

October 2011

Ensouth

The E-magazine brought to you by

N South

Advocates

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1. Managing Partner's Message

This has been a year of such tumultuous change that the entire July issue of Ensouth was devoted to the 2G scam and its consequences alone. This time, we go back to the legal basics and the topical.

First, in **Implosion Prone**, we examine the central structural flaw in Indian family owned businesses which destabilizes them from time to time.

Next, in **Built to Last.**, we analyze the sort of family constitution that could lead to a more stable long term future for family owned businesses.

Third, although we may want to get past the 2G scam, in **Collateral Judicial Damage**, we examine the manner in which judicial attitude to bail in criminal cases has changed.

Finally, in **Public Participation in Parliamentary Democracy**, our associate Ms. Deepti Sinha argues that street protest in India is inevitable unless our democracy becomes more representative.

We welcome your feedback!

Ranjeev C Dubey
Managing Partner

Comment-1

(This column appeared in the December 23rd, 2010 issue of Business World)

Implosion Prone

(The flaw in Indian family owned businesses)

Ranjeev C Dubey

Whatever other lessons the Ambani family spat may have for us, there is little doubt that a family constitution designed to preserve would have helped India's first corporate czar empire hit another order of magnitude by now. Bear in mind that the Mitsui family – which owns 20 per cent of Japan's car industry and 18 per cent of its textile industry – has been held together by a family constitution for over 200 years! Why don't Indian family run businesses write these constitutions? The truth is that the problem is little understood, the solution even less so.

What then is the problem? Unlike the Ambanis which struggled as soon as the founder passed away, things more often fall apart with the third, not the second, generation (Should we tongue-not-in-cheek call them 3G?). Why is this? Second generations consist of blood brothers; they have seen their dad building something from considerably less. They have a sense of reality, a modesty of self image and the memory of a shared journey from a little to a lot more. All this helps them to find a compromise. It helps that their equity holdings in group companies are still substantially equal. As a general proposition, 2G siblings do not split up easily even if they do not always agree.

The equation changes dramatically by the time 3G siblings join management. Management control in 2G is frequently a function of business acumen. The smartest 2G brother runs a great show and ends up with the biggest company: the mediocre brothers end up with smaller businesses. So at the tail end of the 2G era, you have the largest company in the family stable run by the smartest 2G sibling, and his children! Unfortunately, smart

dads do not always produce savvy kids and some mediocre dads produce super smart kids. In the result, the smartest 3G cousins sometimes end up joining their dads in small businesses while the mediocre 3G cousins end up joining their larger than life highly successful dads in the biggest businesses.

Procreative exuberance adds to the skewed pitch of the ball! Because business acumen and reproductive skill do not necessarily run together, some brothers have few children, others more. The ownership pattern – substantially equal in 2G – now becomes significantly unequal. You may have a really bright spark 3G cousin running the smallest company with the smallest share of everything because of the large number of siblings his parents have spawned! You then have the mediocre running juggernauts and bright sparks running bucket shops and everyone resents everyone. By the time the 4G kids start to go to school and their 3G parents start to think about what comes next, the knives are being sharpened.

There is a third element to this déjà vu charade. One talented 3G cousin running a small ship may have large shares in a juggernaut his mediocre cousin runs. It's a case of 'my money and your bird brain' and this simmering discontent frequently triggers a complete breakdown in the family consensus.

At the best of times, over skill and under empowerment is the stuff of palace coups and if it doesn't happen all the time, its because the law does not allow a Mughal emperor style physical - or economic – slaughter. That the family will split is about the only viable option, and yet, it's a poor option at best. So what is to be done?

We need to begin by recognizing that some things can't be done. First and foremost, no family constitution can neutralize the impact of differing procreativity, nor should it. We are all free to choose how many children we will raise and we take responsibility for the consequences of the choices we make. Not to put too profane a point of it, as you make your bed, so you must lie on it!

Second, since fractured ownership across differently sized companies is a given, the family must confront the practical reality of unraveling it. The smartest option here is to cut through the maze of cross holdings and give to each 3G cousin, ownership control of what he runs, and making up the balance in cash. This has the benefit of leaving everyone in-charge of whatever they are doing and free to run their ships to their will at their own risk. Unfortunately, this is totally impractical. Some cousins don't have the cash to give, some cousins don't want to run the companies they do, and most significantly, the tax consequences of these share transfers may be too forbidding to behold. Besides, to unravel the cross holdings is half way to a split which is what we are trying to avoid.

The second smartest option here is to divorce ownership and management completely, a lovely utopian solution that I have found unimplementable for four more or less credible reasons. First of all, many Indian families don't like professional managers, seeing them as spread sheet artists with a lot of jargon and not much appreciation of ground realities. Even when this is not so, there is this unique perception that power without responsibility - or executive freedom without ownership risk - is commercial suicide. Third, social and political leverage comes from the resources a man controls: it is difficult to be merely rich and still have esteem in society. How many shareholders has Businessworld interviewed this year only because they are shareholders? Finally, the material benefit of running a business – and I mean rupees and paisa – is not mainly in the dividends that flow to the owners! Everyone wants that action.

We are then in that classic bind: management control bears no relationship to ownership stakes or managerial talent and no one is prepared to let go. In a perfect world, all group companies would be handed over to professionals to manage and the family would engage itself in philanthropy and of course, shareholder politicking! Since the perfect world is an illusion, it becomes critical to have a family constitution. The whole purpose of a family constitution is to determine the mechanism by group company management is determined. There is more to it of course. A family constitution is not a shareholders agreement of the type we write for collaborating arms length businessmen. There are emotional sensitivities here, the need to stay together for reasons other than commercial prudence, and extra commercial considerations, emotions and legacies that are handed down from generation to generation. Such a constitution requires a deep understanding of the dynamics of Indian families, and of the legacies that are flowing through the blood of each generation. The text and subtext of this family constitution is a large subject, one worthy of another Fine Print, but we cannot underestimate its necessity.

The choice then is simple: write a constitution or face blood on deal street preparatory to an acrimonious split. After all, doesn't everyone want to avoid what happened to India's first and wealthiest family after its patriarch passed away?

Comment-2

(This column appeared in the March 11th, 2011 issue of Business World)

Built to Last

(Preparing constitutions for family-run businesses in India)

Ranjeev C Dubey

When it comes to loyalty and unity, families are no different from nations: identity, culture, self-image, emotion and the instinct for self-preservation comes together in a dynamic unstable mix, the result of which is never certain. In *Implosion Prone* (Businessworld Dec 23rd, 2010), we examined why joint family businesses are torn apart for lack of a family

constitution. Let us now turn to ask the next logical question: what would be the structure of such a family constitution?

Just so there is no misunderstanding, let us be perfectly clear that we are not talking about standard shareholder agreements here. Commercial shareholders agreements are written by arm's length contracting parties who want to synergize their individual strengths so that they can take advantage of specific business opportunities. In doing so, they know that they are collaborating for a finite time for a finite set of objectives. Joint Ventures are not intended to last in perpetuity, their collaborators are partner but they aren't married! This is not true of family businesses. To put it bluntly, joint ventures are about the business while joint family businesses are about the family. We need something else.

What any business structure looks like depends on what we want it to do for us. Here is one possible list of objectives:

- The first task of any constitution - family or nation - must be to preserve. Every family will sooner or later contain disgruntled or fringe elements, or both, with low stakes, high nuisance value and an exaggerated ability to destabilize the group. There must be an easy way to exit such a fringe element without threatening the lot.
- Every government requires a highly empowered executive arm, a sagacious conscious keeper who balances the enthusiasm of individuals and brings a certain gravitas to the quality of management. Since it is difficult for one person to perform this task, a family council is generally a very good idea. Its also very good family politics!
- Executive arms of governments require executive heads. Group companies must be managed by competent persons through a transparent election mechanism. Equal opportunity is the key.
- Every stable society is run by rules that are clearly understood. Decisions on family affairs must be made through a fair application of rules in order to achieve the greatest good of the greatest numbers. Everyone can't be deliriously happy at all times: the rules can only secure that there is no injustice.

How do we translate these touch points into a practical program of action? Let's start with our first objective. Prioritizing preservation means that the family constitution does not allow group companies to separate out, just as India's constitution does not provide a mechanism by which India cedes territory to its neighbors. This does not mean that we cannot allow individual shareholders to leave, any more than Indians are prohibited from leaving the country. If a member of the family does not want to work in the family business, he is free to work elsewhere and he is still free to enjoy the benefits that his ownership brings. However, if he wants to cash out of the family business, he must leave his shares behind. So, an honorable exit mechanism is the first priority because if you don't provide for it, the disgruntled shareholder is going to raise hell and upturn everyone else.

What would such an exit provision look like? Clearly, the exiting shareholder must be paid fair value for his shares. Equally, this price must be independently determined by an impeccable authority. So far, this is a standard put option and it is easily agreed. However, the exiting sibling cannot be free to decide who will buy his shares because this will open another cauldron of family politics. So who will decide? We need a committee, a Family Council. In the context, it will be the Family Council's task to oversee the appointment of the entity that values the shares, the physical process for valuation of these shares, the cost of undertaking this exercise, indeed the entire secretarial aspect of the process. In circumstances where no single family member is prepared to buy these shares, there can be a mechanism by which every family member is obliged to buy some of the shares, or the shares are taken up by a family trust and financed through some kind of leveraged acquisition structure. As is obvious here, it is key that the family gets a Family Council that is both sagacious and trustworthy.

This takes us straight to both the heart of the matter and the second objective we have set out for ourselves: the pivotal nature of the Family Council. As is already apparent, the sovereign authority of the family must rest with the Family Council. How is it to be constituted? Broadly, two patterns are possible: Adult Franchise and Voting Blocks. Each method has its madness.

Adult Franchise - meaning every family member has a vote - is a bit like democracy in a largely illiterate land and you can see the mischief. That said, most democracies eventually settle for this model simply because all the others are biased and elitist. Every member of a family is given a vote and any family member can lobby to be elected to the Family Council. The result of this exercise is easily predicted up to the 4th generation perhaps but the real benefit begins to flow by the time 100 years have passed.

This is how the other method - Voting Blocks - works. If a family has say four second generation brothers, 25 per cent blocks of 'voting rights' are assigned to each brother. In turn, within each brother's family group, these voting rights are split again between his children. Thus if a brother has 3 children, each gets one third of 25 per cent i.e. 8.33 per cent voting rights. In turn the children of each child inherit equal shares of those 8.33 per cent voting rights. This system is complex in the conception but it actually works as well as Adult Franchise.

There is little limit to the role we can mould for the Family Council but it should be clear that it is not a law maker; it is a governing council, policeman and court of justice rolled into one. It supervises the enforcement of the Family Constitution, but does not write a new one without a referendum. It is constituted for a period and members are elected to it periodically: we have even written one where family members retire by rotation. It is a watchdog but it is not an executive body. It does not run

companies and does not ask Group Company CEO's to report to it. It does appoint directors to group company boards. Does it replace the sovereignty of the shareholders meeting? Not in my conception but it does guide the voting of the shareholders block in a listed company.

This takes me to the third element of the Family Constitution: the management of Group Company. Notwithstanding the enthusiasm of every family member of most family run companies to steer their own ship, I am quite clear that every Family Constitution must have an equal opportunity clause. This equal opportunity must not only exist between family members, it must also extend to equal opportunity between a family member manager versus an external professional manager. Once a simple family democracy has been established, any group is free to recommend its nominee as a manager - blood brother or stranger - and it is for the family to decide what must be.

And that brings us to the final big picture point here. A Family Constitution is only as good as the Family Council that implements it. It does not help to have a great constitution but no rules by which it is implemented. Written down transparent procedures lie at the heart of every fair society and a fairly formal way of functioning is the best way to build trust. Every Family Constitution we have written has a long annex legislating the rules of business that its Family Council will follow. This includes rules on how scheduled and extraordinary meetings are held, mechanisms by which meetings are convened and procedures applicable at the meetings. All this may seem faintly ridiculous when we are talking of two brothers and 5 cousins but by the time we get to the fourth generation, trust me, this very formality will secure continuity for several hundred years.

Comment-3

(This column appeared in the June 11th, 2011 issue of Business World)

Judicial Collateral Damage

(In the august quest for a better cleaner society, we are seeing a certain subversion of the very legal system we have meticulously upheld)

Ranjeev C Dubey

When it comes to criminals, a great many Indians think that the real problem with India is its laws, or lack of them. We hear cocktail party chatter that criminals should be shot out of hand and that corrupt politicians should be sent to jail without trial and so forth. Not that we don't already shoot criminals out of hand: what else are 'encounters' but assassinations? Lately, we also seem to be sending a lot of people to jail without any great 'legal' reason to do so. I will give you some examples.

This new trend first emerged in October 2010 when Satyam's promoter Raju had his bail cancelled by the Supreme Court because he was "involved in one of the greatest corporate scams of the commercial world". In the old world, businessmen didn't go to jail for economic offenses, not for long anyway. Then it got worse. Notwithstanding that it is no part of an auditor's

job to discover accounting frauds (Fall Guys), Satyam's internal and external auditors were tossed into jail too and, when the Andhra Pradesh High Court finally let them out, the Supreme Court send them right back. You could have spotted a paradigm shift right there.

Then there was the Pune-based stud farm owner Hassan Ali Khan, who is accused of stashing away humungous amounts of cash in Swiss bank accounts. Like it or not, this rather dodgy looking man, who is also defending a Rs 70,000 crore tax demand, has been attending Enforcement Directorate summons in its on-going investigation for money laundering for nearly ten years! In all these years, the Directorate has not been able to gather material sufficient to arrest him. In March this year, the Supreme Court suddenly decided that custodial interrogation of the man was a good idea. Am I the only one who thinks that in the best tradition of the inquisition, the Enforcement Directorate has received *carte blanche* to 'cleanse his soul through pain' till he squeals and they have a case against him?

Not that anyone cares about this Khan or the Satyam protagonists. Two of them are seriously crooked and the others are either dumb or easily corrupted. Yet the fact remains that if you look at the law on bail as it stands, what is happening here is not right. Let me share some nitty gritty legal stuff with you.

Since at least 1978, the law on letting people out on bail has been clear to the legal community. In the 1978 *Gudikanti Narasimhulu* case, the Supreme Court ruled that there were primarily only two reasons to keep a man in jail: (a) to make sure he turns up for his trial and (b) to keep him from interfering with witnesses. In the colourful words of Justice V.R. Krishna Iyar: "Realism is the component of humanity which is the heart of the legal system...the injustice of innocence long in rigorous incarceration inflicted by the protraction of curial processes, is an irrevocable injury". Okay, that was comic relief for you! I think Justice Iyar is saying that unless we have a very good reason to deny it, we must protect a man's liberty! Who can disagree and still claim to be a liberal?

There is another critical spin we need to put on the table. The 2004 Delhi High Court judgment in *Court on its own motion versus CBI* arose when the first secretary in the Embassy of Tanzania made some fast bucks by issuing visas for cash. The CBI concluded its investigation and filed the charge sheet in court without ever arresting this hotshot. Could he be arrested after the case went to court? The high court said no. A man who does not flee and does not interfere with witnesses during an investigation is not likely to do so later. You'd think that was the last word on the subject. Not so.

Look what is happening in the 2G case. Throughout the investigation, the CBI never made any arrests at all. Once the case went to court, we find powerful businessmen, not so powerful employees of powerful businessmen and a poetic politician —and a woman too — chucked into the slammer for a

good bit. Why? The Delhi High Court judgment defeats me when it argues that the CBI's failure to arrest these persons during investigation "gives an insight into the influence wielded by the petitioners during investigation". Damned if you do and damned if you don't, isn't it? That not being enough, the court also said that just because these accused behaved perfectly "cannot be guarantee that during trial, the petitioners would not try to interfere with the process of justice by tampering with witnesses". What can you say? Why don't I get sent to jail because there is no guarantee I won't drive dangerously and kill someone next week?

What comes through in all this legal speak is that since last year, the courts have found a way to send and keep a great many corrupt types in jail for long periods. The courts have done so in the face of clear and established law thus unsettling well settled principles of law. Most people would agree that at least some of these people deserve to be in jail. Isn't this doing wrong things for the right reasons?

All this may seem very cerebral, arcane and remote because you are dealing with corruption in high places and exotic laws. What happens if these same issues face you? Have you ever tried to get your burnt out electricity meter changed or hook your spanking new house to the municipality's sewerage line. Would you like to spend a long hot summer in jail because you need to move into your new house and can't get a completion certificate without paying someone off? Sure Unitech can live without a telecom license, like you can manage without electricity...

Seen at a distance, I see a clear pattern emerging. As I have already argued (A Century After), the serendipity of changing dynamics in the Indian climate is creating something of an inflection point. The first of these dynamics is political. Having only just managed to put Bofors behind it, very few people believe that the Congress party has a realistic chance of winning another election without doing something about corruption. King Singh wants to do something and Madame agrees. The time has come.

Then there are the changing dynamics within the Indian judiciary. We finally have a man of impeccable integrity at the head of the Supreme Court, determined to undo the damage his two immediate dubious predecessors have done. We also have amongst us now a new breed of crusader lawyers - Prashant Bhushan amongst them - who care nothing for the risk they run in what they are trying to do. These forces have come together to try to initiate change that India desperately needs. Suddenly, corruption is not okay, and we are attacking it at the top.

But there is a problem. In this august quest for a better cleaner society, we are seeing a certain subversion of the very legal system that we have so doggedly and meticulously developed. In our quest for a more obtuse, elusive sense of justice, we are handing out judicial order that on the face of it are unjust. You can be cynical and say this is just collateral damage

but can you afford such damage? I think we need to pause and ponder because history shows that when you start to tamper with something as complex as India's judicial system in this radical way, the Law of Unintended Consequences may have some really nasty surprises yet. And the erosion of individual liberty may be the first of them.

Comment-4

Five year carnival democracy

(Unless our democracy becomes more representative,
street protests are inevitable)

Deepti Sinha

Democracy is supposed to be about majority rules. In India, it's about the candidate who gets rejected the least! The winner gets into power because even fewer people vote for his or her competitors: rarely if ever does the winner carry the approval of the majority of the voters. Is it any wonder then that Indians do not have faith in their government?

Parliamentary democracy gives to the average Indian citizen the right to vote every five years. If an average Indian has the life expectancy of 78 years, then he is expected to cast his vote 12 times in Parliamentary elections in his lifetime. Combining these figures together, we reach the shocking conclusion that an average Indian contributes 0.6% of his lifetime to the democratic process! Is this satisfactory? Is this how we define a government by the people, for the people and from the people? Or have we relegated the classic definition of democracy to the realm of myth, replacing it with a token pseudo democracy?

If the basic purpose of democracy is self-governance, it is natural to assume that the general populace will participate in the manner in which laws and policies are decided. Clearly, with a contribution of 0.6%, not even the most persuasive of political pundits can convince anyone that the common man in India has any influence on any decision-making process. So what choice do the masses have but to get on the streets to make their voice heard to those living in the ivory tower of our Parliament? The recent Lokpal agitation, if studied from the perspective of democracy, was nothing but a demand from the discontented masses to have their voices heard in the creation of a law that deeply impacts their lives. Most of our elected representatives are so alienated from ground realities that more often than not, policy decisions are taken and laws are passed in a total vacuum. Take for instance the Public Liability Insurance Act. In the wake of the Bhopal gas tragedy, this law was enacted to purportedly provide a statutory mechanism to compensate victims of industrial accidents. In doing so, our legislators thought that a measly compensation of Rs. 25,000 is sufficient for a life wantonly lost. No wonder the Bhopal gas victims are still fighting for justice.

Our Constitution envisages that two factors, delegation of powers and accountability, will propel our democracy. The Preamble unequivocally locates

the centre of all power in the voter, which in turn is delegated to elected representatives, who in turn are accountable to Parliament. What actually happens is that the delegated centre of power acts like the real centre of power and since the institution to which they are accountable comprises of them only, there is no real accountability. The larger issue may well be that the two-pronged propulsion engine of our democracy has not found adequate articulation in our election laws. The Representation of People Act, 1951 provides an eligibility criteria for candidates, a procedure of conducting elections and another procedure for resolving election related disputes. Neither this nor any other law makes these representatives directly accountable to the people. This is completely absurd since people are supposed to be the real centre of power. If we want our laws to reflect what the Constitution imagined is the nature of Indian democracy, we will have to change some laws beginning with the Representation of People Act. We will have to give power to the electorate to recall their representative mid-term and choose another to represent them in Parliament or State Assemblies. It goes without saying that such a power should be circumscribed by checks and balances. The procedure may well require that a "petition to recall" be filed with the Election Commission supported by no less than half of the voting population of that constituency. The procedure may well also stipulate that no such petition be accepted before the winning candidate has had two years to prove his worth.

Our first past the post system skews the nature of political representation our people get. A parliamentary democracy splits votes with the result that the winner is the choice at best of a minority. Democracy then becomes minority representation. This encourages political parties to woo small classes of voters. It clouds the true objective of free and fair elections. Elections do not elect candidates interested in and capable of serving the greater good. Political parties pander to particular voting classes, thus creating small interest groups within the electorate. To retain the votes of these smaller interest groups in the next elections, legislators formulate laws that cater to the demands of that interest group, thus creating a bigger divide between the rulers and the ruled.

To bridge this divide, we need consultations before legislation. At present, we invite the electorate by a notice in the official gazette to comments on draft bills before they are legislated. How this works in a country where the vast majority don't know what the official gazette is remains unexplained. Meaningful consultation is impossible without awareness about a bill and this must precede a debate in Parliament. At present, the electorate hears about major bills such as the Civil Nuclear Liability Bill or the Judicial Accountability Bill from the media after they are introduced in the Parliament, leaving little scope for electoral comment. Surely, creating awareness of upcoming legislation should not be a huge brainer in our age of hi-tech digital communication devices. The internet is and can be a powerful tool. Ministries drafting bills should put them up on their website and invite comments from the public. Voters without access to

the internet should be reached through the print media in local newspapers. This comprehensive outreach program should occur at least one session prior to the introduction of the bill in the Parliament for debate. We can then hope that Parliament will listen to the people and the country will avoid embarrassing confrontations of the type we saw in relation to the Lokpal bill.

India needs its electorate to progressively and directly participate in the legislative process. For instance, we need to amend the Constitution to provide for referendums. No doubt, there are obstacles here and the sheer cost of the entire exercise is only one. Referendums will be a practical tool in gauging public opinion when limited to proposed legislation that will affect the lives of many. Objective parameters can be laid down to determine whether a referendum is required before a Bill is legislated.

This is the essence of the matter: what good is a democracy which encourages 1.2 billion people to participate in a huge carnival on occasion and then disperse only to slumber for the next five years? If we don't fix this, we have no business to style ourselves as a democracy.

-X-