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Avinash Kumar

Avinash Kumar has completed his Ph.D. in International Investment Law from the Dept. of Law & Governance, Central University of South Bihar. His research work is on "International Investment Agreement and State's right to regulate Foreign Investment." He qualified UGC-NET and has been selected for the prestigious ICSSR Doctoral Fellowship.He is an alumnus of the Faculty of Law, University of Delhi. Formerly he has been elected as Students Union President of Law Centre-1, University of Delhi.Moreover, he completed his LL.M. from the University of Delhi (2014-16), dissertation on "Cross-border Merger & Acquisition"; LL.B. from the University of Delhi (2011-14), and B.A. (Hons.) from Maharaja Agrasen College, University of Delhi. He has also obtained P.G. Diploma in IPR from the Indian Society of International Law, New Delhi.He has qualified UGC – NET examination and has been awarded ICSSR – Doctoral Fellowship. He has published six-plus articles and presented 9 plus papers in national and international seminars/conferences. He participated in several workshops on research methodology and teaching and learning.

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CLAWBACK PROVISIONS AND CORPORATE GOVERNANCE IN INDIA

AUTHORED BY - SHRISHTI SHARMA

Abstract

This paper will deal with clawback provisions and how they are an effective tool for corporate governance. These provisions work as a mechanism to prevent corporate misfeasance done by key managerial personnel of the company. Clawback provisions are effective in solving agency problems in the company and reduce agency costs. This paper will deal with their development in law in the US as a response to various corporate scandals that have impacted the financial market around the world. The paper will then deal with their legality in India and the law around clawback provisions in India. The paper will also deal with the lacuna in law with respect to its enforcement, which hampers on their effectiveness as a tool for corporate governance in India.

Corporate governance and Clawback provisions.

In today's world, with increased financial activity and participation by the public in the financial markets it is important for companies around the world to have effective corporate governance strategies. Corporate governance strategies by firms help in reducing risk of corporate malpractice and misfeasance. Effective strategies can help tackle agency problems in the company and significantly reduce agency costs. As Armour et al., mentions, that the purpose of corporate law is to establish a structure for the firm as well as to maintain rule for supporting this structure and also to control the conflicts between the firm and its constituents, that is controlling conflict of interests between shareholders, managers and other key managerial personnel.[1] These conflicts materialise into agency problems that can cause hindrances to the proper functioning of the company and cause losses to its business. Agency problems rise when the welfare and interests of one-party are in variance with the interests of another party. As Armour et al. says, contractual relations are subjected to agency problems as agents are better informed with sensitive information than their principals and the principals have less assurance mechanism to ensure that the agent is performing as promised, which gives the agent an opportunity to act in his interests, as opposed

[1]Armour, J., Hansmann, H. and Kraakman, R. (2009) "Agency Problems, Legal Strategies, and Enforcement," *Harvard Law and Economics Research Paper Series No. 644*, pp. 1–17. Available at: https://doi.org/http://www.law.harvard.edu/programs/olin_center/papers/pdf/Kraakman_644.pdf.

to the principal's interest.[2] Overtime, agency problems can lead to frauds and financial misreporting that have the ability to cause international financial scandals. It is, hence, essential for companies to employ and harness corporate governance mechanisms to protect their interests, especially, for key managerial personnel that not only have the power to act in their interest, but due to their high-level position in the company can get benefits from their misconduct easily.

There are various common law duties and obligations that are enforced on directors such as duty to act in good faith and the duty of care, that is directors of a company generally have a fiduciary duty towards the company. This fiduciary duty of directors ensures that they act in the interest of the company and work for the furtherance of the company's business and ensure its wellbeing and welfare.[3] It is an established legal and ethical obligation on the director to act in the company's best interests and can be held personally liable. Claw back provisions are a mechanism to ensure this fiduciary duty of directors and other key managerial personnel. It gives the company a mechanism through which they can hold directors personally liable for their misdeeds that helped them enrich themselves unfairly and against the company's general interests and wellbeing.

Clawback provisions are a mechanism through which compensations and bonuses given to the directors or other key managerial personnel can be refunded or recovered by the company from such executives. A clawback provision is a contractual agreement between the firm and its employees, generally with executives that have power to act in their interests, that allows the firm to recover the bonuses and compensation given to executives.[4] This is done in cases where the executive had acted against the interests of the company and had acted in bad faith. This is done so that executives or directors do not unfairly enrich themselves by their own misdeeds and hence, clawback provisions act as a penalty in cases of corporate scandals against executives. Similarly, a malus clause, on the other hand, allows the firm to stop further payment of bonuses and compensation to directors after their misconduct is reported. Though, they work in a similar fashion but, clawback provisions work as a penalty as they recover all the benefits that the executive or the director have accrued during the employment due to their misconduct.

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[2] *Supra* note 1.
[3] Mittu, N. (2020) "Comparative Analysis of Corporate Governance in India and USA," *VSLR*, 2.1 (18), pp. 18–27.
[4] Babenko, I. *et al.* (2012) "Clawback provisions," *SSRN Electronic Journal*, pp. 1–59. Available at: https://doi.org/10.2139/ssrn.2023292.

Implementation and benefits of clawback provisions

The implementation of clawback clauses is likely to be sped up by signs of poor corporate governance, such as fraud, earnings restatements, and bankruptcies, as well as the ensuing relentless scrutiny from regulators and investors.[5] There are many reasons for implementation of clawback provisions, and they should be considered by the Board of Directors of a company as they reduce agency cost. In such a case, directors will be incentivised to keep their bonuses and compensations intact and not to have them recovered by the company for corporate misconduct.

As Babenko et.al., mentions, they are broadly three reasons for implementing clawback provisions by a company. Firstly, a company-adopted clawback clause can more broadly impose a financial cost post the reporting of the misconduct on an executive who expressly engages in such misconduct or who is inferred to have acted improperly and is like more focused regulatory initiatives limited to fraud and accounting restatements.[6] Secondly, a clawback strategy that permits future recovery may be able to fix a time period discrepancy between recovery and the apparent resolution of the consequences of earlier managerial acts, leading to better managerial judgements initially.[7] This is because impact of managerial decisions can be felt in the future, when the manager would have already benefitted from his misconduct by acting for their own interests. Thirdly, the information regarding business dealings is likely to be improved by a clawback provision as it penalises executives for false financial statements, allowing for more effective incentive alignment via compensation contract.[8] Lastly, a clawback provision is likely to restrict inappropriate and unwise risk-taking by managers and may unintentionally suppress prudent risk-taking as well by extending officers' culpability for unfavourable corporate results and executive wrongdoings.[9]

A clawback provision is essentially a contract between the company and the executive and hence each could be personalised to accommodate the risk reducing behaviour for that company or financial sector in the market. A clawback provision is a great incentive for the executives of the company to work in accordance with company's goals as it reduces the possibility of the provisions being activated, which would lead to their compensation being surrendered and withdrawn. Such provisions directly affect the top executives of a company and hence is an

[5] *Id.*
[6] *Supra* note 4.
[7] *Id.*
[8] *Id.*
[9] *Id.*

effective and useful tool in tackling problems with respect to financial frauds and misreporting within the company. A clawback provision is especially required for solving the agency problem arising from equity incentives, as an executive would keep the stock prices inflated as it affects their equity-based compensation.[10] Equity-based compensation is directly related to the stock price and can lead the executive from hiding or sharing sensitive information for their benefit. Also, when such options are exhausted to keep stock prices inflated, they can take actions that are against the values of the firm.[11] Hence, clawback provisions help in tackling this specific agency problem as a CEO's compensation is linked and related directly to the quality and worth of the firm's financial accounts and statements, and compensation can be recovered for any misstatement.

Clawback provisions and other jurisdictions

The US, after many corporate scandals enacted the Sarbanes-Oxley Act, 2002 (SOX) which had various provisions applicable to companies to protect the interests of the companies and the securities markets from the overall private interest of directors and high-level executives of a company.[12] The clawback provisions for public corporations were mandated by Section 304 of the SOX and apply to the CEO and CFO of a company and it is enforced when there is misstatement or fraudulent reporting in the financial reports and such a misstatement was caused by misconduct.[13] Such provisions are required after many major financial scandals affecting the financial markets worldwide. The SOX law also provides for the compensation to be recovered that was received within 12 months of the misstatements and such a case can only be brought by the Security and Exchange Commission (SEC).[14] However, there are many criticisms to such a law, such as, that the compensation proceedings can only be initiated by the SEC and not the Board or the shareholders of the company. Since, clawback provisions are primarily contracts, these can be modified with respect to the company, in addition to the applicability of section 304 of the SOX. Section 304 of the SOX tries to target the agency problem of equity-based compensation of CEOs and CFOs of public companies and financial institutions. Such provisions should also be extended to other high-level executives or the key managerial personnel of the company to reduce agency costs and risk of financial fraud.

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[10] Natarajan, R. and Zheng, K. (2017) "Clawback provision of SOX, financial misstatements, and CEO compensation contracts," *Journal of Accounting, Auditing & Finance*, 34(1), pp. 74–98. Available at: https://doi.org/10.1177/0148558x16686740.
[11] *Id.*
[12] Stark, J. (2021) "Clawback provisions in executive compensation contracts," *European Company and Financial Law Review*, 18(4), pp. 669–696. Available at: https://doi.org/10.1515/ecfr-2021-0026.
[13] *Id.*
[14] *Supra* note 12.

Clawback Provision under Indian Law.

In India clawback provisions are mostly governed by contract law as there is no specific provision or rule under the Indian corporate laws that mentions the enforcement of such provisions on Indian companies or companies working in India. The RBI has however, made and issued guidelines for whole-time directors, chief executive officers (CEO's) and other risk takers. The guidelines of 2012[15] were applicable solely to private sector banks and the guidelines of 2019[16] broadened the scope of such provisions to foreign banks. The guidelines talk about mandatory disclosures to be done by whole time directors and CEOs to reduce and makes it the responsibility of the Banks to have mandatory malus/clawback arrangements with such executives. The guidelines were enacted as a response to global financial crisis. As the guideline mentions, "The compensation practices, especially of large financial institutions, were one of the important factors which contributed to the recent global financial crisis. Employees were too often rewarded for increasing the short-term profit without adequate recognition of the risks and long-term consequences that their activities posed to the organizations. These perverse incentives amplified the excessive risk taking that severely threatened the global financial system. The compensation issue has, therefore, been at the centre stage of the regulatory reforms"[17]. The guideline also mentions that banks are required to specify a time period when such clawback provisions can be applicable.

In India due to lack of statutory provisions like the SOX in the US, clawback provisions are only applicable if they have been enforced by companies through contracts between their employees. The lacunae in the Indian law, makes it prone to equity-based agency problems. Though, the RBI has acted by issuing these guidelines after corporate scandals, still statutory requirements are required for all companies to reduce financial risks, even for companies that are not voluntarily enforcing such contracts. Also, without the enforcement of statutory provisions, the legality of such clauses can always be challenged and questioned before the court.

The case of Chanda Kocchar v. ICICI Bank[18], tries to give such clarity on the enforcement of clawback provisions, where the court had delved into the question of enforcing on order to clawback bonuses of a senior-level employee. Mrs. Kocchar was the M.D. of ICICI Bank and had

[15] Reserve Bank of India, Guidelines on Compensation of Whole Time Directors / Chief Executive Officers / Risk takers and Control function staff, etc, (Issued on January 13, 2012).
[16] Reserve Bank of India, Guidelines on Compensation of Whole Time Directors/ Chief Executive Officers/ Material Risk Takers and Control Function staff, (Issued on November 4, 2019).
[17] Reserve Bank of India, Guidelines on Compensation of Whole Time Directors/ Chief Executive Officers/ Material Risk Takers and Control Function staff, (Issued on November 4, 2019).
[18] Chanda Kocchar v. ICICI Bank Ltd. 2022 SCC OnLine Bom 4748.

signed a clawback agreement with the bank during her employment. She was granted ESOPs for her good conduct and the representations made by her to ICICI Bank at the same time. In 2018, whistle-blower reports alleged that Mrs. Kocchar had abused her position and had business dealings between Videocon Group and Mr. Deepak Kocchar. This led to the formation of an independent Audit Committee setup by the Bank to investigate these allegations. While the enquiry of the Audit Committee was pending, Mrs Kocchar requested the Board of ICICI Bank for an early retirement. The same was conveyed to Mrs. Kocchar through a letter dated 4th October 2018 wherein the Board had approved the same and granted her the benefits under the Early Retirement Scheme (ERS). Mrs. Kocchar had exercised her ESOP's and had obtained benefits during the pendency of the enquiry. When the enquiry report had found Mrs. Kocchar guilty of gross violations and misconduct, the Board of ICICI Bank treated the removal of Mrs. Kocchar as 'termination for cause' and implemented the clawback agreement. Hence, the bonuses that Mrs. Kocchar received during the pendency period were to be clawed back. In the case, Mrs Kocchar contended that her employee-employer relation with ICICI Bank was over the moment the Bank had accepted her early retirement and hence, could not invoke disciplinary provisions against her. Mrs Kocchar had contended that the Bank gave up its right to invoke disciplinary provisions against her the moment it agreed to the retirement scheme being fully aware of the pending enquiry. ICICI Bank, however contended that, the employment contract was separate from the ESOPs contract and had relied on the clawback agreement for clawing back of previously paid bonuses for breach of conduct. The court here had agreed with counsel for ICICI Bank and held that the employment contract and ESOPs contract had to be considered as separate contracts. The court held that Mrs. Kocchar had violated her undertaking of good conduct, that she had signed during her retirement agreement, and had also violated the Code of Conduct and several other policies of ICICI Bank. As such, the court held that, the obligations and rights were not wiped by the Bank by accepting the Early Retirement Scheme and was justified in revoking the same after the enquiry report.[19] Hence, the court dismissed the interim application filed by Mrs. Kocchar and restrained her from dealing with her ESOPs already exercised by her. In this way, the court accepted the Bank's plan to claw back the money she received from exercising her ESOPs and other bonuses.

In this case, the court had allowed clawing back of the bonuses and compensation paid to Mrs. Kocchar but the lack of any statutory provisions giving legality to claw back provisions under Indian company laws makes such clauses and agreements open to challenge. Though, the

[19] Chanda Kocchar v. ICICI Bank Ltd. 2022 SCC OnLine Bom 4748.

judgement is a way forward in clarifying the status of such clauses in India and ensuring that such clauses can legally be enforced against violators. However, the case doesn't give clarity regarding the legal position of such clauses in non-banking public companies and companies that have voluntarily applied such clauses. In this case, the clauses were present due to the RBI guidelines, which makes the legality of such clauses in other companies questionable. In another situation, these clauses will be governed by principle of contract law unlike in the US where such clauses have statutory legality due to Section 304 of the SOX. The problem also arises on the aspect of the time period for the recovery of compensation from the employee. In the SOX, the recovery of compensation is allowed for all bonuses paid for a period of 12 months before the misstatement was reported. In India, due to the lack of a law, a time period for the recovery of such compensation would have to be entered into such clauses and that time period may still be open to legal scrutiny in courts. Hence, a law giving legality to claw back provisions is required in India that extends to all public companies so as to limit the risk of another financial scandal or fraud that affects the financial markets, and this will also give a legal standing to clauses incorporated by companies voluntarily.

Conclusion

This paper has tried to analyse claw back provisions and their legal standing in India and US. Claw back provisions are efficient in tackling agency problems within the firm and help in reducing agency cost and coordination cost. Such clauses ensure that the interests of the company are protected, and high-level executives act in the benefit of the company. It also helps in tackling the agency problem related to equity-based compensation by allowing companies to claw back compensation granted to high-level executives guilty of inflating stock-value, so as to, increase their compensation and for creating financial misstatements. Sarbenes-Oxley Act (SOX) in the US makes claw back of compensation applicable for CEOs and CFOs of public companies. A similar provision would be ideal in India as a steppingstone for corporate governance practices. Such a provision will largely secure the interests of the shareholders of the company and the general public that takes part in the stock market. It reduces the risk of financial market scandals and helps in keeping high-level executives, that are privy to sensitive information regarding the company and its stock value, accountable and penalises them by future consequences for their past actions, even, after a significant time has passed. Currently, the legality of such clauses and the extent of their enforcement is questionable (can cause hinderance in the recovery of compensation), and as such, a law regarding such clauses is required under the Indian law for better enforceability and corporate governance.