than “maximisers”, i.e. they tend to act in a risk-averse manner and seek an acceptable level of growth because they are more concerned with

[5] Stephen A. Webb, Social Work in a Risk Society: Social and Political Perspectives, 2006, Pg. 10
[6] Corporate Governance Guidelines, 2004, Reserve Bank of Zimbabwe available at http://www.rbz.co.zw/assets/corporate-governance-2004.pdf, Last Visited on 24/10/2017
[7] Supra 4
[8] Cadbury, A. (1992). *Report of the Committee on the Financial Aspects of Corporate Governance*. London: Gee. Pg. 225
[9] Ibid

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perpetuating their own existence than with maximising the value of the firm to its shareholders.

Eg: *Earnings retention conflicts:* Managers may increase retained earnings in order to finance some projects which would not necessarily enhance shareholder wealth. Such grandiose managerial investment policies may not produce results that are clearly apparent to the shareholders as it may be to management. The resultant growth grants to management a larger power base, job security, greater prestige/status, and an ability to dominate the board and award themselves higher levels of remuneration[10]. On the other hand, shareholders would prefer higher levels of cash distributions, especially where the company has few internal positive Net Present Value (NPV) investment opportunities, hence producing a clash of interests between principal and agent.

To mitigate against negative consequences of the agency problem outlined above, various statutory and non-statutory mechanisms may be employed as analysed below.

STATUTORY PROTECTION AVAILABLE TO SHAREHOLDERS: THE COMPANIES ACT, 2013

A company formed and registered under the Companies Act, 2013 including companies that are previously registered under any of the previous laws defined under Section 3 of the Act are called incorporated/ registered companies.[11]

Legislation in the form of the Companies Act, 2013 (hereafter to be referred to as "the Act") has been promulgated to afford shareholders some protection in the face of challenges caused by the agency problem. Such protection is critical given the vast powers that directors have.

Qualifications and Appointment of Directors

The Act prescribes no age limit for for a person to become a director. However Schedule V of the Act that the Managing Director/ Whole Time Director/Manager should have completed an age of 21 years and not above 70 years.

Section 164[12] of the Act prescribes who cannot become a director. For example, a person with any legal disability, a person convicted of certain classes of economic crimes are not

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[10] Supra 1
[11] https://www.corporate-cases.com/2012/01/incorporated-registered-company-meaning.html; Last Visited on 25/10/2017
[12] **Sec 164-Disqualifications of directors**: A person shall not be eligible for appointment as a director of a company, if —

(a) he is of unsound mind and stands so declared by a competent court;
(b) he is an undischarged insolvent;
(c) he has applied to be adjudicated as an insolvent and his application is pending;

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eligible for appointment as director. The objective for placing such restrictions is to keep directorship and management of the company under responsible hands. This screening process will give solace to the shareholder who would know that his investments are under the stewardship of directors who can be trusted.

Further, the Act requires directors (the agents) to be appointed by shareholders (the principals).The Companies Act, 2013 does not contain an exhaustive definition of the term "director". Section 2 (34) of the Act prescribed that "director" means a director appointed to the Board of a company. A director is a person appointed to perform the duties and functions of director of a company in accordance with the provisions of the Companies Act, 2013.

According to section 151 of the Act every listed company may have one director elected by such small shareholders. For the purpose of this section, "small shareholder" means a shareholder holding shares of nominal value of not more than twenty thousand rupees or such other sum as may be prescribed.

Section 152 of the Act gives members/shareholders an opportunity to consider merits of each director individually. Thus, the qualifications required of directors as well as the appointment procedure to be followed ensure that incidents of adverse selection and moral hazard are minimised.

Removal of Directors by Shareholders

To ensure that some checks and balances exist, the Act has a procedure for the removal of directors by shareholders. In terms of section 169(1)[13] of the Act, shareholders can utilize their power from the democratic process of voting by which means they can elect or dismiss directors. When appropriately used, the power to remove directors from office would effectively afford shareholders protection against errant directors who tend to pursue practices that work at cross-purposes with interests of shareholders.

Fiduciary Duties of Directors: No Conflict of Interest

The relationship between the director and the company is a unique one. A director stands in a fiduciary relationship to the company. As such, a director is statutorily bound by the Act to discharge his duties and exercise his powers for the benefit of the company, not his own. This should be reflected in two major ways; firstly, that directors should act with skill

(d) he has been convicted by a court of any offence, whether involving moral turpitude or otherwise, and sentenced in respect thereof to imprisonment for not less than six months and a period of five years has not elapsed from the date of expiry of the sentence:

[13] **169. Removal of directors :**
(*1*) A company may, by ordinary resolution, remove a director, not being a director appointed by the Tribunal under section 242, before the expiry of the period of his office after giving him a reasonable opportunity of being heard:
Provided that nothing contained in this sub-section shall apply where the company has availed itself of the option given to it under section 163 to appoint not less than two thirds of the total number of directors according to the principle of proportional representation.

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and care and secondly, that they should act in good faith. Table "A" Articles as read with section 166[14] of the Act therefore places a special procedure to be followed where directors are required to declare any possible conflicts of interests that may compromise their objectivity when discharging company business. Such a procedure helps preclude incidents of abuse by directors and managers who stand to benefit from inside information they may have gained by virtue of their positions in the company.

Convening of Members' Meetings

In terms of section 142 of the Act, every public listed company is obliged to convene a statutory meeting where directors should present a statutory report. Further, every company (both private and public) should convene an annual general meeting (section 96[15]), where specific business to do with the affairs of the company is discharged.

[14] **166. Duties of directors**
(*1*) Subject to the provisions of this Act, a director of a company shall act in accordance with the articles of the company.
(*2*) A director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of environment.
(*3*) A director of a company shall exercise his duties with due and reasonable care, skill and diligence and shall exercise independent judgment.
(*4*) A director of a company shall not involve in a situation in which he may have a direct or indirect interest that conflicts, or possibly may conflict, with the interest of the company.
(*5*) A director of a company shall not achieve or attempt to achieve any undue gain or advantage either to himself or to his relatives, partners, or associates and if such director If found guilty of making any undue gain, he shall be liable to pay an amount equal to that gain to the company.
(*6*) A director of a company shall not assign his office and any assignment so made shall be void.
(*7*) If a director of the company contravenes the provisions of this section such director shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

[15] **96. Annual general meeting**
(*1*) Every company other than a One Person Company shall in each year hold in addition to any other meetings, a general meeting as its annual general meeting and shall specify the meeting as such in the notices calling it, and not more than fifteen months shall elapse between the date of one annual general meeting of a company and that of the next:
Provided that in case of the first annual general meeting, it shall be held within a period of nine months from the date of closing of the first financial year of the company and in any other case, within a period of six months, from the date of closing of the financial year:
Provided further that if a company holds its first annual general meeting as aforesaid, it shall not be necessary for the company to hold any annual general meeting in the year of its incorporation:
Provided also that the Registrar may, for any special reason, extend the time within which any annual general meeting, other than the first annual general meeting, shall be held, by a period not exceeding three months.
(*2*) Every annual general meeting shall be called during business hours, that is, between 9 a.m. and 6 p.m. on any day that is not a National Holiday and shall be held either at the registered office of the company or at some other place within the city, town or village in which the registered office of the company is situate:
Provided that the Central Government may exempt any company from the provisions of this sub-section subject to such conditions as it may impose.

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Additionally, members have the power to call for or requisition an *extra-ordinary general meeting*. These various meetings are significant in advancing corporate governance and reducing the agency conflict as they assist in bridging the information asymmetry existing between shareholders and managers.

Annual Reports and other Disclosures

It is mandatory for every company, to forward to its members, along with its annual Financial Statement the Board of Director's report. Report of Board of Directors should be attached to the Balance Sheet laid before the AGM.

A director's report is intended to explain to shareholders, the overall financial position of the Company and its operation & Business Scope. In Companies Act 2013, lot of sections makes it mandatory to make disclosure in Boards report contrary to previous Act, where only section 217, talks about the Boards Report.

As per Section 134(6) of the Act, Board Report and annexure thereto shall be signed by

(i) At least 2 (Two) Director, one of whom shall be a Managing Director.

(ii) its 'CHAIRPERSON' if he is authorized by Board of director; Where he is not so authorized by,

(iii) If there is no Managing Director then by Two Directors.

Significant issues of corporate governance arise here. Effective corporate governance by company boards requires both good information and the will to act on negative information. The requirement to distribute the company's accounts and other reports to members forms the hallmark of transparency and accountability by the agents to their principals and ensuring that information asymmetry is reduced as between agent and principal.[16] Thus, the platform afforded by statutory and other meetings and the reports that are presented at those meetings gives shareholders an opportunity to assess not only "what" a company reports but also "why" particular actions were taken.

Limits on Power of Directors

As a way of averting corporate scandals where directors would end up prejudicing the shareholders, the law prohibits directors from disposing of the undertaking of the company or of the whole part of such company's assets without the approval of the company in a general meeting. This limits the powers of directors to unilaterally do as they wish with the company's assets, hence preventing the possibility of ripping-off shareholders.

[16] Shivdasani, A. and Yermack, D. (1999), *CEO involvement in the selection of new board members: an empirical analysis*, Journal of Finance, Vol. 54 No. 5, Pg. 1829.

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In the case of *Jaswant Rai Arora Vs. Bhawani Paper Mills Ltd*[17] while interpreting Section 241[18], read with section 242, of the Companies Act, 2013 it was held" Where assets of company were sold without informing petitioner director holding majority shares in company, itself, was proof of alleged act of oppression and mismanagement"

OTHER / NON-STATUTORY PROTECTION AVAILABLE TO SHAREHOLDERS

Apart from the statutory provisions, other measures are also available to be taken by shareholders to shield themselves from the agency problems.

Appointing Non-Executive Directors

As stressed above, one of the reasons for the existence of the agency conflict is the appointment of board members who are also members of the management team (executive board members). To counter the negative effects of a board dominated by the management team, shareholders may consider shifting the board composition in favour of non-executive directors. A non-executive board member would not normally sympathize with decisions that are in conflict with the goal of maximising the wealth of shareholders[19]. Effective boards dominated by non-executive directors are better able to separate the problems of decision management and decision control.

Managerial and Director Incentives

Effective compensation contracts should provide management with sufficient incentive to make value maximising decisions at the lowest possible cost to shareholders. The main forms of managerial and director compensation are basic salary, accounting-based

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[17] Jaswant Rai Arora vs. Bhawani Paper Mills Ltd, [2017] 85 taxmann.com 263 (NCLT - Kolkata)

[18] **241. Application to Tribunal for relief in cases of oppression, etc**

(*1*) Any member of a company who complains that—

(*a*) the affairs of the company have been or are being conducted in a manner prejudicial to public interest or in a manner prejudicial or oppressive to him or any other member or members or in a manner prejudicial to the interests of the company; Or

(*b*) the material change, not being a change brought about by, or in the interest of, any creditors, including debenture holders or any class of shareholders of the company, has taken place in the management or control of the company, whether by an alteration in the Board of Directors, or manager, or in the ownership of the company's shares, or if it has no share capital, in its membership, or in any other manner whatsoever, and that by reason of such change, it is likely that the affairs of the company will be conducted in a manner prejudicial to its interests or its members or any class of members, may apply to the Tribunal, provided such member has a right to apply under section 244, for an order under this Chapter.

(*2*) The Central Government, if it is of the opinion that the affairs of the company are being conducted in a manner prejudicial to public interest, it may itself apply to the Tribunal for an order under this Chapter.

[19] https://corporatelaws.taxmann.com/company-law-commentary.aspx; Last visited on 25/10/2017

performance bonuses, performance-based share option schemes and long-term incentive plans.

Accounting Based Bonus Schemes

Basing bonuses upon accounting measures of performance provides an improved mechanism for aligning managers' interests with those of the company's shareholders. At the same time, Bonuses related to company sales may further encourage earnings retention and firm size growth, which doesn't always equate with payment of dividends hence shareholder wealth growth. Another weakness is that accounting bonuses may also lead to a focus on the determining variables of these compensation plans, perhaps leading managers to neglect other non-financial aspects of performance like occupational health and safety; social investment; environmental impact; and development and skilling of staff.

Performance Shares

The use of share options in executive compensation plans is generally seen as the one of the most effective means of tying the interests of managers and shareholders. Under this scheme, shares are offered to managers as a reward for performance which enhances shareholder wealth. Such options give management the right to buy company stock at a fixed price at given times in the future.

Threat of firing

One of the most consistent empirical results in the corporate governance literature is that directors are more likely to lose their jobs if they are poor performers. Poorest performing management would lose their jobs at the instance of directors, more so should such poor performance be for prolonged periods. In light of this, managers may be forced to take shareholder maximising actions simply in order to keep their jobs and in the process protecting the interests of shareholders hence reducing goal non-congruence between shareholders and management.

Block holder or Institutional Investors

The existence of large block investor(s) in a company may overcome the problem normally encountered by small shareholders who may not have the time, skill, or the interest to monitor managerial activities. Institutional shareholders are better able to overcome this challenge, as they may have more skill, more time, and a greater financial incentive to overcome this free-rider problem and closely monitor management. Additionally, large shareholders may be able to elect themselves onto company boards, increasing their ability to monitor management. [20] Further, institutional shareholders like pension funds and insurance companies can afford to exert direct intervention. The managers of these institutions usually have the power and take an active interest in the management of the companies in which they hold shares. They can lobby for the interests of all shareholders

[20] Supra 18

and suggest ways in which the business may be run. Such direct intervention by shareholder representatives will influence management into shareholder value maximization.

Disciplinary Take-overs

Disciplinary takeovers will occur in response to breakdowns of internal control systems in companies with large levels of free cash flows. A hostile takeover is likely to happen when the shares of the company are undervalued relative to their potential due to poor management. Where managers fear that they may lose their jobs following takeovers, they may react by investing these free cash flows in more efficient investment projects.

CONCLUSION

Agency problems are real in the business realm. The scope of each type of agency conflict will differ from one firm to another, as will the effectiveness of governance mechanisms in reducing them. However, hope is not lost for the shareholder as various mechanisms may be employed, both statutory and non-statutory to minimise the damage to shareholder wealth caused by agency problems. Each type of governance and other mechanisms discussed in this paper can be important in reducing the agency costs of the separation of ownership and control, and afford protection to the shareholder.