

# The Indian Journal Law & Economics of



VOLUME 1

2010

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*Published by*

The Registrar

NALSAR University of Law

3-5-874/18, Apollo Hospital Lane,

Hyderguda, Hyderabad – 500 029, India

This Journal is not for sale and general circulation.

**Cite this Volume as:**

1 INDIAN J. LAW & ECON. <PAGE NUMBER> (2010)

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## **VICE-CHANCELLOR'S MESSAGE**

It gives me great pleasure to present the inaugural issue of the Indian Journal of Law and Economics (IJLE). The IJLE is an initiative of the students of NALSAR, with the goal of promoting interest and encouraging scholarship in the field of law and economics. The IJLE has been launched with the aim of remedying the lack of authoritative academic writing devoted to the economic analysis of law and legal institutions. It is intended to serve as a platform where students, academics, lawyers, policymakers, and other scholars can contribute to the ongoing legal, political, and social debates in this field.

On behalf of the students and faculty of NALSAR, I wish to express my gratitude to Mr. Hemant K. Batra, Lead Partner, Kaden Boriss Legal LLP, Lawyers for wholeheartedly supporting this student initiative.

The IJLE is an annual publication managed by a board of student editors who are selected through an annual test. The IJLE boasts of an eminent Advisory Panel, comprising of noted academics, members of the judiciary, renowned jurists, and economists. The consulting editors of the IJLE play a crucial role in the success of this enterprise by providing valuable advice and support to the board of student editors. Under the able guidance of the Advisory Panel and the consulting editors, I believe that the IJLE will serve as the leading platform in India promoting a culture of academic research and original thought in the area of law and economics.

This first issue of the IJLE, I hope, will be a trendsetter; both in terms of its significance to the field of study as well as the direction it provides for future initiatives. The Journal will undoubtedly increase and encourage scholarship, especially amongst students, and I sincerely believe it will prove invaluable to academics and practitioners alike. I wish the IJLE and the Editorial Board success in all their endeavours and hope that they will keep up their good work.

  
**Prof. (Dr.) Veer Singh**





Kaden Boriss Legal LLP, Lawyers

Mail : Kaden Boriss Legal LLP, Kaden Boriss Building, 495, Udyog Vihar, Phase-V,  
National Capital Region (Delhi), Gurgaon-122016, India  
Tel: +91 124 404 0193 (hunt lines), Fax: +91 124 404 0194,  
Email: info@kadenboriss.com

## PATRON'S MESSAGE

Law and Economics have always been inextricably linked to each other. Despite the immense relevance in this age of globalization, law and economics remains a field without a plethora of academic authorities. It is, hence, a matter of great pleasure and pride for me to present the first volume of the Indian Journal of Law and Economics (IJLE). This journal has been introduced with an aim to promote exchange of ideas in the area of law and economics and encourage economic analysis of law.

An initiative of NALSAR students, IJLE promises to serve as a congregation connecting law students, practitioners, policymakers, scholars and academics by a common thread of law and economics enabling contemporary multidisciplinary debates and discussions. Managed by a board of student editors from NALSAR University of Law, this annual publication has a distinguished Advisory Panel comprising of judges, policymakers, eminent jurists and economists. I believe that active participation of the noteworthy consulting editors serves to provide high standards to this journal making it the potential flag-bearer of a quality-centric law and economics forum in India.

I hope this volume of IJLE sparks discussions and analysis among legal circles and sets a strong base for future developments and contributions in the field of law and economics. I believe that the Journal will encourage law students in particular and will also be duly appreciated by practicing lawyers, academics and policymakers.

I congratulate the Editorial Board of IJLE and all those involved in the publication, especially the Vice-Chancellor of NALSAR Prof. Veer Singh and the Advisory Panel on publishing the first volume of the Journal and wish them success in all their endeavours.

**Hemant K. Batra**  
*Managing Partner,*  
**Kaden Boriss Legal - India, Lawyers**  
*Secretary General,*  
**SAARCLAW**







## EDITORIAL

Why must private property be protected by a public law regime? Why are private contracts best enforced through legislations? How are creative achievements best rewarded by intellectual property rights? Are alternative dispute resolution methods better than litigation? What is the best tax structure and rate that the government should adopt? On a more abstract note, how should society structure its political, economic and legal institutions in order to maximise welfare for everyone? These questions and many more *sui generis* have and will continue to haunt lawyers and policymakers alike.

Justice Oliver Wendell Holmes famously wrote in 1881, “The life of the law has not been logic, it has been experience.” One of the several rather astounding experiences that life has to offer law is the intersection between law and economics. While law provides the theoretical framework of the logic of norms, rights and duties in this relationship, economics provides a conceptual framework to gather diffused experiences in most areas in which the law operates.

The aim of the Indian Journal of Law and Economics is to initiate and sustain a conversation encompassing the interactions between the disciplines of law and economics. From a lay person’s point of view, this new ‘hybrid’ discipline can be said to be a two-headed coin. One side of this coin is micro- and macro-economic theory that seeks to analyse the behavioural consequences of any society’s legal rules and through the lessons of economics, steer these rules towards a socially desirable end. The other side of the coin is legal theory as we traditionally understand it. Sometimes traditional legal theory is used to study the functioning of economies, property rights regimes, contract enforcement, institutions of labour market, etc. From the point of view of governance, law and economics can be said to be concerned with the effects of legal rules on the behaviour of relevant actors; and whether these effects are socially desirable. It differs from previous approaches in that it reformulates the rationales behind adopting legal rules. For instance, the basic tort law question, “Did X have a duty to Y?” gets transformed into, “What are the economic effects if X is found to have a duty to Y?”<sup>1</sup> Concurrently, the desirability of a proposed legal regime is studied not so much through the languages of ‘rights’ and other such categorical imperatives as through ‘efficiency.’ The achievement of a socially and/or economically desirable outcome is the aim of a lawmaker’s perspective on law and economics.

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1 George L. Priest, *Michael Trebilcock and the Past and Future of Law and Economics*, 60 U.TORONTO L.J. 155 (2010).

The domain of law and economics can broadly be demarcated into positive or descriptive analysis and normative analysis. While the positive analysis is an attempt at prediction, description and explanation of the likely impact of any policy or law, normative analysis is a venture into comparison of available alternatives and proposed solutions in the light of such analysis. Consider the following example in a manner of understanding the role of law in regulating activities in a society:<sup>2</sup> in an imaginary land with no traffic rules, individuals must decide whether to drive the car on the left (L) or on the right (R) side of the road. Obviously, traffic would be smoothest for everybody if everyone would drive on the same side of the road, i.e. all choose either R or L. Such an outcome prevents accidents. Seen from another angle, an outcome where half choose L and the other half choose R is the most probable to result in accidents. Clearly the above structure involves a problem of coordination among drivers; let us call this problem a ‘coordination game.’ Let us also call the two desirable situations – all drivers choosing R or L – as the equilibriums of this coordination game. Evidently, the mere knowledge that these equilibriums exist does not help the drivers to make a definite decision on which choice to adopt. To achieve a socially efficient equilibrium, the law steps in by announcing a definitive traffic rule to coordinate the actions of different players in the game (by overcoming information asymmetry and variations in strategies). Legal rules such as this offer incentives for players’ desired behaviour. In game-theoretic terms, law is a coordination device in situations where the interests of agents coincide.

In other situations, individual interests do not coincide but conflict. The trial is one example: the prosecutor and the defendant in a trial would agree to coordinate through an out-of-court settlement or settle on a plea bargain only if both parties could be made better off than their expected trial outcomes. This seemingly apparent premise is at the heart of alternative dispute resolution and the law on plea bargaining. A law and economics approach would seek to determine which outcome would accommodate the interests of both parties, while at the same time adhering to society’s mandate of law-enforcement. This would be a considerably more difficult task, involving not only the determination of the cost-benefit analysis of each outcome for each stakeholder but also deciding the level of final equilibrium and the associated distribution of scarce resources that society ultimately desires. It is in these complex formulations that the tools presented by law and economics come once again to the aid of the hitherto single-tracked ‘law’ person.

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2 *The Economic Analysis of Law*, in THE STANFORD ENCYCLOPEDIA OF PHILOSOPHY, available at <http://plato.stanford.edu/entries/legal-econanalysis/>.

## Spreading roots - Evolution of the discipline

The 1940s and 1950s saw the emergence, in Western universities and among writers, of the study of several legal subjects with undeniable economic underpinnings. These included corporate law, bankruptcy, securities regulation, labour law, income tax, public utility regulation and torts. The 1960s' agenda was to apply 'economics to core legal doctrines and subjects such as contract, property, tort and criminal law.'<sup>3</sup> The study of legal regulation of markets and business practices, primarily anti-trust cases, formed the foremost and the most significant aspects of analysis in the nascent discipline of law and economics. The effects of the lack of protectionist measures in 'most-favoured nation' clauses, the performance of the industry under deregulation and the effect of collective bargaining decision on labour disputes were the most covered areas in the discipline's early days.

The biggest thrust to the theoretical underpinnings of the law and economics movement was provided by the quadruplet of Coase-Calabresi-Posner-Becker whose contributions explored unconventional territories and radically transformed the manner in which the academia perceived law and economics.

Ronald Coase, widely considered the father of the law and economics movement, proposed the Coase's theorem<sup>4</sup>, which states that *when transaction costs are zero, the allocation of resources is independent of the distribution of property rights*,<sup>5</sup> shedding an insight into the conditions under which people might bargain to reach the socially optimal level of output in spite of the existence of externalities. Judge Guido Calabresi, also considered one of the fathers of the law and economics movement, pioneered the application of economic reasoning to tort law through his works *Some Thoughts on Risk Distribution and the Law of Torts*<sup>6</sup> and *The Cost of Accidents: A Legal and Economic Analysis*.<sup>7</sup> Under his supervision, the Yale Law School has become a hub of research in law and economics.

Gary S. Becker forayed into an economic analysis of crime, racial discrimination, marriage and divorce and a range of non-market behaviour like charity, love, and addiction. His studies opened to economic analysis large areas of the legal system which had hitherto remained uncharted by Calabresi's

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3 N. DUXBURY, *PATTERNS OF AMERICAN JURISPRUDENCE*, 340 (Oxford Clarendon Press, 1995).

4 Ronald Coase, *The Problem of Social Cost*, 3 *JOURNAL OF LAW AND ECONOMICS* 1 (1960). Coase received the Nobel Memorial Prize in Economic Sciences in 1991.

5 *Id.*

6 Guido Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 *YALE L.J.* 499 (1961).

7 GUIDO CALABRESI, *THE COST OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS* (Yale University Press, 1970).

and Coase's studies of property rights and liability rules.<sup>8</sup> After Judge Richard Posner, "never again would Law and Economics be thought of as exclusively the domain of antitrust and corporate law. Now its domain was the very heart of the legal system, torts, property, contracts, domestic relations, procedure, even constitutional law."<sup>9</sup> Posner showed how a series of simple principles underline and render coherent a wide variety of legal institutions, across public and private law.

Owing primarily to the contributions of these and other scholars in the field, the scope of law and economics today runs across diverse fields such as intellectual property, environmental law, anti-discrimination law, criminal law, consumer protection, information technology, medical malpractice, land use planning, effect of legal precedent on litigation, and indeed, the legal process itself.

### **Law Schools and the Discipline**

With the growth of law and economics as an academic discipline came the growth of centres of learning focussed on this new approach. While in the United States this specialisation has been completed over the last four decades, Europe is today steadily increasing its focus on law and economics, with programs like the Erasmus Mundus Masters and Doctorates in Law and Economics.

India, sadly, still has a long way to go. Law and economics is in its nascent stages of recognition by the Indian academic fraternity. With only a few law schools offering undergraduate courses, the discipline is yet to get under way as a self sustaining choice for a successful career. One of the major hurdles is that the legal world – including law students – needs the rigorous understanding of economics that is indispensable to any serious research on the subject. Such a concentration in economics is rarely found outside specialised economics degrees. Other hurdles include a systemic opposition to change, especially in the legal world, an almost total absence of references to the parameters of "efficiency" in court judgements and parliamentary debates, and a suspicion on part of the established legal system that law and economics is merely a passing 'fad': a new way of looking at a world that, the argument goes, was managing adequately without such lenses.

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8 WILLIAM M. LANDES & RICHARD A. POSNER, *THE ECONOMIC STRUCTURE OF TORT LAW* 7 (Harvard University Press, 1987).

9 Sophie Harnay & Alain Marciano, *Posner, Economics and the Law: From Law and Economics to an Economic Analysis of Law*, 31.2 JHET 215 (2009).

Fortunately this situation is changing, albeit gradually. Periodic colloquiums<sup>10</sup>, conferences, seminars and crash courses have ensured that the discipline finds its feet and the much deserved relevance in the academic circles. The Indira Gandhi Institute of Development Research in Mumbai is partnering the Erasmus Mundus Program in Law and Economics for the year 2011. Several academic stars of law and economics are beginning to shine bright in the Indian academic spheres, and expectations that the next generation of law students will be better trained in law and economics are gradually materialising. With a good grip on economics and a sound economic understanding of law, law students, whether as legal consultants to corporations, or as law firm associates or as litigators, can take the discipline to the peak of significance. The experts of law and economics can also find cross appointments both in the law and economics departments of universities. That state of affairs will reflect the true integration of two seemingly independent disciplines which dovetail on several counts and we hope that the journal will mark a successful start in that direction.

### **The Contributions**

Our edition begins with F.E. Guerra-Pujol's 'Coase's Paradigm: First Principles of the Economic Analysis of Law,' which traces the intellectual foundations of the law and economics movement through a homage to its founding father, Ronald Coase. Pujol identifies two foundational values on which this movement has been based: intellectual agnosticism and intellectual irreverence, and examines in detail the implications of each quality. He then dispels several misconceptions relating to the Coasian, or economic approach to the study of law. Finally, in what will serve as an excellent primer for the uninitiated reader into the methodology of this field, Pujol delineates the exemplars that guide the economic approach's day-to-day puzzle-solving activities: material scarcity, self-interest, the law of demand, and transaction costs. Pujol concludes masterfully that the entire methodology of the law and economics movement can be distilled into the single question posed long ago by Cicero: *cui bono?* ("to whose profit?").

The second article in the journal is Afra Afsharipour's 'The Promise and Challenges of India's Corporate Governance Reforms.' Afsharipour presents a picture of the difficulties associated with the enforcement of a reformed corporate governance regime in India, and argues that the success of such a regime is made challenging by the political economy of India's corporate law regime and the traditional ownership structure of many Indian firms. She begins by tracing the history of one such reform, Clause 49 of the SEBI Listing Agreement, through the various committee reports leading up to it. Highlighting

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10 For instance, see The 2008 National Law School International Law and Economics Colloquium, *The Elephant and the Dragon: Lessons and Challenges Respecting the Role of Law in Economic Development in India and China*, May 2008.

the Satyam scandal of 2009 as an example of the dire need for stringent corporate governance norms in India, Afsharipour delves into the impact of the scandal, and the consequent industry and government reforms brought about in India's corporate governance regime.

One of the most striking features of the law and economics movement has been its contribution to existing legal issues by presenting solutions and analyses from fresh lenses. Public Interest Litigation has been a hotbed of constitutional law controversy in India ever since its emergence in the 1980s. There has been no dearth of proponents and opponents of this peculiarly Indian brand of "judicial overreach," and a resolution of these differences is often surrendered as owing purely to personal, political and legal ideology.

Varun Gauri's article, 'Fundamental Rights and Public Interest Litigation in India: Overreaching or Underachieving?' brings into this old debate the new tools of economic and empirical analysis. In the resultant path-breaking article, Gauri tackles a number of objections leveled at the public interest litigation movement and seeks to determine the extent to which these can really be justified. As he makes clear at the outset of his study, the debate to date has largely been abstract, helping to generate a set of normatively significant questions, but calling for a more pressing empirical work today. He identifies that almost all the objections stem from either of two sources: suspicions related to the separation of powers, and those regarding judicial attitudes. Through presenting the results of a comprehensive empirical study involving such innovative parameters as the number and matter of fundamental rights cases before the Supreme Court, the rates of 'winning' those cases according to litigants' affluence, cases involving women and child rights, and those involving the rights of backward and scheduled classes, Gauri shows that public interest litigation does not in fact consume a significant share of the resources of the Supreme Court, that concerns regarding inequality are not altogether unjustified, and that advantaged social groups can expect significantly lower win rates for fundamental rights claims than their disadvantaged peers in the new millennium.

The fourth article in the journal is Vikas N.M.'s 'Carbon Lock-In in the Automobile Industry – A Case for Regulation?', which presents the case of the carbon polluting technological lock-in in the automobile industry as an example of a market failure, where the ability of market participants to correct inefficiencies is severely constrained due to the clash of private and social interests. Vikas identifies these market inefficiencies as arising from problems of inertia, technological limitations, consumer indeterminacy, inadequacy of infrastructure, uncertainty of future development, and the lack of supporting facilities. Discussing the mechanism of an automobile, the author demonstrates how the Internal Combustion Engine (ICE) gained dominance in the automobile

sector and resulted in a 'lock-in' phenomenon creating entry barriers to any other technology in the market. He then makes a case for government intervention as the only feasible remedy to the problem of carbon-lock in. Such regulation, Vikas argues, should aspire to achieve zero-emission and every other inefficiency that exists in the market.

Mandar Kagade's article 'Independent Director Law In India: An Economic and Behavioural Analysis.' proceeds from an appreciation of the fundamental difference between the 'rules-based' versus 'standards-based' discourse in law and economics. Kagade argues that when it comes to designing prescriptions defining the normative requirements for the independence of company directors, rules-based solutions are inappropriate. The law ought to keep the understanding of directors malleable and heuristic, based on standards instead, and reform should be imposed through a proper legislation rather than through delegated devices like Clause 49 of the SEBI Listing Agreement. Relying on the economic analysis of independent director law, Kagade articulates that these definitional reforms will strengthen the institution of independent directors and foster optimum corporate governance.

The sixth contribution in our collection is also the most philosophical in terms of its meditations on the Indian law and economics movement. In his Essay 'Refuse to Choose: The Role of Methodological Pluralism in Thinking About Law and Economics in India', Bikku K. Kuruvila seeks to answer: "What ... is Indian law and economics?" Surveying existing scholarship written on and in the subject, Kuruvila concludes that Indian legal scholarship appears to be intermittently developed and dependent upon the efforts of talented individual scholars, without the emergence of a concerted body of scholarship or a normative idea of what it should consist of. Kuruvila traces the applications of law and economics as it stands today – its method, the insights offered through its analyses, the program it offers to the legal system, the avatars it assumes, and the critiques it is subjected to. Meditating on a possible future for the subject in India, he argues that practitioners of law and economics in the Indian context should explore a broad variety of fields to understand the complex interactions of law, legal processes and institutions, and socio-economic relations.

The seventh article is Tissy Mandal's 'The Role of Economics in Cartel Detection Through Leniency Programmes' focusing on anti-trust policies as tools to detect and combat oligopolistic collusion such as cartels. Mandal diagnoses the circumstances under which the 'leniency policy,' one such anti-trust policy intended to incentivize disclosures by identified colluders, can be used as a functional instrument to detect cartels. The leniency policy, as per Mandal's argument, is a specialized form of the prisoner's dilemma game albeit with a few appreciable differences. Incentives are structured in a way so as to



make confession of the cartelists a dominant strategy. At the same time, Mandal brings out the challenges the Competition Authority has to face in order to establish a favourable prisoner's dilemma.

The eighth article in this journal is Vrinda Bhandari's 'A Study of the Aviation Sector in India: An Analysis of the Employment Contracts of Airhostesses in Light of *Sheela Joshi v. Union of India*,' which revolves around the jurisprudence of the 'termination clauses' incorporated in air-hostesses' employment contracts. Bhandari assesses the economic implications of a recent Delhi High Court judgment upholding the termination of overweight air-hostesses' contracts. She approaches this question through three prongs: the relationship between passenger tastes and attendants' appearance; the purpose of the employment contract; and whether an "at will" or "just cause" system of employment would be more efficient. Bhandari concludes in favour of the ruling, since economic factors such as standardized consumer preferences towards attractive air-hostesses and the cut-throat competition of the aviation industry indicate, albeit somewhat unfortunately, that prioritizing appearance-based discrimination over blind assessments of employee performance is indeed more economically efficient.

Finally, the journal closes its law and economics survey with a review of Dambisa Moyo's book, '*Dead Aid: Why Aid Is Not Working And How There Is A Better Way For Africa*' by Priya S.Gupta. In her book, Moyo suggests that aid to Africa is not merely ineffective, but is the root cause of poverty and underdevelopment in the continent. More important than simply aid, Moyo argues, is the development of financial instruments towards economic growth. Priya Gupta critiques Moyo's book, arguing that even though Moyo gives adequate reasons why aid is not working, the book lacks conviction due to the absence of authoritative sources in support of Moyo's claims. Gupta points out that Moyo's central argument condemning aid crumbles due its own oversimplification. There is no distinction between effective and ineffective aid, a fact brought home by Jeffrey Sachs shortly after the publication of Moyo's book. Gupta however concludes by pointing out that the significance of the book lies in its offering of financial prescriptions to suit Africa's peculiar problem.

### **Acknowledgements**

This Journal would not have been possible without the gracious and essential support of several individuals. The personal interest of Mr. Hemant K. Batra enabled us in executing the idea of a journal in India dedicated to the study of law and economics. We are grateful to him for his catalytic support. We sincerely thank Professor Veer Singh for his encouragement in bringing out this journal. The Advisory Panel and our Consulting Editors provided



extraordinary support and our gratitude is due to them.

We express our sincere gratitude to Ms. Menaka Guruswamy and Mr. Nicholas Robinson for their invaluable help in reviewing certain contributions. We acknowledge the efforts of Ms. Swethaa Ballakrishnen, Ms. Aparna Chandra, Professor Vikramaditya Khanna, Mr. Bikku Kuruvilla and Mr. Jayanth Srinivasan and thank them for judging the editorial tests for the Journal.

We wish to thank Mr. Prasan Dhar and Mr. Khalyaan Karunakaran for supporting this initiative and designing the posters and the website. We wish to thank the members of the second editorial board – Srishti Kalro, Abdaal Akhtar, Sidhant Buxy and Anees Backer – for their assistance towards this volume. We wish to express our appreciation for Mr. Kamlesh Dessai for his untiring support in the publication of this edition.

Finally, our special thanks to the faculty, students and alumni of NALSAR who have had faith in this undertaking.

**The Members of the Board of Editors  
2009-10**



# COASE'S PARADIGM: FIRST PRINCIPLES OF THE ECONOMIC ANALYSIS OF LAW

F.E. Guerra-Pujol\*

## I. INTRODUCTION

Law professors are a cantankerous and bickering bunch, rarely agreeing on anything. Most legal scholars would agree, however, that Ronald Coase's seminal paper, *The Problem of Social Cost*, published fifty years ago, is one of the lasting literary and intellectual achievements of the economic approach to law.<sup>1</sup> Professor Coase's insights have forever altered the study of law, meriting his work a special place in the legal canon.

The purpose of this paper is not to reappraise the validity of the Coase Theorem or critique Coase's economic approach to law - these tasks have been performed by more able commentators.<sup>2</sup> Instead, we wish to take a step back and put Professor Coase into proper context, for Coase's work is part of a larger intellectual framework: a mature research program or paradigm<sup>3</sup> commonly described as "law and economics." We submit that without the pre-existence of this underlying paradigm, Coase's seminal social cost paper and its implications on "law and economics" generally would be unthinkable.

This paper is divided into five parts. Following this brief introduction, Part Two turns to the philosophy of science and formally introduces the concept of scientific paradigms. The remainder of the paper then delves into the difficult and elusive task of reducing the economic approach to law to its essential bare-bone components, moving from the general

## II. THE PRIMACY OF PARADIGMS

*The New Palgrave Dictionary of Economics and the Law*, ironically, contains no entry for "law and economics."<sup>4</sup> Although there are myriad essays describing the sundry branches of the economic approach to law - including

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\* Associate Professor, Barry University Dwayne O. Andreas School of Law, Florida.

1 Ronald H. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960) [hereinafter *Coase I*], reprinted in RONALD H. COASE, *THE FIRM, THE MARKET, AND THE LAW* (1988) [hereinafter *Coase II*].

2 See THE LEGACY OF RONALD COASE IN ECONOMIC ANALYSIS (Steven G. Medema ed., 1995); George J. Stigler, *Two Notes on the Coase Theorem*, 99 Yale L.J. 631 (1989). For a sample of the critical literature, see Jules Coleman, *Efficiency, Utility, and Wealth Maximization*, 8 HOFSTRA L. REV. 509 (1980), reprinted in Jules L. Coleman, *Markets, Morals, and the Law* (1988); Mark G. Kelman, *Consumption Theory, Production Theory, and Ideology in the Coase Theorem*, 52 S. CAL. L. REV. 669 (1979), reprinted in LAW AND ECONOMICS ANTHOLOGY (Kenneth G. Dau-Schmidt & Thomas S. Ulen eds., 1997); Frank Michelman, *Norms and Normativity in the Economic Theory of Law*, 62 MINN. L. REV. 1015 (1978).

3 For an influential analysis of the primacy of "paradigms" in day-to-day scientific research, see THOMAS S. KUHN, *THE STRUCTURE OF SCIENTIFIC REVOLUTIONS* (3d ed. 1996) [hereinafter *Kuhn I*].

4 See THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW (Peter Newman ed., 1998).

assorted entries for “anthropological law and economics,” the “Chicago school of law and economics,” and even “law-and-economics from a feminist perspective” – there is no attempt to define law and economics *qua* “law and economics.”<sup>5</sup> Our goal, then, is to articulate the general properties of the Coasean paradigm and identify its central tenets. Like a nuclear scientist in search of subatomic particles, we attempt to identify the elementary particles below the surface of the law-and-economics literature.

Our thesis, in brief, is that the Coasean or economic approach to law is not just a hodgepodge of models and assorted mathematical formulas. It is a full-fledged paradigm, a mature research program, one that unifies a diverse family of scholars. Indeed, we dare say that the economic approach to law is the most influential, original, and revolutionary legal paradigm to emerge in the English-speaking world since the publication of Oliver Wendell Holmes’s classic tome *The Common Law*.<sup>6</sup> Furthermore, in the absence of a competing paradigm, one that is able to attract new scholars and the lion’s share of funding for research, no other approach to the study and practice of law will be able to dethrone this influential paradigm.<sup>7</sup> As Mark Twain once said in a different context, reports of the economic approach’s death are greatly exaggerated.<sup>8</sup>

But it is well-worth asking at the outset: what precisely is a “paradigm”? Although one commentator was able to discern no less than twenty-three different shadings of meaning in Thomas Kuhn’s use of the term in his classic work *The Structure of Scientific Revolutions*,<sup>9</sup> Kuhn subsequently clarified this concept.<sup>10</sup> According to Kuhn, a paradigm can be reduced to two major usages. On one level, a paradigm consists of the “universally recognized scientific achievements that for a time provide mode problems and solutions to a community of practitioners.”<sup>11</sup> A paradigm in this literal sense refers to the “exemplary past

5 By the same token, the major “law and economics” textbooks also fail to provide a comprehensive exposition of first principles.

6 OLIVER WENDELL HOLMES, *THE COMMON LAW* (Mark DeWolfe Howe ed., 1963) (1881).

7 In the words of Thomas Kuhn, “Competition between segments of the scientific community is the only historical process that actually ever results in the rejection of one previously accepted theory or in the adoption of another.” See *Kuhn I, supra* note 3, at 8.

8 There is a wealth of old and new articles reporting the untimely and perpetual demise of law and economics. For a sample of the old, see Morton J. Horwitz, *Law and Economics: Science or Politics?*, 8 *HOFSTRA L. REV.* 905 (1980) (arguing that law and economics had “peaked out” as the latest fad in legal scholarship). For a sample of the new, see Ugo Mattei, *The Rise and Fall of Law and Economics* (unpublished manuscript) (arguing that the once-dominant law-and-economics movement has now disintegrated). For what it is worth, “law and economics” is not the only successful paradigm to be criticized in vain by outsiders. Cf. Ernst Mayr, *The Death of Darwin?*, in *TOWARD A NEW PHILOSOPHY OF BIOLOGY* 258, 264 (1988) (“Paraphrasing Mark Twain, we are justified in saying that ‘the news of the death of Darwin’ is greatly exaggerated”).

9 See Margaret Masterman, *The Nature of a Paradigm*, in *CRITICISM AND THE GROWTH OF KNOWLEDGE* (Imre Lakatos & Alan Musgrave eds., 1971).

10 See Thomas S. Kuhn, *Second Thoughts on Paradigms*, in *THE ESSENTIAL TENSION* (1977) [hereinafter *Kuhn II*]. See also *Kuhn I, supra* note 3, at 174-75.

11 See *Kuhn I, supra* note 3, at x.

achievements”<sup>12</sup> or “exemplary problem solutions”<sup>13</sup> or “standard example[s]”<sup>14</sup> of a particular field of study, such as Kepler’s laws of planetary motion, Newton’s second law ( $F=ma$ ), and the law of demand in economics. According to Kuhn, this definition is the original and most appropriate meaning of the term “paradigm.”

Kuhn’s definition is, however, not exclusive. A paradigm may also refer to a person’s general world-view or frame of reference. The biologist Ernst Mayr, for example, calls this type of paradigm one’s “conceptual framework.”<sup>15</sup> At this higher level of abstraction, one’s paradigm or conceptual framework consists of “the entire constellation of beliefs, values, techniques, and so on shared by members of a given [scientific] community.”<sup>16</sup> This school of thinking has led some commentators to emphasize research programs and traditions in place of paradigms. For example, in an influential paper titled *The Methodology of Scientific Research Programmes*, Imre Lakatos explains that a scientist *qua* scientist is one who works within an established tradition of research.<sup>17</sup>

In our view, there is a large overlap between Lakatos’s and Kuhn’s visions of scientific activity because one tends to find that a scientific field or discipline or in the case of law, a movement like law and economics is usually dominated at any one time by a set of unstated premises or assumptions about what constitutes proper methodology and what questions and problems are appropriate for study and research.<sup>18</sup> In this sense, a paradigm or research tradition tells scientists not only what the world is like, but also what strategies to adopt to extend one’s knowledge of the world. In this paper, we shall use terms like “conceptual framework”, “first principles”, and “frame of reference” in place of “paradigms” and “research traditions” to refer to a person’s world-view, that is, his or her collection of foundational principles, unstated premises, and

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12 *Id.* at 175.

13 *Kuhn II*, *supra* note 10, at xix.

14 STEPHEN TOULMIN, *FORESIGHT AND UNDERSTANDING: AN ENQUIRY INTO THE AIMS OF SCIENCE* 57 (1961).

15 See ERNST MAYR, *ONE LONG ARGUMENT: CHARLES DARWIN AND THE GENESIS OF MODERN EVOLUTIONARY THOUGHT* ix (1991) (using terms like *Zeitgeist* and conceptual framework to describe the basic foundations of a scientific theory). For his part, Kuhn once proposed the awkward term “disciplinary matrix” to describe the foundational aspect of paradigms. See *Kuhn II*, *supra* note 10, at 297.

16 See *Kuhn I*, *supra* note 3, at 175. See also *Kuhn II*, *supra* note 10, at xix (stating expanded definition of paradigms as “the entire global set of commitments shared by members of a particular scientific community”).

17 See Imre Lakatos, *Falsification and the Methodology of Scientific Research Programmes*, in *CRITICISM AND THE GROWTH OF KNOWLEDGE* (Imre Lakatos & Alan Musgrave eds., 1971).

18 The major exception, of course, is the humanities and most of the social sciences—these fields are inherently unscientific in the Kuhnian or Lakatosian sense because they are characterized by competing paradigms and conflicting research programs. See C.P. SNOW, *THE TWO CULTURES AND THE SCIENTIFIC REVOLUTION* (1959) (describing the enormous gulf separating the physical sciences and the humanities). One commentator has gone as far as to say that a sort of intellectual anarchy reigns in the soft sciences. See PAUL FEYERABEND, *AGAINST METHOD: AN ANARCHIST THEORY OF KNOWLEDGE* (1975).

assumptions about the world.

Nevertheless, whichever terminology is used, it is imperative to isolate as best one can the central tenets of the 'new' economic approach precisely because most scholarly research, or what Kuhn has called "normal science," is ultimately paradigm-dependent.<sup>19</sup> As a result, one's analysis of the merits of any proposal will depend on the frame of reference through which the proposal is viewed.<sup>20</sup> In day-to-day life, for example, people often see the world through conflicting frames of reference, especially economists and non-economists.<sup>21</sup> The case of minimum wage laws provides a useful example: where a non-economist might see a progressive aspiration to provide "a living wage" or social justice to low-income workers, an economist might see the selfish hand of factions at work.

Our aim, then, is to articulate the general properties of the economic approach to law, but before we attempt this difficult and elusive task, a disclaimer is in order. After all, why is there no entry for "law and economics" in the *New Palgrave Dictionary of Economics and the Law*? Why has no one attempted to perform this task in a systematic fashion?

Our disclaimer is twofold. First, this paper is not meant to provide an exhaustive survey of law-and-economics literature. Instead, our more limited aim is to provide an overview of the intellectual foundations of this approach. Having said this, however, our second disclaimer is that in the process of writing this paper, we have come to realize first-hand that any attempt to articulate a given paradigm or conceptual framework is bound to be tentative, incomplete, and imperfect. Like trying to find a particular rabbit in the entire state of West Virginia or pinpoint Osama Bin Laden's precise whereabouts, it is appallingly difficult to articulate the elements of a particular movement's foundation or conceptual framework.<sup>22</sup> Indeed, it is perhaps no coincidence that the disciples of the economic approach – those very scholars who should know the law-and-economics paradigm the best – have rarely bothered to articulate the central tenets of their paradigm or explain their world-view to outsiders or even to

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19 According to Kuhn, normal science refers to the day-to-day "mop-up work" and "fact-gathering" activities of scientists. See generally Kuhn I, *supra* note 3, at 23-42.

20 As Daniel Kahneman puts it, "competing interpretations of reality appear to suppress each other." See Daniel Kahneman, *Maps of Bounded Rationality: A Perspective on Intuitive Judgment and Choice*, 93 AMERICAN ECONOMIC REVIEW 1449, 1453 (2003).

21 For example, as Thomas Schelling puts it, "You can often tell an economist from a non-economist by asking whether at the peak season for tourism and camping there should be substantial entrance fees at the campgrounds of national parks." See Thomas Schelling, *Economic Reasoning and the Ethics of Policy*, 63 THE PUBLIC INTEREST 37 (1981), reprinted in FOUNDATIONS OF THE ECONOMIC APPROACH TO LAW 18-26 (Avery Wiener Katz ed., 1998) [hereinafter Katz].

22 According to Thomas Kuhn, "definitions are seldom taught and ... occasional attempts to produce them often evoke[ ] pronounced disagreement." See Kuhn II, *supra* note 10, at xix.

themselves. This is an embarrassing omission but perhaps an inevitable one. Before proceeding, we wish to explain why this is necessarily so.

It is difficult to articulate a group's paradigm or conceptual framework for several reasons. The main reason is probably psychological. The practitioners of a particular discipline, whether that specialty is "law and economics" or nuclear physics, may not even realize that they see the world differently than non-economists or non-physicists do because a person's frame of reference is not necessarily derived from data or observations or from other forms of empirical work. We simply accept – often unconsciously – a particular frame of reference as true. Contrary to Francis Bacon's Doctrine of the Idols, a scientist or scholar will more often than not see only what he expects to see.<sup>23</sup>

This is the central lesson of Jorge Luis Borges's classic parody "Pierre Menard: Author of the *Quixote*."<sup>24</sup> In this story, the great Argentine writer explains that an obscure novelist, one Pierre Menard, has rewritten "word for word and line for line" the ninth and thirty-eighth chapters of Cervantes's classic novel *Don Quixote*.<sup>25</sup> Borges then goes on to argue that Menard's version of the *Quixote*, though visibly identical to the original, is in fact more complex and philosophically profound in light of the historical circumstances in which both versions were written: "To compose the *Quixote* at the beginning of the seventeenth century was a reasonable undertaking, necessary and perhaps even unavoidable; at the beginning of the twentieth, it is almost impossible. It is not in vain that three hundred years have gone by ..."<sup>26</sup> In other words, how one perceives the outside world, or a chapter of the *Quixote*, depends on the lens one is using to see the world. Cervantes and Pierre Menard may have written the same words, but they are describing different worlds.

A related point is the problem of tacit knowledge. As Michael Polanyi and Thomas Kuhn have argued, most day-to-day scientific activities are based on "tacit knowledge,"<sup>27</sup> or what behavioral psychologists call intuition.<sup>28</sup> That is,

23 In the words of one behavioral psychologist, "The master chess player does not see the same board as the novice ..." See Kahneman, *supra* note 20, at 1435.

24 This wonderful short story is reprinted in THE NORTON ANTHOLOGY OF SHORT FICTION 89-97 (R.V. Cassil ed., James E. Irby trans., 3d ed. 1986) [hereinafter Norton]. Borge's short story was originally published in 1942 in Buenos Aires, Argentina as part of a collection of short stories entitled "El jardín de senderos que se bifurcan" ("The garden of divergent paths"). Though Borges's short story is a parody of a scholarly paper, one wishes that 'real' scholarly papers were as succinct and as beautifully written as Borges's parody.

25 "[Pierre Menard's] admirable intention was to produce a few pages which would coincide—word for word and line for line—with those of Miguel de Cervantes." See *id.* at 93.

26 *Id.* at 94-95.

27 See generally MICHAEL POLANYI, PERSONAL KNOWLEDGE (1958); see also Kuhn I, *supra* note 3, at 44, 191.

28 There is an extensive literature in social-cognitive psychology documenting the basic distinction between tacit knowledge or intuition on the one hand and deliberative thought processes on the other. For a fairly large sample of this literature, see the extensive bibliography in Kahneman,

much of a scientist's success depends upon knowledge that is acquired through practice and cannot be articulated explicitly. The problem, then, is that this type of knowledge or intuition is not subject to direct inspection. By its very nature, it is what one takes for granted.

Moreover, the problem of tacit knowledge is magnified by the closed, insulated, and incestuous nature of modern scholarly activity. The leading scholars of a given discipline will usually consist of a relatively small circle of insular intellectuals. By definition, they are addressing an extremely narrow audience.<sup>29</sup> And since they are largely writing to each other in highly specialized journals, they have no need to restate the central tenets of their paradigm; they presumably already know what these are. The members of any given scholarly community simply take their view of the world for granted.

Of course, one might expect to find an exposition of the central tenets of the economic approach in the appropriate textbooks.<sup>30</sup> But aside from the fact that textbooks (as opposed to casebooks) are rarely used in Anglo-American law schools, the major textbooks in the field fail to provide a comprehensive exposition of first principles. Richard Posner, for example, devotes a single short chapter to explaining the central tenets of law and economics.<sup>31</sup> Not, it seems, to be outdone in succinctness, Steven Shavell devotes a mere three pages to elucidating the first principles of law and economics in his introduction to the subject.<sup>32</sup> And for his part, Gary Becker once summarized the whole of the economic approach in a single sentence.<sup>33</sup>

Instead, leading law-and-economics textbooks are devoted almost entirely to what Kuhn has called "normal science" and "puzzle-solving", that is, to workaday applications of the economic approach to various problems and areas of the law. The economic approach's emphasis on puzzle-solving is another important reason why so few scholars have taken the time to articulate the central tenets of their paradigm. Practitioners of law and economics are, for the most part, far more interested in the applications of economic theory to specific problems than to elucidating the first principles of their approach.<sup>34</sup>

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*supra* note 20, at 1484-89. Despite this wealth of literature, we think it is safe to say that psychologists still know very little about the inner working of human intuition.

29 See, e.g., Thomas Kuhn, *Comment on the Relations of Science and Art, in Kuhn II, supra* note 10, at 344 ("... for the man in a particular specialty, the relevant audience is even smaller, consisting entirely of that specialty's other practitioners").

30 Three leading law-and-economics textbooks include RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* (6th ed. 2003); A. MITCHELL POLINSKY, *AN INTRODUCTION TO LAW AND ECONOMICS* (3d ed. 2003); ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* (4th ed. 2003).

31 See Posner, *supra* note 30, at 3-22.

32 See STEVEN SHAVELL, *ECONOMIC ANALYSIS OF LAW* 1-3 (2004).

33 See GARY S. BECKER, *THE ECONOMIC APPROACH TO HUMAN BEHAVIOR* 5 (1976) ("The combined assumptions of maximizing behavior, market equilibrium, and stable preferences, used relentlessly and unflinchingly, form the heart of the economic approach as I see it").

34 Cf. Toulmin, *supra* note 14, at 13 ("He [the scientist] may be so close to the activity [of solving intricate puzzles] that its most general features and widest connections begin to escape him").



Also related to this emphasis on puzzle-solving is the growing mathematical sophistication of the economic approach. As game theory and mathematical models have been introduced to “improve” and refine the economic approach, law and economics has become only more sophisticated and technical over the years.<sup>35</sup> There is no time to review or go back to first principles when one is busy attempting to solve complicated equations and devising sophisticated algorithms and mathematical formulas.

Another difficulty in deciphering a particular group's working paradigm is the problem of circularity. Any effort to articulate the elements of a paradigm runs the risk of being circular because there is no such thing as a neutral observer. For example, according to Kuhn, the acquisition of a paradigm is like learning a language.<sup>36</sup> In the process of learning such a new language, “new members acquire a set of cognitive commitments that are not, in principle, fully analyzable with that language itself.”<sup>37</sup> How, then, can one step outside of one's paradigm to describe it in neutral terms?

Despite the inherent difficulties of articulating a particular field's paradigm, this task is not entirely impossible or hopeless. By its very nature, the central elements of a paradigm are *shared* by a group of scholars. Even a scholar's tacit knowledge or intuition partakes of this shared quality.<sup>38</sup> If a given paradigm consists of shared commitments, then it is – in principle at least – discoverable. Accordingly, it should be possible in principle to reconstruct the shared foundations of a paradigm though they are hidden from one's immediate view.

To sum up: we neither recognize at the outset that anyone can pretend to paint a perfect picture of a given paradigm, nor do we make any pretense to ultimate truth or neutral objectivity. We attempt to describe the major underlying assumptions of the economic approach to law so that by the time the reader has finished reading this paper, the discordant parts of the conceptual framework of law and economics will form a consistent and sensible whole: *concordia*

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35 It is a matter of genuine debate whether the use of mathematics has actually “improved” the study of economics, let alone the economic approach to law. See, e.g., Ronald H. Coase, *Marshall on Method*, 18 J.L. & ECON. 25, 30-31 (1975) (criticizing “blackboard economics”). Cf. PAUL ORMEROD, *THE DEATH OF ECONOMICS* (1994) (criticizing macroeconomic theories' lack of predictive power).

36 According to Thomas Kuhn, the “[o]ne thing that binds the members of any scientific community together ... is their possession of a common language or special dialect.” See *Kuhn II*, *supra* note 10, at xxii.

37 *Id.* Or, as Kuhn puts it in a different context, “each group uses its own paradigm to argue in that paradigm's defense.” See *Kuhn I*, *supra* note 3, at 94.

38 For example, Kuhn has emphasized this quality of sharedness, defining tacit knowledge as “the tested and *shared* possessions of the members of a successful group.” See *Kuhn I*, *supra* note 3, at 191 (emphasis added).

*discors*.<sup>39</sup> Now that we have made our disclaimers, it is time to perform the task at hand.

What are the first principles of law and economics? What “shared exemplars” guide the puzzle-solving activities of scholars who follow the economic approach? To answer these questions, we shall attempt to articulate the conceptual framework of the economic approach, moving from the general to the specific. Part Three below describes the elements of the underlying mental attitude of an intellectually-honest practitioner of the economic approach, i.e., his or her way of seeing and ordering states of affairs in the world.<sup>40</sup> Part Four, subsequently, identifies the basic theories or “shared exemplars” that guide the day-to-day work and applications of law-and-economics scholars – the basic though often unstated premises that disciples of the economic approach implicitly rely on to conduct their day-to-day puzzle-solving activities.

### III. GENERAL OUTLOOK AND INTELLECTUAL ATTITUDE

The economic approach to law generally exhibits two defining characteristics: (1) it is agnostic toward all moral and normative values, and (2) it is irreverent toward authority and secular dogma, framing all problems as reciprocal in nature. Although these twin foundational values – intellectual agnosticism and intellectual irreverence – operate at a high level of abstraction, they inform and infuse the day-to-day work and puzzle-solving activities of Coase’s intellectual heirs.

#### A. *Intellectual Agnosticism*

The Coasean or economic approach to law adopts an intellectually agnostic or skeptical attitude toward normative values.<sup>41</sup> Thus, normative values and moral reasoning have no place in the economic analysis of law; on the contrary, the economic approach is utterly and completely agnostic or neutral with respect to competing claims about justice, fairness, or integrity, indeed with respect to any moral or normative values whatsoever.<sup>42</sup> In the words of George Stigler,

39 “Harmony in discord”; See HORACE, EPISTLES 328-29 [Epistle XII, line 19] (Loeb Classical Library ed. 1926, revised and reprinted 1929) (H. R. Fairclough trans.). The passage from which this celebrated phrase appears is *quid velit et posit rerum concordia discors*: “What is the meaning and what [are] the effects of Nature’s jarring harmony?”

40 Even if we are far off the mark, at the very least we will disclose our own mental attitude toward law.

41 I prefer the term “agnosticism” to “moral skepticism,” in part, to avoid confusion. The term “skepticism” has a precise and special connotation in the philosophy of science, where it generally refers to the problem of unobservable entities, such as gravity. See, e.g., David Papineau, *Introduction*, in *THE PHILOSOPHY OF SCIENCE 3* (David Papineau ed., 1996). That is, how do we know that a given scientific theory discloses the truth about the underlying structure of the unobservable world?

42 Ironically, as Richard Posner once pointed out, an agnostic, to be consistent, should be agnostic about agnosticism too (Personal correspondence with Richard Posner, July 18, 2004). Posner’s point about being agnostic about agnosticism is a valid criticism, and a potentially fatal one.

the economic approach “den[ies] the existence of a widely accepted, coherent moral code ... The assertion of moral values, in the absence of such a code, is either a disguised expression of personal preferences or a refusal to continue the analysis of a problem.”<sup>43</sup> Simply put, Coase and his intellectual heirs are not Kantians.

The agnostic attitude in economics can be traced all the way back to Adam Smith, the founding father of classical economics. Consider the following passage from *The Wealth of Nations* in which Smith explains why laws against smuggling generate deadweight losses to society:

“By the ruin of the smuggler, his capital, which had before been employed in maintaining productive labour, is absorbed either in the revenue of the state or in that of the revenue officer, and is employed in maintaining unproductive, to the diminution of the general capital of the society, and of the useful industry which might otherwise have maintained.”<sup>44</sup>

In other words, the morality of permitting or prohibiting smuggling is beyond the purview of Smith's analysis. He takes the activity of smuggling as a given, the natural and unavoidable result of high customs duties and outright restrictions on various imports. His sole concern is with describing the economic effects of punishing this activity on the society.<sup>45</sup>

Before proceeding, however, a few clarifications are in order. To begin with, though we do not wish to belabor this point, there is a subtle distinction to be made between the intellectual agnosticism of the economic approach and the all-out moral relativism of the Richard Rorty variety. On one hand, moral relativism takes the hardcore position that there are no absolute moral truths.<sup>46</sup> In contrast, an agnostic merely believes that one is unable to determine whether there are absolute moral truths but does not necessarily deny the possibility of their existence; that is, he or she is agnostic even about moral relativism.

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because if one is agnostic about agnosticism, then what does one have left at the end of the day? For the time being, we have resolved this potential contradiction by adopting the following default position: although one should be agnostic about agnosticism, one should adopt an agnostic posture toward all moral and normative values until a consensus is reached about the meaning of justice and other normative values. Since we are confident that no such consensus will be reached in our lifetimes, our default position works as a trump.

43 See George J. Stigler, *Wealth, and Possibly Liberty*, 7 J. LEGAL STUD. 213, 216 (1978). I thank Richard Posner for bringing this paper to my attention.

44 ADAM SMITH, *AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS* 563 (Easton Press 1991) (1776).

45 By the same token, Adam Smith objected to the policy of mercantilism not on moral grounds but rather on practical ones, that mercantilism reduces the wealth of nations.

46 See, e.g., RICHARD RORTY, *CONSEQUENCES OF PRAGMATISM* (1982).

Next, to say that the economic approach is agnostic about moral values is not to say that it is incapable of taking sides on moral questions. Rather, agnosticism implies that the economic approach will not resort to moral reasoning to justify a particular conclusion or argument. The economic approach banishes all forms of moral discourse from its vocabulary. A conventional or traditional analysis of theft, for example, might start from the premise that theft is wrong for moral reasons - namely, theft is wrong because it involves coercion and harms an innocent victim. But, then, so does the collection of taxes! The problem with traditional legal analysis is that it does not provide a principled method for distinguishing taxes from theft. Under the economic approach, in contrast, theft (like taxes) is merely a forced transfer of wealth. From this view, theft is “bad” not because it involves coercion (so do taxes) but rather because it produces enormous social costs (deadweight losses) and distorts the allocation of resources.<sup>47</sup>

Third, the agnostic attitude transcends the traditional distinction one sees in economics textbooks and journal literature between positive economics and normative economics.<sup>48</sup> The economic approach’s agnosticism is across-the-board. Whether one is engaged in the observation and collection of data (positive economics) or in policy analysis (normative economics), the economic approach eschews ethical considerations. Even when concerned with questions of policy, the economic analyst is ideally concerned with the empirical consequences of adopting or rejecting a given policy recommendation and not with its underlying moral implications.

Finally, it is worth noting that intellectual agnosticism is not the exclusive domain of law and economics. It is central to all scientific activity.<sup>49</sup> Nor do all philosophers reject the agnostic approach. The logical positivists of the Vienna Circle famously embraced and celebrated this attitude. In the words of Arthur Alan Leff: “The knowledge of good and evil, as an intellectual subject, was ... systematically and effectively destroyed” by the members of the Vienna Circle

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47 For example, the time and resources consumed by criminals in planning and carrying out their crimes and the resources consumed by potential victims in protecting themselves against crime (e.g. the cost of a car-alarm system) could have been put to a different use (e.g. help the needy, protect the environment, etc.).

48 Cf. George J. Stigler, “The Process and Progress of Economics” (Nobel Memorial Lecture, Dec. 8, 1982), *reprinted in* NOBEL LECTURES IN ECONOMIC SCIENCES 1981-1990, at 69 (Karl-Goran Maler ed., 1992) (“The textbooks on methodology lecture us on the need to separate positive and normative theories”). For a textbook example of this phenomenon, see Shavell, *supra* note 32, at 1 (“The economic approach ... seeks to answer two basic questions about legal rules. One type of question is *descriptive*, concerning the effects of legal rules on behavior ... The other type of question is *normative*, concerning the social desirability of legal rules”) (emphasis in original).

49 Cf. Thomas Kuhn, *Logic of Discovery or Psychology of Research*, in *Kuhn II*, *supra* note 10, at 273 (defining a scientist as one who eschews “the tradition of claims, counterclaims, and debates over fundamentals [that], except perhaps for the Middle Ages, have characterized philosophy and much of social science ever since”).

long before Ronald Coase wrote *The Problem of Social Cost* or Richard Posner published his textbook.<sup>50</sup> While agnosticism, therefore, is nothing new, its application to law is new, bold, and revolutionary.

This effort to banish normative values from the study of law is especially momentous because if any discipline – with the possible exception of theology – is infused with moral concepts, it is the law. If Holmes was the first jurist who warned of taking the moral language of the law – terms such as justice, equity, and fault – too seriously,<sup>51</sup> Coase and his heirs were the first ones to take Holmes's admonition to heart.<sup>52</sup> The economic approach is not in the business of making moral judgments. This decidedly unscientific task is relegated to the philosophers. In place of idle speculation about the nature of justice, virtue, or the good life, the economic approach simply aspires to observe and describe the world as it is.<sup>53</sup>

Nevertheless, we concede that not all disciples of the economic approach are truly agnostic, since some scholars may have open or hidden agendas in favor of *x* or *y* ideology, be it individual liberty (Hayek) or private property (Epstein). A cursory glance at law-and-economics literature reveals that many jurists and economists have used and perhaps abused economics to vindicate their preferred personal values, especially private property and negative liberty.<sup>54</sup> Although we do not dispute that individual liberty and private property are often socially desirable and instrumental in promoting the accumulation of social wealth and expanding one's choices, our overall point is that the economic approach does not, in principle, prefer a particular right or moral value for its own sake.

On this note, the Coasean or economic approach to law is riddled with several related misconceptions. One of the most common is that the economic approach is somehow about vindicating "individual human freedom."<sup>55</sup> Another myth is that the economic approach is about markets and property rights. Yet

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50 See Arthur Alan Leff, *Economic Analysis of Law: Some Realism about Nominalism*, 60 VA. L. REV. 451, 477 (1974) (stating that "individual human freedom" is the "one value qua value that directs and informs Posner's analysis").

51 Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457 (1898).

52 One could argue that Holmes and the legal realists were the first to depart from this tradition, but I think law and economics is the first movement to systematically embrace agnosticism and to apply it relentlessly to all legal institutions, including family law, torts, and criminal law, areas that traditionally abound in moral discourse.

53 Of course, one's research will be guided by one's conceptual framework, but my point is that the economic approach attempts to banish moral discourse from its conceptual framework.

54 See, e.g., Milton Friedman, *The Methodology of Positive Economics*, in *ESSAYS IN POSITIVE ECONOMICS* 4 (Milton Friedman ed., 1953), reprinted in Katz, *supra* note 21 ("Laymen and experts alike are inevitably tempted to shape positive conclusions to fit strongly held normative preconceptions and to reject positive conclusions if their normative implications-or what are said to be their normative implications-are unpalatable.").

55 See, e.g., Leff, *supra* note 50.

another misnomer is that the economic approach values efficiency for efficiency's sake. We shall address and refute each one of these myths and misconceptions in turn.

First and foremost, the economic approach is not really about promoting freedom. Law and economics is not libertarianism nor is it about any other normative value, for that matter. The problem with "freedom" as a foundational value is that there can be no consensus as to its precise meaning.<sup>56</sup> As soon as one attempts to define a normative value, even a value as praiseworthy as freedom, one will necessarily get bogged down in an intractable and metaphysical level of generality.<sup>57</sup> At what level of generality should freedom be defined? How narrow or broad should one's definition be? Any attempt to answer these questions will necessarily involve a subjective and arbitrary value choice,<sup>58</sup> and the economic approach 'is not committed to any particular moral or political theory because moral concepts such as liberty and justice are ultimately subjective, elastic, vague, and open-ended.

In short, the economic approach is not absolutist; it does not value freedom for freedom's sake. For example, there can be no doubt that compulsory seat-belt laws or compulsory vaccinations restrict people's freedom. But if it can be shown that these freedom-reducing policies are a cost-effective and practical way of reducing accident costs and the spread of dangerous epidemics, then the economic approach will not object to the reduction in freedom in these cases.

Nor is law and economics about vindicating the primacy of markets or the sanctity of private property. We shall call this the Blackstonian view of law, to avoid offending the living, and to honor William Blackstone, who wrote long ago: "So great ... is the regard for the law for private property, that it will not authorize the least violation of it; no, not even for the general good of the whole community."<sup>59</sup> Though this view of law still attracts partisans,<sup>60</sup> it is so dogmatic,

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56 For an excellent and succinct explanation of the futility of defining freedom, see Stigler, *supra* debating the content of liberty, see citations in Amartya Sen, *The Possibility of Social Choice*, 89 AMERICAN ECONOMIC REVIEW 349 (1999). Sen's attempt to define liberty in the face of this endless and intractable debate is, I think, pure folly. See also ROBERT NOZICK, ANARCHY, STATE, AND UTOPIA (1974).

57 See, e.g., LAURENCE H. TRIBE & MICHAEL C. DORF, ON READING THE CONSTITUTION 73-80 (1991); LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW 1427-28 (2d ed. 1988); Paul Brest, *The Fundamental Rights Controversy*, 90 YALE L. J. 1063, 1085 (1981) (explaining the "indeterminacy and manipulability of levels of generality").

58 Justice Scalia famously pretended to resolve this problem in the context of defining fundamental constitutional rights. According to Scalia, the solution to the problem of defining an abstract right is to refer to "the most specific level at which ... the asserted right can be identified." See "specificity," though I suppose one cannot fault him for trying.

59 See I WILLIAM BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND 135 (1765) (capitalization altered).

60 See, e.g., Walter Block, *Private Property Rights, Economic Freedom, and Professor Coase: A Critique of Friedman, McCloskey, Medema, and Zorn*, 26 HARV. J.L. & PUB. POL'Y 923 (2003) ("Private property rights are the basic building blocks of economic freedom").

simplistic, and pedantic that it merits little discussion. Suffice it to say that markets and property rights – like freedom and liberty- however defined are purely instrumental under an intellectually-honest economic approach.

Although as a practical matter, there can be no doubt that markets and voluntary transactions are generally more efficient (or less inefficient) than collective or socialist policies, if it can be shown that collective ownership of a particular resource (such as a military base or a lighthouse) is more practical than private ownership, then the economic approach will favor the collective solution. Oliver Wendell Holmes made this same pragmatic point when he wrote, “I have no *a priori* objection to socialism any more than to polygamy. Our public schools and our post office are socialist, and whenever it is thought to pay I have no objection.”<sup>61</sup>

Last but not least, the economic approach does not embrace economic efficiency or wealth maximization as an end in itself. Admittedly, this last point demands some explanation. First, let us put aside the Byzantine complexities relating to the precise meaning of “economic efficiency” and simply take efficiency to mean “wealth maximization” or the largest possible economic pie a community can produce at a given moment in time.<sup>62</sup> In our view, the economic approach is not *per se* committed to promoting wealth maximization because it recognizes *ex ante* that people are often willing to trade wealth off for other things, such as protecting the spotted owl or helping the needy.<sup>63</sup> How much efficiency, if any, should we be prepared to give up or trade off in order to protect the environment, feed the hungry, etc.?<sup>64</sup> This is a normative question, and as such, it is beyond the scope of the economic approach. The economic approach is, in principle, neutral as to the choice society should make in this regard. All the economic approach does is to make one realize that there *is* a trade off to be made, but it does not pretend to lay down a hard-and-fast Kantian-type rule in favor of an abstract notion of efficiency in every situation.

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61 See Letter to Lewis Einstein (Nov. 24, 1912), in *THE ESSENTIAL HOLMES: SELECTIONS FROM THE LETTERS, SPEECHES, JUDICIAL OPINIONS, AND OTHER WRITINGS OF OLIVER WENDELL HOLMES, JR.* 66 (Richard A. Posner ed., 1992). In the interest of full disclosure, I especially like the remainder of this quote: “But I have as little enthusiasm for [socialism] as I have for teetotalism.”

62 This is Richard Posner’s position. Professor Jules Coleman provides a comprehensive and comprehensible exposition of the various meanings of economic efficiency. See JULES COLEMAN, *MARKETS, MORALS, AND THE LAW* 95-132 (1988).

63 Cf. Guido Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 *YALE L. J.* at 499, 503-04 n.17 (1961) (“... there are other things which count more in our society than allocation of resources and that we will gladly forego the best allocation of resources if by doing so some more important policy is served”).

64 Although I am suggesting that freedom and efficiency must be traded off against each other, it is worth noting that George Stigler once argued that freedom and efficiency are not necessarily in conflict. See Stigler, *supra* note 43.



Accordingly, instead of saying that efficiency or wealth maximization is the Holy Grail of the economic approach, I think it is more accurate to say that the economic approach values instrumental efficiency, or to borrow from Lionel Robbins's classic definition of economics, the gist of the economic approach is to call one's attention to "the relationship between (given) ends and scarce means."<sup>65</sup> Notice how Robbins's elegant definition of economics leaves the selection of appropriate ends entirely open to debate. The ends can include such things as helping the needy or protecting the environment. No doubt society as a whole wishes to use its scarce resources efficiently, that is, avoid squandering its scarce resources whatever ends are ultimately chosen – but the selection of ends itself is entirely up for grabs.

For his part, Richard Posner made this same point in early editions of his classic textbook *Economic Analysis of Law*: "The demand for justice is surely not independent of its price."<sup>66</sup> That is, the economic approach does not attempt to discover or impose a singular definition of justice. It is agnostic toward any and all moral values. All that the economic approach is supposed to do at the end of the day is to point out the costs or alternatives one must forego in order to attain one's particular conception of justice, whatever the content of that conception happens to be.

Summing up, the economic approach to law is agnostic toward moral values, and this agnosticism serves to insulate law and economics from intractable and indeterminate moral debates.<sup>67</sup> But the economic approach is not just agnostic, it is also downright irreverent toward authority, dogma, and established institutions.

### B. Intellectual Irreverence

Another trademark characteristic of the economic approach is its intense critical spirit and studied irreverence toward authority. Coase and his heirs have adopted a critical attitude toward all claims of authority, especially intellectual.<sup>68</sup> Our *modus operandi* is constant questioning. Nothing is sacred,

65 LIONEL ROBBINS, AN ESSAY ON THE NATURE AND SIGNIFICANCE OF ECONOMIC SCIENCE 16 (2d ed., 1935). It is worth noting that Professor Coase has stated that Robbins's elegant and concise definition of economics expresses the "dominant view" of economics held by economists. See *Coase II, supra* note 1, at 1-2.

66 RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 23 (2d ed., 1977). Judge Posner dropped the word "surely" from subsequent editions of his textbook, and he deleted the entire quote from the last two editions. I brought this mysterious and surreptitious omission to Posner's attention in the summer of 2003.

67 According to Thomas Kuhn, one of the functions of a paradigm is to serve as "a criterion for choosing problems ... that [are] assumed to have solutions." *Kuhn I, supra* note 3, at 37.

68 In many respects, one could argue that the legal realists were irreverent toward authority as well, and the same might be said of the movement known as "critical legal studies" or CLS. The legal realists, however, are an extinct species, and the CLS literature has by and large a more angry and self-righteous tone than the law-and-economics literature does.



and no one is exempt from our critical gaze. No institution – whether it be the holy sacrament of matrimony or the august halls of Congress – is immune from its probing lens.

This attitude probably goes back to Adam Smith, who was willing to break with tradition and question the established and pernicious dogma of his time - mercantilism. In addition to Adam Smith, some commentators have attributed the economic approach's irreverent attitude to Professor Frank Knight, one of the founders of the "Chicago school" in economics.<sup>69</sup> According to one historian, no economist did more to promote a "studied irreverence toward authority" than Knight did.<sup>70</sup> George Stigler, for example, once commented that "Knight was the original source of the Chicago tradition that 'great reputation and high office deserve little respect.'"<sup>71</sup>

But with the possible exception of Richard Posner, no man exemplifies this quintessential Knightian attitude of "studied irreverence" more than Ronald Coase. *The Problem of Social Cost* not only played a leading role in unifying the fields of 'law' and 'economics'; it also made irreverence an integral part of this new economic approach to law. Indeed, one could argue that Coase's famous article is to traditional economists and lawyers what Martin Luther's Ninety-Five Theses were to the corrupt Church hierarchy in Rome, for Coase was one of the first economists to display an agnostic and irreverent attitude not only toward traditional economics but also to law. Coase's contribution is so central to the creation of law and economics that we must take a moment to describe what Coase did and how he did it.

In *The Problem of Social Cost*, Coase begins with the problem of "harmful effects," or what is more commonly called "negative externalities" in economics textbooks.<sup>72</sup> "The standard example," he writes, "is that of a factory, the smoke from which has harmful effects on those occupying neighbouring properties."<sup>73</sup> In a now-famous passage, Coase strikes a fatal blow against the

69 PAUL SAMUELSON, *ECONOMICS FROM THE HEART: A SAMUELSON SAMPLER* 60 (1983); see also Melvin W. Reder, *Chicago Economics: Permanence and Change*, 20 *JOURNAL OF ECONOMIC LITERATURE* 6-7 (1982). For what it is worth, Professor Knight was also one of the few leading economists who wrote in old-fashioned prose, and among his students were half a dozen or so future Nobel laureates.

70 According to the historian Robert Nelson, "Knight's greatest source of influence was in a spirit of radical questioning that he inculcated. Almost in the manner of Socrates, Knight was a doubter of every orthodoxy, often extending this attitude to his own arguments." ROBERT H. NELSON, *ECONOMICS AS RELIGION: FROM SAMUELSON TO CHICAGO AND BEYOND* 115 (2001) (footnote omitted). See also LIVES OF THE LAUREATES: THIRTEEN NOBEL ECONOMISTS 98 (William Breit & Roger W. Spencer eds., 3d ed. 1995).

71 Quoted in Nelson, *supra* note 70, at 115.

72 *Coase I*, *supra* note 1, at 1. In the preface to his collection of essays, *THE FIRM, THE MARKET, AND THE LAW*, Coase explains why he chose the term "harmful effects" in place of the more conventional terminology, "externalities." See *Coase II*, *supra* note 1, at 27.

73 *Id.* at 95.

traditional economic approach to the problem- and to the traditional legal approach as well - replacing tradition with a radically agnostic and irreverent approach. Because of its simplicity and its monumental impact on the subsequent evolution and development of “law and economics,” it is well worth quoting this passage in its entirety:

“The traditional approach has tended to obscure the nature of the choice that has to be made [between A, the owner of the factory, and B, the neighbors]. The question is commonly thought of as one in which A inflicts harm on B and what has to be decided is, How should we restrain A? But this is wrong. We are dealing with a problem of a reciprocal nature. The real question that has to be decided is, Should A be allowed to harm B or should B be allowed to harm A? The [correct solution] is to avoid the more serious harm.”<sup>74</sup>

Coase’s irreverent utterance – “But this is wrong. [*This is wrong!*] We are dealing with a problem of a reciprocal nature” – is the single most insightful and revolutionary statement in the annals of Anglo-American legal history since Oliver Wendell Holmes uttered his famous maxim, “The life of the law has not been logic; it has been experience.”<sup>75</sup> For Coase is not just repeating the old saw that there are two sides to every dispute, he is saying something much more original and insightful.

First, Coase says that one side to the dispute will suffer “harmful effects” *no matter what* the result is. For example, if we permit the owner of the factory to continue to emit smoke, the neighbors will be harmed. If, however, we rule in favor of the neighbors, then the owner of the factory will be harmed. In the latter case it is not just the owner of the factory who will be harmed but also all consumers who wish to purchase the products produced by the factory.<sup>76</sup> By the same token, to say that the owner of the factory has a moral right to use the factors of production free from legal or government intervention is not dispositive because one could argue that the neighbors have a moral right to clean air or to good health. However we frame the problem- as one involving property rights in the factors of production or moral rights to good health- the problem remains reciprocal.<sup>77</sup> One of the parties will suffer harmful effects however the dispute between them is resolved.

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74 *Id.* at 2.

75 See Holmes, *supra* note 6, at 1.

76 Of course, the extent of the consumers’ injury will depend in large part on the elasticity of demand for the factory’s products.

77 It is worth noting that Guido Calabresi had reached the same conclusion as Ronald Coase did regarding the reciprocal nature of externalities, but Calabresi made the mistake of relegating his conclusion to a footnote. See Calabresi, *supra* note 63, at 500 n.4.

On one level, then, Coase simply makes a practical point about trade-offs. One must weigh and balance (a) the cost to the neighbors caused by the emission of smoke versus (b) the cost to the factory owner and to consumers that will be caused by preventing the emission of smoke. But at a much deeper level, Coase, perhaps unwittingly, discloses a profound and irreverent insight, for his approach implies that neither party to the dispute has an *ex ante* moral right to be free from harmful effects. An appeal to moral concepts, such as fault and culpability, is totally unhelpful in solving this concrete problem of the factory smoke because, from a moral or metaphysical perspective, one could argue that both sides are culpable. The concept of justice or fairness is too broad to be of any practical help. It is not enough to say that it is unjust or unfair to pollute the air and that we should therefore rule in favor of the neighbors. We could just as well argue that it is unjust to interfere with the factory owner's property rights or that it is unfair to make all consumers pay for the clean air of the neighbors.

Coase thus taught his students that agnosticism and irreverence are virtues and thus played a leading role in taking law out of the "normative swamp," to borrow Leff's apt phrase.<sup>78</sup> Rather than attempt to identify which party is the victim and which is the wrongdoer, the Coasean or economic approach recognizes *ex ante* that both parties can be classified as victims or wrongdoers depending on how moral concepts are defined and manipulated in any given case. Accordingly, the economic approach discards moral language and instead weighs the practical consequences of deciding a dispute one way or another.

#### IV. SHARED EXEMPLARS

Up to this point, we have examined the economic approach's general mental outlook toward the outside world, saying nothing about its specific premises or shared exemplars. If agnosticism and irreverence comprise the general mind-set or mental attitude of Coase's intellectual heirs, the exemplars set forth below guide the economic approach's day-to-day puzzle-solving activities. And of all the assumptions, models, and theories that attempt to simplify and explain how the world works, first and foremost among these is the brute fact of material scarcity.

##### A. Scarcity

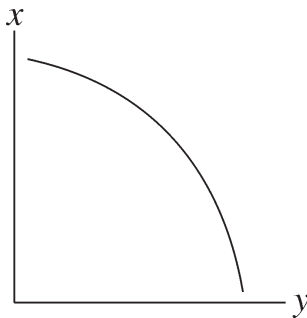
It is fitting that Richard Posner has stated on the first page of every edition of his masterpiece, *Economic Analysis of Law*, that "resources are limited in relation to human wants,"<sup>79</sup> for the notion of scarcity is the linchpin of

<sup>78</sup> See Leff, *supra* note 50, at 454 (stating that "normative thought crawled out of the swamp and died in the desert") (footnote omitted).

<sup>79</sup> See Posner, *supra* note 30, at 3. For reasons unknown to me, chapter one of Posner's textbook actually commences on page three.

the entire intellectual structure of law and economics.<sup>80</sup> Likewise, one of Guido Calabresi's most poignant and recurring themes is that no society will expend infinite resources to protect human life.<sup>81</sup> And, of course, the scarcest resource of all is time itself.<sup>82</sup> Thus while philosophers continue to debate the meaning of "justice" in outdoor cafés, the economic approach realizes that a community can produce only  $x$  amount of goods with the material, technological, and human resources it has at its disposal at any given moment in time. Like Newton's inverse-square law of gravitational attraction, scarcity is a universal and brute fact of nature.<sup>83</sup>

Although the word "scarcity," taken in a literal dictionary sense, might conjure up images of abject poverty and material deprivation, in economics it does not refer to wealth transfers or the distribution of resources. Rather, it refers to the overall allocation of resources among competing uses and is related to the notion of "opportunity cost": the cost incurred by society as a whole when someone is denied the use of a resource. This idea is illustrated in the following simple diagram:



**Figure 1**

This diagram depicts what economists call the "production possibility frontier." Although it is oversimplified- the diagram displays a community that produces only two types of goods,  $x$  and  $y$  – it communicates a fundamental and unalterable truth about the material world: there is an upper limit to the amount of goods and services a community can produce for its members at any

80 And as Posner once pointed out to the author of this essay, scarcity would exist even in a Utopian world full of do-gooders and altruists, for one might desire scarce goods for one's family, neighbors, and friends. Personal correspondence with Richard Posner, July 18, 2004.

81 See generally GUIDO CALABRESI & PHILIP BOBBIT, *TRAGIC CHOICES: THE CONFLICTS SOCIETY CONFRONTS IN THE ALLOCATION OF TRAGICALLY SCARCE RESOURCES* (1978).

82 See, e.g., Gary S. Becker, *Nobel Lecture: The Economic Way of Looking at Behavior*, 101 *JOURNAL OF POLITICAL ECONOMY* 385, 386 (1993) [hereinafter *Becker I*], reprinted in *NOBEL LECTURES IN ECONOMIC SCIENCES 1991-1995* (Torsten Persson ed., 1997) ("For while the growing abundance of goods may reduce the value of additional goods, time becomes more valuable as goods become more abundant").

83 Thus Marxist schemes for eliminating scarcity are pure folly. Cf. Nelson, *supra* note 70, 27-29.

given moment in time.<sup>84</sup> How these goods should be distributed – that is, how the slices of a community's economic pie should be divided in terms of such values as justice and equity – is entirely outside the scope of economics.<sup>85</sup> But whether a community's economy is efficient, i.e. whether the size of the economic pie is as large as can be, is the domain of economics proper.<sup>86</sup>

Lionel Robbins's classic definition of economics elegantly and concisely expresses this point: "Economics is the science which studies human behavior as a relationship between ends and scarce means which have alternate uses."<sup>87</sup> Notice how this definition does not pretend to say what one's ends in life should be, that is, what goods one should produce or consume. As our analysis of intellectual agnosticism has shown, the economic approach cannot do this because the choice of ends is ultimately based on subjective normative values. Instead, economics is simply about "the relationship between ends and scarce means."<sup>88</sup> That is, given certain ends, how do we go about achieving them? The question of ends lies outside the domain of economics.

But why is the problem of scarcity relevant to law? Once again, it is Ronald Coase who was the first to supply the answer. One of Coase's central lessons in *The Problem of Social Cost* is that the substantive legal rules of a community *will* have an effect on the allocation of resources.<sup>89</sup> As a result of this insight, the economic approach takes law to be a factor of production, just like any other factor of production (such as labor, technology, etc.), affecting what goods will be made and how much of them will be produced. That is why the economic approach is not concerned with abstract theories of justice and right but rather with the actual and potential effects of the law on the allocation of resources.

To understand this point, imagine a society with infinite resources.<sup>90</sup> In this fictional society, the economic approach to law would probably have no role to play because, by definition, the laws of this paradise- no matter how silly

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84 The phrase "at any given moment in time" is important because an increase in productivity or an improvement in technology or the discovery of new minerals, for example, can have the effect of pushing the production frontier outwards.

85 Actually, this statement is not entirely accurate because it is proper to study the economic effects (as opposed to the moral aspects) of a given community's distribution of resources.

86 For purposes of this discussion, we use the term "efficiency" in its literal sense to mean productive efficiency.

87 See Robbins, *supra* note 65, at 16.

88 *Id.*

89 *Coase II, supra* note 1, at 114-119. A number of scholars, however, who either have never read "The Problem of Social Cost" or have misunderstood it, have unfairly caricatured Coase as saying that the law will have no effect on the allocation of resources. In fact, Coase said that this is true only in the absence of transaction costs, and he has always recognized "that there are transaction costs and that they are large." *Id.* at 26.

90 As an aside, is this not what Marx and Engels promised their hapless followers?

or unjust - would have no effect on the allocation of its resources.<sup>91</sup> Of course, philosophers could go on debating in outdoor cafés whether the laws of this society were just, but economists would have to find another line of work. Thus the significance of scarcity to the economic approach cannot be understated. In essence, it carves out a new role for legal actors and legal institutions to play. In place of the search for justice or absolute truth, the work of the economic approach is far more modest. Its goal is simply to identify and measure the effects of the law on the allocation of resources. And as we shall see below, the concept of scarcity leads us in one way or another to the remaining principles of law and economics. In particular, scarcity implies a certain view of human nature, the hard-core Hobbesian view that man's appetite for consumption is insatiable.

### B. *Self-interest*

The Irish have a saying: "Everyone looks after himself."<sup>92</sup> The most eloquent defense of self-interest, though, was probably made by a Scot:

"It is not from the benevolence of the butcher, the baker, or the brewer that we expect our dinner, but rather from a regard to their own interests.... Nobody but the beggar chooses to depend chiefly upon the benevolence of his fellow citizens."<sup>93</sup>

Yet the assumption that man is ruled by self-interest is one of those ideas- however accurate it may be as an empirical description of human behavior in the real world- that one is not supposed to bring up in polite company. Indeed, the notion of self-interest conjures up ugly connotations. People tend to equate it with selfishness, depravity, and hoarding.<sup>94</sup> Perhaps it is too closely associated with the Hobbesian "war of all against all"<sup>95</sup> or with the crude Darwinian "struggle for existence," the idea that all living organisms vie for mastery and survival.<sup>96</sup> These connotations are apparently so distasteful that economists have fathered a wealth of euphemisms and neologisms: in place of self-interest, economists now talk of rent-seeking and opportunistic behavior, shirking and free-riding, moral hazard and methodological individualism – though this last neologism

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91 Recall that we postulated that this Utopian society has infinite resources.

92 "*Gach aoinne ag cur a bhó féin thar abhain.*"

93 Smith, *supra* note 44, at 12. The last sentence about the beggar (or "the homeless" as beggars are called these days) is usually omitted from this oft-cited quotation.

94 One need not equate self-interest with selfishness because, as Richard Posner pointed out to me, one's "utility function" can include not only one's own utility but also the utility of someone else (Personal correspondence with Richard Posner, July 18, 2004).

95 See THOMAS HOBBS, *LEVIATHAN, reprinted in* 3 *THE ENGLISH WORKS OF THOMAS HOBBS* 82 (W. Molesworth ed., 1839-45) (stating that the state of nature is a state of war, "every man, against every man").

96 CHARLES DARWIN, *ON THE ORIGIN OF SPECIES* 60-79 (Harvard University Press 1964) (1859) (describing the "struggle for existence").

sounds more like some sort of disease.<sup>97</sup>

The most ubiquitous of these euphemisms in law-and-economics literature is by far the notion of rationality, the idea that man is a rational actor.<sup>98</sup> Richard Posner, for example, has stated that “people are rational maximizers of their satisfactions – *all* people ... in *all* of their activities ... that involve choice.”<sup>99</sup> Likewise, Gary Becker has stated that “individuals maximize welfare as they conceive it, whether they be selfish, altruistic, loyal, spiteful, or masochistic.”<sup>100</sup> While we suspect that most people do indeed act selfishly most of the time, Becker’s point that self-interest is not the same as outright selfishness is one of the most important philosophical insights of the economic approach.

Despite this deep insight, the concept of rationality – like the notion of self-interest – is not free from controversy. In fact, the idea of ends-means rationality has generated a ferocious academic battle. Many scholars prefer the notion of “bounded rationality” to outright rationality, while others reject the notion of rationality altogether.<sup>101</sup> For the purposes of this essay, we prefer to sidestep these interminable semantic debates between self-interest and rationality, between rationality and rationality-lite (i.e. “bounded rationality”).<sup>102</sup> To avoid having to choose among these competing terms, we shall coin a euphemism of our own: insatiability. Whether one describes man’s behavior as self-seeking or as rational, in either case, his appetite for consumption is insatiable.

97 For purely aesthetic reasons, we prefer the plain-English term “self-interest” to these exotic euphemisms. The economists who have coined such neologisms seem to forget that the economic approach takes the same view of human nature that the authors of *The Federalist* took. In the immortal words of James Madison: “No man is allowed to be a judge in his own cause, because his interest would certainly bias his judgment, and, not improbably, corrupt his integrity.” THE FEDERALIST NO. 10, at 79 (Clinton Rossiter ed., 1961).

98 Whichever euphemism one prefers, the coining of these euphemisms is a fairly recent business, for even a philosopher as inscrutable as Hegel chose to describe human behavior simply as “self-seeking.” See G.W.F. HEGEL, PHILOSOPHY OF RIGHT 186, 200 (S.W. Dyde trans., Prometheus Books 1996) (1821). Hegel even talks of the “spectacle of excess, misery, and physical and social corruption” caused by man’s insatiable wants. *Id.* at 188.

99 RICHARD A. POSNER, THE PROBLEMS OF JURISPRUDENCE 353 (1990).

100 *Becker I*, *supra* note 82, at 386.

101 See, Calabresi, *supra* note 63, at 515, n. 43 (stating that “the whole ‘rational economic man’ approach strikes me as so unreal”). See also *Coase II*, *supra* note 1, at 2 (describing the concept of “utility” as similar “to that of ether in the old physics”). Our own position is that, even if man were “rational,” the concept of rationality is a superfluous entity in that scarcity and the law of demand wind up doing all the work of the rational actor model.

102 While we sympathize with these well-meaning attempts to provide a comprehensive explanation of all human behavior, at the same time these explanations miss the larger point, the point that as a matter of empirical reality most people are self-interested most of the time and that altruism is an anomaly. Or maybe altruism is not an anomaly at all. Is it not possible to display all the behavior patterns that Becker described in his Nobel lecture — altruism, loyalty, courage, spite, masochism, etc. — for self-interested or self-seeking reasons and is this not what most people do in the real world most of the time. In short, we are downright flabbergasted that so many scholars have rejected the premise of self-interest on the basis of a few isolated and rare anomalies.



Becker's analysis of time scarcity is one of the best arguments in support of this thesis.<sup>103</sup> After all, the total time available to consume would not be finite unless people's wants perpetually outstripped their capacity to satisfy them, and people's wants would not have this expansive tendency unless our appetites were basically insatiable, always wanting more and more scarce goods to consume.<sup>104</sup>

Before proceeding, however, consider once again Posner's statement that "resources are limited in relation to human wants."<sup>105</sup> Posner's statement implies that human wants are insatiable.<sup>106</sup> Furthermore, his statement not only attempts to describe the world as it is, it also raises a fascinating and perhaps unsolvable metaphysical question. Are our appetites insatiable because resources are inherently scarce, or are resources scarce because our appetites are inherently insatiable? However this metaphysical question is answered – that is, whatever the final causes of man's behavior are – the economic approach simply takes man's insatiable appetite as a given.

The larger point to be made is that independent of the particular terminology used to describe the behavior of human actors in a world of scarcity, the economic approach to law takes a dim (we would say realistic) view of human nature: people respond more effectively and consistently to material incentives than to sermons or abstract ideals. Call it self-interest; call it rationality. Whatever term is used, this premise is central to "law and economics," for the notions of incentive effects and strategic behavior are based on it.<sup>107</sup>

Nevertheless, many critics of the economic approach vehemently reject this rationality/self-interest premise out of hand, and one commentator has gone so far as to argue that this view of human nature is a secular version of the

103 See *Becker I*, *supra* note 82, at 386 ("For while the growing abundance of goods may reduce the value of additional goods, time becomes more valuable as goods become more abundant"). See also STAFFAN BURENSTAM LINDER, *THE HURRIED LEISURE CLASS* (1970); Gary S. Becker, *A Theory of the Allocation of Time*, 75 *ECON. J.* 493 (1965).

104 And as Posner himself once pointed out to the author of this essay, this would be true even if people acted on altruistic motives, for one might desire scarce goods not for one's own consumption but for other, more needy people. Personal correspondence with Richard Posner, July 18, 2004.

105 Posner, *supra* note 30, at 3.

106 This is why even rich countries are unable to provide for the basic needs of all its citizens. The notion of "basic needs" or of "primary goods" is a moving target, one that is relative to the wealth of a particular society.

107 Cf. THE FEDERALIST NO. 10, at 81 (James Madison) (Clinton Rossiter ed., 1961) ("If the impulse and the opportunity [to act on one's self-interest] be suffered to coincide, we well know that neither moral nor religious motives can be relied on as an adequate control."). In addition, anyone who has ever read Edward Gibbon's *Decline and Fall of the Roman Empire* will have seen this view of man countless times before, but one need not be a classical scholar to understand this view of human nature. Anyone who has ever seen siblings fight for the same toy (mine! mine!) will recognize it at once.



Christian doctrine of original sin.<sup>108</sup> The problem with this line of argument, however, is that it equates self-interest with selfishness and thus implies that self-interest is “bad” in the moral sense – the equivalent of a mortal sin.

In economics, though, the notion that man's appetite is insatiable (or is ruled by self-interest or is a rational maximizer of his ends in life) carries no moral connotation whatsoever. Self-interest is neither good nor bad in the moral sense. In fact, on balance, self-interest is probably a good thing in that it is the motor that drives all activity in all walks of life. It is why publishers publish newspapers: not so much to inform the public or promote democracy, but rather to sell a copy and turn a profit. It is why people study law and other learned professions: to generate a future stream of income. And it is why Adam Smith's metaphorical baker wakes up at the crack of dawn to bake bread.<sup>109</sup> In short, it is hard to imagine the endeavors of inventors, entrepreneurs, Nobel laureates, and even artists, as anything other than principally motivated by the insatiability of their appetites. Whether one's motives consist of fame, recognition, or lucre, one generally aspires to improve in one way or another one's lot in life.

Furthermore, self-interest is “bad” only when it leads to a collective action problem or produces a negative externality – what Coase calls “harmful effects” in *The Problem of Social Cost*.<sup>110</sup> That is, to the extent my self-interested actions harm a third party, then and only then can one say that my self-interest is “bad” in a law-and-economic sense. This, then, is one of the most original insights of the economic approach: self-interested behavior is in and of *itself* neither morally good nor morally bad. It is a non-moral quantity. Whether it is good or bad depends solely on the external effects of one's actions. The mere fact that a person is motivated to take a particular action for selfish or self-seeking reasons is not relevant to the economic approach to law. It is simply taken as given, like gravity in Newtonian physics.

One could argue that this insight is just a dressed-up and sophisticated version of the old adage that one should do no harm to others. In fact, the economic approach takes a more refined and subtle position toward the problem of externalities or harmful effects, for just because an activity may impose costs on third parties does not mean that the activity should be discontinued or sanctioned. The key to determining whether such an activity is ‘bad’ is the presence of deadweight losses. That is, the only activities that should be proscribed or regulated are those whose social cost exceeds their benefits to society as a whole. In the absence of deadweight losses, it might actually be more cost-effective to permit the activity, even if the activity produces harmful

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108 See Nelson, *supra* note 70, at 28.

109 See Smith, *supra* note 44, at 12.

110 See Coase I, *supra* note 1, at 1.

effects to third parties.<sup>111</sup>

In any case, scarcity and self-interest point us towards yet another major shared example of the economic approach: the law of demand. Thus far, we have seen how the twin assumptions of scarcity and self-interest provide a general overview of the world. The law of demand, in turn, builds on these concepts to explain and predict human behavior in specific situations and contexts. Using a chessboard as a metaphor for the world, the assumptions of scarcity and self-interest combine to form a factual description of the chessboard, while the law of demand attempts to explain and predict how the pieces on the board will move.

### C. *The Law of Demand*

The law of demand is to law and economics what Newton's inverse-square law of gravitational attraction is to classical physics: both laws are paradigms *par excellence* for their simplicity and elegance and pretension to universality. Furthermore, without the law of demand there would be no way to subject the theories and predictions of the economic approach to falsification and empirical verification; that is, without the law of demand the economic approach would consist merely of idle speculation, making it impossible to distinguish from moral philosophy.

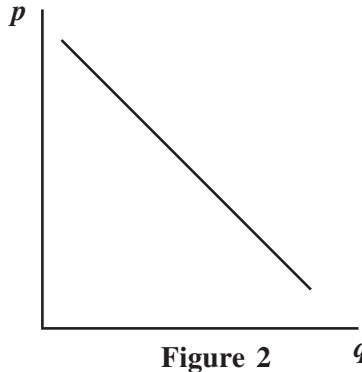
The law of demand posits a universal inverse relationship between the quantity demanded of a good and its price: people will buy less of a good as its price increases.<sup>112</sup> Put another way, "in almost all circumstances, a higher (relative) price for anything will lead to a reduction in the amount demanded."<sup>113</sup> In addition, this causality between price and quantity runs in both directions. For example, if a monopolist were to unilaterally reduce its output, then the price level of its goods would increase (and vice-versa). This insight is illustrated in the figure below:

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111 This is also one of the lessons of "The Problem of Social Costs". As Coase puts it in discussing the contamination of a stream by a neighboring factory, "If we assume that the harmful effect of the pollution is that it kills the fish, the question to be decided is, Is the value of the fish lost greater or less than the value of the product which the contamination of the stream makes possible?" See *Coase I*, *supra* note 1, at 2.

112 It is worth noting that there seems to be a direct relationship between the law of demand and the twin assumptions of scarcity and self-interest discussed above: the fewer of X there is, the greater the demand will be for X. This explains the paradox of why air, which is absolutely essential to human life (and to commercial flight), is free, while diamonds, a frivolous and non-essential luxury, are expensive. See, e.g., GARY S. BECKER, *ECONOMIC THEORY* 19-23 (1971).

113 *Coase II*, *supra* note 1, at 4. The rise in price of a good must be relative to the prices of other goods because if the price level is rising for all goods (i.e. inflation) there is generally no effect on the quantity demanded.



The demand curve in this diagram plots the relationship between price ( $p$ ) and quantity demanded ( $q$ ) of a given product or service. The product or service can be toothpaste, illicit drugs, abortions, or “society dentistry”<sup>114</sup> – the particular product or service does not really matter, for the scope of the law of demand is universal. Furthermore, the demand curve is always downward sloping (i.e. it is negatively inclined) as shown in figure 2 because of two effects, the substitution effect and the income effect, which in turn are the result of scarcity and insatiability.<sup>115</sup> That is, when the price of a good rises, it becomes more expensive relative to other goods (substitution effect) and people have less real income than before (income effect).

The exact degree or angle of the slope will depend on what economists call the “price elasticity of demand,” that is, the *pro rata* effect of a small change in the price charged will have on the quantity demanded.<sup>116</sup> Though the degree of elasticity may vary from product to product, one must not lose sight of the larger point that the relationship between price and quantity continues to be an inverse one.

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114 I have intentionally borrowed this last example (“society dentistry”) from Leff, *supra* note 50, at 457-58. Leff used this particular example to illustrate the annoying tendency of law and economics scholars to explain away observations that are inconsistent with economic theory: “If, for instance, a society dentist raises his prices and thereby increases his gross volume of business, it is no violation of the principle of the inverse relation between price and quantity.” *Id.* Aside from the fact that Leff did not bother to cite any actual data (he just makes this fanciful example up out of whole cloth), the problem with Leff’s hypothetical example (aside from the fact that it is hypothetical) is that Leff incorrectly assumes that the services of all dentists are perfect substitutes. In reality, if a “society dentist” were to attend his patients by appointment only, reducing the waiting time of his patients, and provide a more comfortable waiting room and better parking facilities than his competitors, then Leff’s society dentist would be a textbook illustration of the law of demand. Also, even if Leff’s critique were factually correct, he ignored the fact that there will always be anomalies in any field, law and economics being no exception.

115 In addition, the aggregate demand curve in macroeconomics is downward sloping because an increase in the overall price level induces an increase in the money demand.

116 That is, elasticity measures just how inverse is the price-quantity relationship.

The law of demand not only permeates the whole of economic analysis, it also permits the economic approach to enlarge its gaze and invade the subject matter of many other disciplines, including law. This is so because the economic approach takes an expansive (and perhaps irreverent) view of the concept of “price.” Price is not just the explicit market price of a good. In the words of Ronald Coase, “[price] does not only refer to a money price but to price in its widest sense,” and price “in its widest sense” refers to the entire panoply of burdens and costs one must incur when one purchases a good.<sup>117</sup>

In fact, price is even broader than that, for it includes the whole panoply of burdens and costs, including risk factors, involved in taking any decision whatsoever. Simply put, the more onerous or unpleasant or risky a particular activity is, the higher its shadow price.<sup>118</sup> For example, Gary Becker’s famous article on crime and punishment is a textbook illustration of this expansive view of price.<sup>119</sup> Professor Becker’s central thesis is that the crime rate reflects the severity and probability of punishment.<sup>120</sup> In Becker’s analysis, the punishments fixed in the criminal law are the shadow prices of committing a particular offense.<sup>121</sup>

Seen in this light, the law of demand – like all successful paradigms – offers a cogent and ready-made explanation for a wide array of anomalous phenomena. For instance, it explains why the overwhelming majority of criminal defendants agree to “plea bargains” despite the presumption of innocence and the right to counsel,<sup>122</sup> or why most federal judges delegate the onerous chore

117 *Coase II, supra* note 1, at 4. This is why Leff’s “society dentistry” anomaly does not falsify the law of demand. In fact, it does not even constitute an anomaly. The society dentist’s higher price might reflect the fact that he received his dentistry degree from a prestigious university. Or, perhaps he charges a higher price because he provides more convenient parking facilities or sees his patients by appointment only, reducing the waiting-time of his patients.

118 This is why, unlike Polinsky and others, we do not consider the idea of risk aversion to be a separate component of the economic approach. See chapter 7 in Polinsky, *supra* note 30. In our view, risk is simply part of the cost of an activity and is thus a subpart of price theory.

119 Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 JOURNAL OF POLITICAL ECONOMY 169 (1968) [hereinafter *Becker II*].

120 As Richard Posner has noted, this argument can be traced back to Jeremy Bentham’s essay “An Introduction to the Principles of Morals and Legislation,” originally published in 1789. Nevertheless, this idea lay dormant for almost two centuries until Gary Becker published his paper on criminal law, cited in note 119 above. See RICHARD A. POSNER, FRONTIERS OF LEGAL THEORY 31-34, 51-61 (2001). See also RICHARD A. POSNER, THE ECONOMICS OF JUSTICE 2-3 n.1 (1983) (citing a few other predecessors in addition to Bentham who applied economics to non-market behavior).

121 According to Becker, “A fine *can* be considered the price of an offense, but so too can any other form of punishment; for example, the “price” of stealing a car might be six months in jail. The only difference is in the units of measurement: fines are prices measured in monetary units, imprisonments are prices measured in time units, etc.” (emphasis in original). See *Becker II, supra* note 119, at 195.

122 This is because the expected cost of going to trial (which carries the risk of a more severe punishment) is higher to risk-averse people than the cost of accepting a lighter sentence by plea. Of course, this logic does not apply to criminal defendants facing capital punishment, since they have nothing to lose, and something to gain, by going to trial.

of judicial opinion-writing to their law clerks,<sup>123</sup> or even why high-income parents tend to have fewer children than low-income parents.<sup>124</sup> We would even venture to say that most of the puzzle-solving activities of law and economics consist of applying price theory to non-market situations. For example, the leading works in the law and economics canon – from Guido Calabresi's *The Costs of Accidents* to Richard Posner's *Economic Analysis of Law* – consist precisely of this type of basic application.

Despite its wide range of successful applications, the law of demand is open to the criticism that it is obvious, trivial, or banal. Whether this perpetual critique is valid is ultimately a matter of opinion, depending on one's conceptual framework. Nevertheless, in the natural sciences the simplicity of a scientific law, such as Kepler's first law of planetary motion, in no way detracts from the law's explanatory power. Indeed, the contrary is often true. The more simple and elegant a law of nature is, the more powerful it is.<sup>125</sup> Take, for example, Einstein's equation  $E = mc^2$  or Newton's Second Law,  $F = ma$ . The simplicity and abstract beauty of these mathematical equations in no way detracts from their explanatory power.<sup>126</sup>

Summing up, because of its success in describing the world and explaining all manner of non-market behavior, the law of demand – combined with the assumptions of scarcity and self-interest – is the core exemplar of the economic approach to law. Yet because of Ronald Coase, one more concept must be added to our list of the elementary particles of law and economics: the concept of transaction costs.

#### *D. Transaction Costs*

Although what follows is an unorthodox move on our part-for the concept of transaction costs is rarely, if ever, expressed as a scientific "law" the way the law of demand is-we shall postulate a "law of transaction costs" to illustrate its meaning and significance to law and economics.<sup>127</sup> In essence, the "law of

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123 This is because the cost of writing one's own opinions, a time-consuming task, is higher than the cost of simply editing an opinion written by a law clerk.

124 High-income people place a higher value on time than low-income people do; the higher value of time raises the cost of children and thereby reduces the demand for large families. *See, e.g., Becker I, supra* note 82, at 396-98.

125 *See* SUBRAHMANYAN CHANDRASEKHAR, TRUTH AND BEAUTY: AESTHETICS AND MOTIVATIONS IN SCIENCE (1987).

126 As an aside, we would argue that until the critics of law and economics can come up with a rival formula or explanation as simple or successful as the law of demand, their criticisms will fail to rise above the level of mere metaphysical diatribes and their perpetual criticisms will continue to fall on deaf empirical ears. That is, the critics must either come up with an alternative model to explain the world (like Einstein and Darwin did in their respective fields) or stop asserting that the economic approach has "peaked out." *See* Horwitz, *supra* note 8.

127 Some scholars have argued that there is still no standard definition of transaction costs. *See, e.g.,* Alexandra Benham & Lee Benham, The Costs Of Exchange 3-5 (June 28, 2001) (unpublished manuscript, on file with The Ronald Coase Institute and Washington University in St. Louis).

transaction costs” is that the higher the cost of performing  $x$  activity, the less likely  $x$  activity will be performed.

Seen in this light, the existence of transaction costs is just one more application of the law of demand, but it is a very important application, for it carves out a new role for legal actors and legal institutions to play. In place of the search for justice or the meaning of fairness, the work of the economic approach is far more modest: identify transaction costs and propose methods for minimizing them whenever feasible.<sup>128</sup> Again, it was Ronald Coase who posited the existence of transaction costs.<sup>129</sup> Coase’s discovery and his reasoning process are illustrative of the economic approach to law, and so it is worth taking a moment to explain how Coase made this discovery.

Before Coase came onto the scene, ‘law’ and ‘economics’ were separate fields, and economists worked on the simplistic and patently false assumption that markets as well as government intervention operated costlessly. Coase was the first scholar to point out that these assumptions are wrong. Specifically, in *The Nature of the Firm*, Coase explained that the existence of business firms – indeed, the entire institutional structure of a modern economy – could be explained by the concept of transaction costs.<sup>130</sup>

*The Nature of the Firm* poses two basic questions: (a) why are there firms; and (b) why is each firm of a certain size? Prior to Coase, no one had bothered to address these questions in a systematic fashion. It was not that traditional economic theory took the existence of firms for granted; it ignored their existence altogether. Traditional theory assumed not only that markets worked perfectly but also that markets consisted of atomized individuals having perfect information.

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128 Today, there is a flourishing body of transaction-costs literature. For a sizeable sample of citations, see Harvey S. James, *Annotated Bibliography on Transaction Cost Economics*, available at <http://web.missouri.edu/~jamesha/tce/index.htm>. In addition, there is now even a textbook on the subject. See P. K. RAO, *THE ECONOMICS OF TRANSACTION COSTS: THEORY METHODS, AND APPLICATIONS* (2003).

129 Although Ronald Coase is credited with discovering transaction costs, this idea can be traced as far back as Adam Smith. In a series of lectures he gave at the University of Glasgow during the 1750s, he lamented that the revenues generated by customs duties and excise taxes were eaten up by the “legions of officers” that were employed in collecting them. Customs officers had to have supervisors over them to examine their proceedings, and the supervisors in turn were subordinate to Collectors, who were in turn accountable to the Exchequer: “To support these officers there must be levied a great deal more than the government requires, which is a manifest disadvantage.” See *LECTURES ON POLICY, JUSTICE, REVENUE AND ARMS BY ADAM SMITH* (Edwin Cannan ed., 1896), quoted in E.G. WEST, *ADAM SMITH: THE MAN AND HIS WORKS* 91 (1976).

130 See Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937) [hereinafter *Coase III*], reprinted in *Coase II*, *supra* note 1.

Coase, in contrast, grappled with two major and persistent anomalies in classical economic theory.<sup>131</sup> First, he recognized that in the real world large chunks of economic activity take place within firms. Second, he saw that intra-firm activities are not market transactions subject to the “pricing mechanism” of classical theory; instead, activities within firms are the result of centralized planning and coordination. That is, Coase saw islands of central planning amid the ocean of capitalism and markets. But isn't central planning synonymous with inefficiency, waste, and ineptitude?

Coase resolved this paradox by introducing the concept of transaction costs into economic theory: “The main reason why it is profitable to establish a firm would seem to be that there is a cost to using the price mechanism.”<sup>132</sup> Notice that transaction costs – the cost of using the pricing system – are distinct from direct costs or production costs. Broadly defined, transaction costs refer to the costs of entering into a contract, of enforcing rights and remedies, of making decisions, or of engaging in any activity.<sup>133</sup> In short, Coase's great insight was that every activity or decision involves not just direct costs but also indirect costs, and the indirect costs can be just as significant as the direct ones.<sup>134</sup>

Coase's achievement is nothing less than spectacular. He not only single-handedly explained the emergence of firms and their size; his conception of transaction costs made it possible to unify the fields of economics and law. That is, Coase made it possible for both traditional lawyers and classical economists to make the necessary *Gestalt* switch from “law *and* economics” (two separate fields) to “law *and economics*” (a unified field) and thus made it possible for us to see the world differently from the way we had it seen it before.<sup>135</sup>

In addition, because of the existence of transaction costs, legal rules and institutions are now seen in a whole new light. We could provide countless examples; a few, however, should suffice. The length and sophistication of a contract are seen as varying proportionately with the amount at stake for the parties to the contract, and standard-form consumer contracts are seen, not as a method of large firms for exploiting helpless consumers, but as a method for reducing the transaction costs of having to negotiate with each individual consumer.

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131 Recall from Kuhn that an “anomaly” is a “novelty of fact” or an observation that does not fit one's expectations about nature. See *Kuhn I, supra* note 3, at 52-65. See also *Kuhn II, supra* note 10, at xvii.

132 *Coase III, supra* note 130, at 390.

133 *Id.* at 390-91.

134 For example, the variation in the price of a McDonald's Big Mac hamburger can be explained empirically in terms of transaction costs. See the “Big Mac Index” published annually by THE ECONOMIST, available at <http://www.economist.com/markets/Bigmac/Index.cfm>.

135 See, e.g., *Kuhn I, supra* note 3, at 111-14 (describing paradigm shifts as changes in world view).



Similarly, both criminal and civil law writ large are seen afresh. Criminal laws are not self-enforcing, for society must incur massive expenditures to secure convictions and impose punishments, and the concession of new constitutional rights to criminal defendants (or the expansive judicial interpretation of existing rights) is seen as increasing the costs to society of punishing criminals (or reducing the costs of committing crime), since it will now be more difficult to gain convictions. Likewise, civil trials are seen, not as a pure search for truth, but rather as just another arena for rent seeking and strategic behavior, and the costs of litigation to the parties are seen differently as well, since these costs will include not only direct costs, such as court fees and attorney fees, but also the length of time it takes for the court system to process cases as well as the probability of winning or losing.

The political process too is also seen in a new light. Laws are seen as responses to collective action problems or as attempts by compact factions to extract rents from diffuse groups. Furthermore, once one recognizes that laws and regulation often entail enormous enforcement costs, one can predict the effectiveness of a given law simply by measuring the amount of resources set aside for its enforcement. Unless society sets aside sufficient resources for law enforcement, the law will be a dead letter.

#### V. CONCLUSION

Summing up, the core of the Coasean paradigm is the inevitability of trade-offs. To illustrate this modest conception of the economic approach to law, consider the following aphorism attributed to George Savile, the Marquis of Halifax: “Men are not hanged for stealing horses, but that horses may not be stolen.”<sup>136</sup> That is, if horses were not a scarce resource, or if people were trustworthy, it is possible that no one would care if horses were stolen in the first place. In such a Utopia, horse thieves would refrain from stealing or equestrians would share their horses. In other words, in the absence of scarcity and self-interest there would be no need to establish property rights in horses or to impose sanctions to protect those rights.

Accordingly, one of the main lessons of Coase’s social cost paper and “law and economics” generally is that we do not live in a perfect world. We will always have to make difficult choices involving trade-offs. Some people will always try to steal horses, or refuse to share their horses. Furthermore, notice how the horse problem is, like all social problems, thoroughly “reciprocal in

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136 I found this magnificent quotation in *The Oxford Dictionary of Quotations* 237 (3d ed. 1979, reprinted with corrections 1980). It is interesting to note that Benjamin Franklin once made a scathing critique of this same adage. See Benjamin Franklin, *On the Criminal Laws*, reprinted in *THE AUTOBIOGRAPHY OF BENJAMIN FRANKLIN AND SELECTIONS FROM HIS OTHER WRITINGS* 117 (Herbert W. Schneider ed., 1952).



nature,” to borrow Coase’s apt phrase. That is, if horse thieves refrained from stealing other people’s horses, we would not have to contend with the problem of stolen horses. By the same token, if horse owners were more willing to share their horses, or if they never let their horses out of their sight, we would likewise not have to contend with the problem.

Now, these observations may sound trivial, and perhaps they are, when compared to such sophisticated metaphysical concepts as Kant’s Categorical Imperative or Hegel’s Absolute Ideal. What is not trivial, however, is the way in which the economic approach frames the problem of stolen horses. The question is not whether stealing horses is wrong in the abstract or whether, on the contrary, the institution of property is theft, as Proudhon famously argued.<sup>137</sup> The question is what is the most cost-effective way of dealing with the problem of stolen horses? If society decides that it doesn’t like horse thieves, the question then becomes what is the most cost-effective way of reducing the incidence of stolen horses?

From this emphasis on choices and trade-offs, the essence of the economic approach can also be distilled from the type of questions that are asked when a disciple of the economic approach examines a specific problem or policy proposal. Whether it be the problem of stolen horses (or crime generally) or gratuitous promises (or contracts generally), the economic approach to law is not concerned with subjective notions of justice or with efficiency in the abstract. Instead, the economic approach asks the following straightforward and materialist questions: how much will it cost society to solve the problem, and what groups will ultimately have to pay this cost? This spirit of questioning can be summed up: the question posed by Cicero so long ago: *cui bono?* (“to whose profit?”). Or, perhaps, one could sum it up this way: “how much, and who pays?”

Of course, the answers to these quotidian questions are not always easy to obtain, for there is no single or foolproof method for obtaining the correct answers. This is why “law and economics” has never been a monolithic school of thought. Like other scientific revolutions, the economic approach has not developed in an orderly, incremental process.<sup>138</sup> Even the founding fathers of the vaunted Chicago school of economics – scholars like Frank Knight, George Stigler, and Milton Friedman – have differed on many specific questions and applications of the economic approach.

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137 See, e.g., PIERRE JOSEPH PROUDHON, *WHAT IS PROPERTY?: AN INQUIRY INTO THE PRINCIPLE OF RIGHT AND OF GOVERNMENT* (Benjamin R. Tucker trans. 1970, Dover Publications, Inc.)(1840). Proudhon’s famous reply to this question was that “property is theft.” *Id.* at 12.

138 See THE CHICAGO SCHOOL OF POLITICAL ECONOMY (Warren J. Samuels ed., 1976). See also A.W. Coats, *The Origin of the ‘Chicago School(s)’?*, 71 *JOURNAL OF POLITICAL ECONOMY* 487 (1963).

Nevertheless, the practitioners of law and economics ask the same types of questions, and they share a single, overarching conceptual framework. In this sense, academics as different as Guido Calabresi and Richard Posner are, in fact, intellectual siblings, for they work under the same Coasean paradigm. They accept the inevitability of trade-offs, and they ask the same types of questions – “how much and who pays?” – although they may not agree on what the right answers are.

And so, like a scientist attempting to discover and explain the elementary building blocks of matter, we have attempted to describe the intellectual foundations of the economic approach to law. Perhaps our description is imperfect, but what cannot be disputed is the singular debt the economic approach to law owes to Ronald Coase. In summary, Coase was not only the first scholar to combine the fields of “law” and “economics”; he was also one of the first to celebrate intellectual agnosticism and irreverence by showing us why the problem of harmful effects is reciprocal in nature, as well as the first to discover the existence and pervasiveness of transaction costs. In short, Coase’s ideas are to law and economics what Sir Isaac Newton’s *Principia* is to physics: a radical and fundamental departure from the past, a new way of looking at the world, a scientific revolution.

The historian of science, Stephen Toulmin, once wrote, “The greatest fame is reserved for those who conceive new frameworks of fundamental ideas, and so integrate apparently disconnected branches of science. Isaac Newton, Clerk Maxwell, and Charles Darwin are best remembered, not as great experimenters or observers, but as critical and imaginative creators of new intellectual systems.”<sup>139</sup> I think the same can be said for Ronald Coase. More than anyone else, Coase established the central tenets of the economic approach to law and saw further. He is our Newton.

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139 Toulmin, *supra* note 14, at 109.

# THE PROMISE AND CHALLENGES OF INDIA'S CORPORATE GOVERNANCE REFORMS

*Afra Afsharipour\**

## I. INTRODUCTION

Since the late 1990s, India has undertaken sweeping corporate governance reforms.<sup>1</sup> These reforms were initially spearheaded by corporate India and quickly became an important component of the work of the Securities Exchange Board of India (SEBI), the primary regulatory authority for India's capital markets, and the Ministry of Corporate Affairs (MCA). Many of the most significant transformations in Indian corporate governance became mandatory requirements for listed companies through the amendment of Clause 49 of the Listing Agreement of Stock Exchanges (Clause 49).<sup>2</sup> Recent reforms, such as the MCA's Corporate Governance Voluntary Guidelines, 2009 have been more voluntary in nature, with the aim of encouraging companies to adopt better corporate governance practices.<sup>3</sup>

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\* Acting Professor of Law, University of California, Davis, School of Law; B.A., Cornell University; J.D., Columbia Law School. The author gratefully acknowledges Reeba Chacko, Thomas Joo, Nivedita Rao, Vijay Sambamurthi, Roshan Thomas and Umakanth Varottil for their valuable insights. I am grateful to UC Davis School of Law, particularly Dean Kevin Johnson and Associate Dean Vikram Amar and to the U C Davis International Law Programs particularly the Executive Director Beth Greenwood, for providing generous institutional support for this project and to the library staff at UC Davis School of Law for their assistance. I also appreciate the generous hospitality of the National Law School of India University, Bangalore and the assistance of their library staff during my visit in June 2010. Michelle Hugard and Khalil Mohseni provided outstanding research assistance. Portions of this article were adapted from my prior article *Corporate Governance Convergence: Lessons from the Indian Experience*, 29 NORTHWESTERN JOURNAL OF INTERNATIONAL LAW & BUSINESS 335 (2009). Substantial revisions have been made to incorporate recent developments from January 2009-June 2010.

1 Corporate governance is broadly defined as "a set of relationships between a company's board, its shareholders, and other stakeholders." OECD, PRINCIPLES OF CORPORATE GOVERNANCE (1999). Corporate governance rules broadly address, among other matters, powers, structures, and relationships among various participants in the corporate entity, namely the board, shareholders, and managers. See generally THOMAS W. JOO, CORPORATE GOVERNANCE: LAW, THEORY AND POLICY 3 (2004). For a detailed history of developments in Indian corporate governance, see Afra Afsharipour, *Corporate Governance Convergence: Lessons from the Indian Experience*, 29 NW. J. INT'L L. & BUS. 335 (2009); Rajesh Chakrabarti, Corporate Governance in India-Evolution and Challenges 20 (Jan. 17, 2005) (unnumbered working paper), available at <http://ssrn.com/abstract=649857>.

2 CIRCULAR, SECURITIES AND EXCHANGE BD. OF INDIA, AMENDMENTS TO CLAUSE 49 OF THE LISTING AGREEMENT (Sept. 12, 2000), available at <http://web.sebi.gov.in/circulars/2000/CIR422000.html>; CIRCULAR, CORPORATE GOVERNANCE IN LISTED COMPANIES-CLAUSE 49 OF THE LISTING AGREEMENT (Oct. 29, 2004), available at <http://www.sebi.gov.in/circulars/2004/cfdcir0104.pdf> [hereinafter Clause 49 (2004)].

3 Ministry of Corporate Affairs, Government of India, Corporate Governance Voluntary Guidelines 2009 (December 2009), available at [http://www.mca.gov.in/Ministry/latestnews CG\\_Voluntary\\_Guidelines\\_2009\\_24dec2009.pdf](http://www.mca.gov.in/Ministry/latestnews CG_Voluntary_Guidelines_2009_24dec2009.pdf) [hereinafter the Voluntary Guidelines].

India's corporate governance reforms have accompanied the country's economic transformation. The needs of India's expanding economy, the increased presence of foreign and institutional investors (both domestic and foreign), and the growing desire of Indian companies to access global capital markets by gaining listing on stock exchanges outside of India, have spurred corporate governance reforms.<sup>4</sup>

Beginning in the late 1990s, SEBI formed a number of committees to help formulate corporate governance standards for publicly listed Indian companies. After lobbying by large firms and a governance code proposed by a leading industry group, in 2000, SEBI introduced unprecedented corporate governance reforms via Clause 49 of the Listing Agreement.<sup>5</sup> Clause 49, which has been described as a "watershed event in Indian corporate governance," established a number of requirements with a focus on the role and structure of corporate boards, internal controls, and disclosure to shareholders.<sup>6</sup> As noted by several scholars, many of the provisions – such as a minimum number of independent directors and independent audit committees – were derived from governance reforms adopted in developed countries, especially those in the United States and the United Kingdom.<sup>7</sup> The Clause 49 reforms were phased in over several years, applying at first to larger entities and later to smaller listed companies.<sup>8</sup> Eventually, thousands of listed Indian public companies were required to comply with a new corporate governance regime.

Despite much fanfare and threats of vigorous enforcement, even several years after its enactment, compliance with Clause 49 remains problematic. Moreover, Indian regulators have been less successful in enforcing Clause 49's extensive standards than in establishing them.

Weaknesses in India's corporate governance reforms came to dominate the national discussion in 2009. In January 2009, the Indian corporate community was rocked by a massive scandal involving Satyam Computer Services, one of India's largest information technology companies.<sup>9</sup> The Satyam scandal prompted

4 See Bernard S. Black & Vikramaditya S. Khanna, *Can Corporate Governance Reforms Increase Firms' Market Value: Evidence from India* 9 (Univ. of Mich. Law Sch., Olin Working Paper No. 07-002, Oct. 2007), available at <http://ssrn.com/abstract=914440>.

5 The Listing Agreement with stock exchanges defines the rules and processes that companies must follow in order to remain listed companies on an Indian stock exchange. See *id.* at 9.

6 *Id.* at 5; see also Chakrabarti, *supra* note 1, at 20.

7 See, e.g. Afsharipour, *supra* note 1; Umakanth Varottil, *A Cautionary Tale of the Transplant Effect on Indian Corporate Governance*, 21 NAT'L L. SCH. OF INDIA REV. 1 (2009), available at <http://ssrn.com/abstract=1331581> [hereinafter Varottil, *A Cautionary Tale*].

8 Not all publicly-traded and listed firms in India are required to comply with Clause 49. While all firms listed after 2000 must comply with Clause 49, existing listed companies with paid-up share capital of less than Rs. 3 crore are exempt from compliance. See CLAUSE 49 (2004), *supra* note 2.

9 See James Fontanella-Khan, *Timeline: The Satyam Scandal*, Fin. Times, Jan. 7, 2009, available at <http://www.ft.com/cms/s/0/24261f70-dcab-11dd-a2a9-000077b07658.html>. The Satyam scandal has been described as India's Enron. See *India's Enron*, ECONOMIST, Jan. 8, 2009, available

quick action by the Indian government, including the arrest of several Satyam insiders and auditors, investigations by the MCA and SEBI, and substitution of the company's directors with government nominees.

The Satyam scandal has served as a catalyst for the Indian government to rethink the corporate governance, disclosure, accountability, and enforcement mechanisms in place.<sup>10</sup> As described in this article, Indian regulators and industry groups have advocated for a number of corporate governance reforms to address some of the concerns raised by the Satyam scandal. The responses of both the regulators and industry groups to the Satyam scandal are certainly commendable. However, the suggested reform efforts continue to have voids not just in compliance and enforcement, but also in terms of substantive rules that address critical issues in Indian corporate governance. This article contends that, given the political economy of corporate law in India and the traditional ownership structure of many Indian firms, achieving more significant corporate governance reforms will be a substantial challenge.

This article provides an overview of India's recent corporate governance reforms and analyzes their continuing shortcomings. Part I of this article explores the origins and promises of these reform efforts. Part II documents the Satyam scandal and analyzes the resulting corporate governance reform efforts. Part III of this article evaluates India's corporate governance reform efforts and demonstrates that although extensive reforms have been instituted, there remain significant lapses in the implementation and enforcement of these rules. Moreover, Part III of this article argues that not only have both reform and enforcement efforts by regulators lagged, but many of the reforms that have been adopted fail to address fundamental areas of concern such as the relationship between controlling and minority shareholders, the role of promoters,<sup>11</sup> the limited activism of shareholders, including institutional investors,

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at [http://www.economist.com/business/displaystory.cfm?story\\_id=12898777](http://www.economist.com/business/displaystory.cfm?story_id=12898777) However, as analyzed in detail by Professor Vikramaditya Khanna, the similarities between Satyam and the Enron scandals "may be more superficial than real" and implicate a different set of corporate governance concerns. Vikramaditya Khanna, *Corporate Governance in India: Past, Present and Future?*, 1 JINDAL GLOBAL L. REV. 171, 188-89 (2009). While Satyam was a majority-minority shareholder conflict, Enron was a manager-shareholder conflict. *Id.*

10 See Omkar Goswami, *Aftermath Of Satyam*, Businessworld (India), Jan. 23, 2009, available at <http://www.businessworld.in/index.php/Columns/Aftermath-Of-Satyam.html>; Prashant K Sahu, Sapna Dogra & Aditi Phadnis, *Satyam Scam Prompts Clause 49 Review*, BUS. STANDARD, Jan. 14, 2009, available at <http://www.business-standard.com/india/news /satyam-scam-prompts-clause-49-review/05/05/346123/>.

11 "Promoter" and "promoter group" are defined to include (i) the person or persons who are in overall control of the company, (ii) the person or persons who are instrumental in the formulation of a plan or program pursuant to which securities are offered to the public, and (iii) the person or persons named in the prospectus as promoters. See Reg. 2(1)(za) SEBI (Issue of Capital and Disclosure Requirements Regulations, 2009), available at [http://www.sebi.gov.in/Index.jsp?contentDisp=Section&sec\\_id=1](http://www.sebi.gov.in/Index.jsp?contentDisp=Section&sec_id=1).

and issues with director independence. This article expresses concerns that these challenges may prevail because they have been shaped by unique political and social forces. These forces include the traditional closed ownership structures of Indian firms, an ineffective institutional framework to support enforcement efforts, weaknesses in the judiciary, and political pressures related to government ownership of certain industries.

## II. THE FIRST PHASE OF INDIA'S CORPORATE GOVERNANCE REFORMS

Beginning in the late 1990s, the Indian government started implementing a significant overhaul of the country's corporate governance system. These reform efforts were initiated by corporate industry groups, many of which were instrumental in advocating for and drafting corporate governance guidelines. Following vigorous advocacy by industry groups, SEBI proceeded to adopt considerable corporate governance reforms. The first phase of India's corporate governance reforms was aimed at "making Boards and Audit Committees more independent, powerful and focused monitors of management" as well as aiding shareholders, including institutional and foreign investors, in monitoring management.<sup>12</sup> These reform efforts were channeled through a number of different paths and fraught with significant conflicts between SEBI and the MCA.

This part is organized as follows. Section A begins with a brief overview of the primary motivation for reform efforts. Section B summarizes the process leading to adoption of Clause 49, and provides an overview of Clause 49. Section C addresses the conflicts that arose between SEBI and the MCA in the reform process and the competing Companies Act Bill proposed by the MCA.

### *A. Economic Expansion and the Initial Motivation for Corporate Governance Reform Efforts*

#### 1. The Transformation of Indian Companies

In the past two decades, India has experienced exponential economic growth and become a global economic leader.<sup>13</sup> India has been hailed as an "emerging giant," due to its economic growth, with some analysts going so far as to predict that between 2015 and 2050 India's GDP growth rate "would exceed that of all other major countries in the world, including China."<sup>14</sup> India's growth trajectory has remained robust despite a crippling global economic crisis,

12 Dhammika Dharmapala & Vikramaditya S. Khanna, *Corporate Governance, Enforcement, and Firm Value: Evidence from India* 7 (Univ. of Mich. Law Sch., Olin Working Paper No. 08-005, 2007), available at <http://ssrn.com/abstract=1105732>.

13 For an excellent account of India's economic transformation, see ARVIND PANAGARIYA, *INDIA: THE EMERGING GIANT* 107 (2008).

14 *Id.* at xv; see also Jayashankar M. Swaminathan, *Sea Change in Indian Economy*, in *INDIAN ECONOMIC SUPERPOWER: FICTION OR FUTURE?* 3 (Jayashankar M. Swaminathan ed., 2009); see also Goldman Sachs, *Global Economics Paper No. 99, Dreaming With BRICs: The Path to 2050* (2003), available at <http://www2.goldmansachs.com/ideas/brics/book/99-dreaming.pdf>.

with India experiencing a growth rate of 6.7% in 2008 and an even better rate of 7% in 2009.<sup>15</sup>

This growth has resulted in significant regulatory reform efforts in India's economy and corporate legal regime.<sup>16</sup> Not only were economic liberalization policies implemented, but new legal institutions, such as SEBI, were established to implement new rules in India's corporate and securities laws. These new regulatory institutions have been the primary avenue for producing new corporate governance standards.<sup>17</sup>

India's economic growth and regulatory reforms have fundamentally shifted the ways Indian companies, particularly its large public companies, raise capital and conduct business.<sup>18</sup> In the past decade, as part of their globalization efforts, Indian companies have launched multimillion and multibillion dollar deals to acquire companies around the globe, with a significant concentration of targets in the West, in particular the United States and the United Kingdom.<sup>19</sup> Moreover, the largest Indian companies, companies such as Infosys, a leading Indian technology company,<sup>20</sup> or the several businesses of the Tata Group<sup>21</sup> conglomerate, have strived to become global corporate actors and have attempted to access capital markets both inside and outside of India.<sup>22</sup> The strength of the Indian economy is now widely recognized, with investors, including foreign investors, seeking to invest in Indian companies.<sup>23</sup> India's securities markets

15 See *India manages to clock 6.7% growth in 2008-09*, HINDU, May 30, 2009 available at <http://www.hindu.com/2009/05/30/stories/2009053054191300.htm>; *India FY10 GDP Growth at Around 7.75%: Pranab Mukherjee*, ECON. TIMES, Feb. 10, 2010, available at <http://economictimes.indiatimes.com/India-FY10-GDP-growth-at-around-775-Pranab-Mukherjee/articleshow/5555010.cms>.

16 See PANAGARIYA, *supra* note 13, at 100–03.

17 John Armour & Priya Lele, *Law, Finance, and Politics: The Case of India 2* (ECGI—Law, Working Paper No. 107/2008, 2008), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1116608](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1116608).

18 See Rajesh Chakrabarti, William Megginson & Pradeep K. Yadav, *Corporate Governance in India*, 20 J. APPLIED CORP. FIN. 59 (2008).

19 See NIRMALYA KUMAR, *INDIA'S GLOBAL POWERHOUSES 2* (2009); see also Suma Athreye & Sandeep Kapur, *Introduction: The internationalization of Chinese and Indian firms—trends, motivations and strategy*, 18 IND. & CORP. CHANGE 209, 209–21 (2009).

20 In 1998 Infosys listed its securities on the National Association of Securities Dealers Automated Quotations (NASDAQ) in the United States. See *Gravity's Pull*, ECONOMIST, Dec. 15, 2007.

21 Tata Group—Our Businesses—Tata Sons, [http://www.tata.com/company/profile.aspx?sectid=DpOT+Lbrdv&v=\(last visited Jan. 30, 2010\)](http://www.tata.com/company/profile.aspx?sectid=DpOT+Lbrdv&v=(last%20visited%20Jan.%2030,%202010)).

22 See TARUN KHANNA, *BILLIONS OF ENTREPRENEURS: HOW CHINA AND INDIA ARE RESHAPING THEIR FUTURE AND OURS* (2007). For an overview of the history of capital markets developments in India, see generally P.M. Vasudev, *Capital Market and Corporate Governance in India: An Overview of Recent Trends*, *Corporate Governance Law Review*, Vol. 3, No. 3, pp. 255–282, 2007, available at <http://ssrn.com/abstract=1436185>.

23 See Vikas Bajaj, *India Finds Itself Awash in Foreign Investment*, N.Y. TIMES, Oct. 13, 2009. The Indian government has increasingly opened up the economy to foreign direct investment (FDI). After decades of prohibitive policies on FDI, India's current "foreign investment policy . . . is approximately as open as that of China." PANAGARIYA, *supra* note 13, at 107.



have attracted both institutional and retail domestic investors.<sup>24</sup>

After some of corporate India's successful listings abroad, India's regulators and its leading companies argued that good corporate governance and internationally accepted standards of accounting and disclosure could help them access capital, particularly foreign capital.<sup>25</sup> This need for capital explains the leading role of large corporations and industry groups in pushing for tough new corporate governance standards.<sup>26</sup> They have argued that sustaining India's economic growth requires attracting portfolio investors, including foreign institutional investors.<sup>27</sup> As discussed below, large corporations in India have been instrumental in leading the path toward formal corporate governance changes in India.

## 2. Industry's Role in Advocating for Reforms

Unlike governance reforms in many countries that arise as a result of major corporate scandals, the process of governance reforms in India was initiated by industry leaders. India's first major corporate governance reform proposal was launched by the Confederation of Indian Industry (CII), India's largest industry and business association. Indeed, Indian industry leaders have continued to work closely with the government in promoting corporate governance reforms.<sup>28</sup>

CII – a non-government, not-for-profit, industry-led and industry-managed organization dominated by large public firms – has played an active role in the development of India's corporate governance norms.<sup>29</sup> In 1996, the CII formed a task force on corporate governance in order to develop a corporate governance code for Indian companies. *Desirable Corporate Governance: A Code* (CII

24 Pitibas Mohanty, *Institutional Investors and Corporate Governance in India*, (2003) (unnumbered working paper), available at <http://unpan1.un.org/intradoc/groups/public/documents/APCITY/UNPAN023823.pdf>.

25 Bala N. Balasubramanian, Vikramaditya S. Khanna & Bernard S. Black, *Firm-level Corporate Governance: A Case Study of India*, at 5 (U. of Tex. Law, Law and Econ. Research Paper No. 87, 2007), available at <http://ssrn.com/abstract=995650>.

26 *Id.* Dharmapala and Khanna do not find evidence that the Clause 49 reforms caused an increase in foreign institutional investment. *Id.* at 30.

27 *See id.* at 31. At least in India, foreign and institutional investors have generally demanded great disclosure and a more rigorous, clear, and recognizable governance regime. *See* NATIONAL FOUNDATION FOR CORPORATE GOVERNANCE, *CORPORATE GOVERNANCE IN INDIA: THEORY AND PRACTICE* 7 (Sept. 2004) [hereinafter NATIONAL FOUNDATION]; LALITA SOM, *STOCK MARKET CAPITALIZATION AND CORPORATE GOVERNANCE* 29 (2006).

28 In 2004, the MCA established the National Foundation for Corporate Governance (NFCG) in partnership with Confederation of Indian Industry (CII), Institute of Company Secretaries of India (ICSI) and Institute of Chartered Accountants of India (ICAI). *See* National Foundation for Corporate Governance, About Us, <http://www.nfcgindia.org/aboutus.htm> (last visited Jan. 30, 2010).

29 Confederation of Indian Industry, About Us, [http://cii.in/menu\\_content.php?menu\\_id=3](http://cii.in/menu_content.php?menu_id=3) (last visited Jan. 30, 2010). The CII also played an important role in the economic reform efforts of the 1990s. *See* JOS MOOI, *THE POLITICS OF ECONOMIC REFORMS IN INDIA* 24 (2005).



Code) for listed companies was proposed by the CII in April 1998.<sup>30</sup>

The CII Code was heavily influenced by corporate governance standards found outside of India. Like many corporate governance codes, the CII Code initially notes that one system of corporate governance is not “unambiguously better than others[;] . . . [therefore, it could not] design a code of corporate governance for Indian companies by mechanically importing one form or another.”<sup>31</sup> Nonetheless, it adopted at the outset the Anglo-American system’s focus on relationships between the company’s board of directors and its shareholders.

The CII Code was a significant step forward for a country not then known for robust corporate governance standards. However, the CII Code’s voluntary nature did not result in a broad overhaul of governance norms and practices by Indian companies. Although the CII Code was welcomed with much fanfare and even adopted by a few progressive companies, many then-believed that “under Indian conditions a statutory rather than a voluntary code would be more purposeful and meaningful.”<sup>32</sup>

### *B. The First Phase of Reforms – Clause 49*

#### 1. The Initial Adoption of Clause 49

In 1998, following the lobbying efforts of industry groups such as the CII, SEBI sprang into action to develop corporate governance standards for publicly listed companies. A significant manifestation of SEBI’s efforts to improve corporate governance standards in India was its appointment of several high-level committees to recommend revisions of Indian corporate governance standards.<sup>33</sup>

SEBI appointed the Committee on Corporate Governance (the Birla Committee) on May 7, 1999.<sup>34</sup> While SEBI has not disclosed the method by which it selected committee members, the Birla Committee included major industry representatives in India, including representatives from the CII and the All India Association of Industries.<sup>35</sup> The Birla Committee was chaired by Kumar Mangalam Birla, Chairman of the Aditya Birla Group, one of India’s foremost

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30 CONFEDERATION OF INDIAN INDUSTRY, *DESIRABLE CORPORATE GOVERNANCE: A CODE* (1998) [hereinafter CII Code].

31 *Id.* at 1.

32 NATIONAL FOUNDATION, *supra* note 27, at 7.

33 *Id.* at 7-8.

34 SHRI KUMAR MANGALAM BIRLA ET AL., *THE SEC. EXCH. BD. OF INDIA, REPORT OF THE KUMAR MANGALAM BIRLA COMMITTEE ON CORPORATE GOVERNANCE § 2.5* (1999), available at <http://www.sebi.gov.in/commreport/corpgov.html> [hereinafter Birla Report].

35 *Id.*

business houses.<sup>36</sup> The Birla Committee also included a number of representatives from various stock exchanges in India, as well as representatives from government agencies, including SEBI.<sup>37</sup>

The Birla Committee's recommendations were primarily focused on improving the function and structure of company boards and increasing disclosure to shareholders. The Birla Committee specifically invoked the U.S. Blue Ribbon Committee's emphasis on independent directors in discussing board recommendations.<sup>38</sup> With respect to company boards, the Committee made specific recommendations regarding board representation and independence.<sup>39</sup> The Committee also recognized the importance of audit committees and made many specific recommendations regarding the function and constitution of board audit committees.<sup>40</sup>

The Birla Committee made several recommendations regarding disclosure and transparency issues, in particular with respect to information to be provided to shareholders. Among other recommendations, the Birla Committee stated that a company's annual report to shareholders should contain a Management Discussion and Analysis (MD&A) section, modeled after annual reports issued by companies in the United States, and that companies should transmit certain information, such as quarterly reports and analyst presentations, to shareholders.<sup>41</sup> Furthermore, with respect to shareholder complaints, the Committee recommended that a board committee, chaired by a nonexecutive director, be formed to address grievances.<sup>42</sup>

SEBI implemented the Birla Committee's proposals less than five months later in February 2000. At that time, SEBI revised its Listing Agreement to incorporate the recommendations of the country's new code on corporate

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36 Aditya Birla Group, Kumar Mangalam Birla Profile, [http://www.adityabirla.com/the\\_group/km\\_birla\\_profile.htm](http://www.adityabirla.com/the_group/km_birla_profile.htm) (last visited Jan. 30, 2010). The Aditya Birla Group includes major Indian companies such as Hindalco, Grasim, and Ultra Tech Cement. Mr. Birla also serves as director for the Reserve Bank of India and the Board of Trade, as well as other prominent positions. *Id.*

37 See BIRLA REPORT, *supra* note 34, at Annex. 1.

38 BIRLA REPORT, *supra* note 34, at § 6.6.

39 *Id.* §§ 6.5, 6.9. The Committee recommended that at least half the members should be independent (or one-third if the chairman of the board is an independent director), and defined an independent director as one who has no "material pecuniary relationship[, other than remuneration,] or transaction with the company [et al.] . . . which in the judgment of the board may affect [the director's] independence of judgment." *Id.* To ensure that directors give companies due attention, the Committee also recommended that directors be limited to holding a maximum of ten directorships and five chairmanships. *Id.* § 11.2.

40 *Id.* § 9.6. The Committee recommended that the audit committee be composed of at least three directors, all nonexecutive directors, a majority of independent directors, and at least one director with financial and accounting knowledge. *Id.* The chair of the audit committee should be independent. In addition, the Committee recommended that the audit committee should meet at least three times a year. *Id.* § 9.7.

41 *Id.* § 13.4, 14.7.

42 *Id.* § 14.12.

governance. These rules – contained in Clause 49, a new section of the Listing Agreement – took effect in phases between 2000 and 2003. The reforms applied first to newly listed and large companies, then to smaller companies, and eventually to the vast majority of listed companies.<sup>43</sup>

## 2. Further Re-evaluation of Clause 49

In late 2002, SEBI constituted another committee on corporate governance chaired by Shri N.R. Narayana Murthy.<sup>44</sup> SEBI formed the Murthy Committee in the wake of the Enron scandal in the United States in order to evaluate the adequacy of the existing Clause 49, to further enhance the transparency and integrity of India's stock markets and to “ensure compliance with corporate governance codes, in substance and not merely in form.”<sup>45</sup> The Murthy Committee stated that recent corporate governance failures, particularly in the United States, combined with the observations of India's stock exchanges that compliance with Clause 49 up to that point had been uneven, compelled the Committee to recommend further reform.<sup>46</sup>

The background of many of the Murthy Committee members mirrored those on the Birla Committee, including many committee members with significant ties to well-established Indian companies<sup>47</sup> and representatives from some of India's stock exchanges and industry groups.<sup>48</sup> SEBI representatives included some of those who had served on the Birla Committee, such as D.N. Raval and Pratip Kar, Executive Directors of SEBI.

Like the Birla Committee, the Murthy Committee examined a range of corporate governance issues relating to boards and audit committees, as well as disclosure to shareholders. The committee focused heavily on the role and structure of corporate boards and strengthened the director independence definition in the then-existing Clause 49, particularly to address the role of insiders.<sup>49</sup> For example, while the new definition actually encompassed the old, it also indicated, among other things, that the director cannot be related to

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43 For a discussion of the phase-in process under the initial Clause 49 adoption, see Black & Khanna, *supra* note 4; *see also*, Omkar Goswami, *Getting There – Pretty Rapidly: The State of Corporate Governance in India*, in *A COMPARATIVE ANALYSIS OF CORPORATE GOVERNANCE IN SOUTH ASIA* 155 (Farooq Sobhan & Wendy Werner, eds., 2003) (“Today, listed companies accounting for over 95% of India's market capitalisation have to follow SEBI's corporate governance guidelines.”), available at <http://www.bei-bd.org/docs/cg1.pdf>.

44 N.R. NARAYANA MURTHY ET AL., THE SEC. EXCH. BD. OF INDIA, REPORT OF THE SEBI COMMITTEE ON CORPORATE GOVERNANCE § 2.1 (2003), available at <http://www.sebi.gov.in /commreport/corpgov.pdf> [hereinafter Murthy Report].

45 *Id.* § 1.6.

46 *Id.* §§ 1.5.4-1.5.5.

47 *Id.* at 30.

48 *See* Afsharipour, *supra* note 1, at 370-373.

49 MURTHY REPORT, *supra* note 44, § 3.2.2.3.

promoters or management at the board level, or one below the board; an executive of the company in the preceding three years; a supplier, service provider, or customer of the company; or a shareholder owning two percent or more of the company.<sup>50</sup> The Murthy Committee also recommended that nominee directors (i.e., directors nominated by institutions, particularly financial institutions, with relationships with the company) be excluded from the definition of independent director, and be subject to the same responsibilities and liabilities applicable to any other director.<sup>51</sup> In order to improve the function of boards, the Murthy Committee recommended that they should also receive training in the company's business model<sup>52</sup> and quarterly reports on business risk and risk management strategies.<sup>53</sup>

The Murthy Committee paid particular attention to the role and responsibilities of audit committees. It recommended that audit committees be composed of "financially literate" members,<sup>54</sup> provided a greater role for the audit committee,<sup>55</sup> and stated that whistle-blowers should have access to the audit committee without first having to inform their supervisors. Further, the committee required that companies should annually affirm that they have not denied access to the audit committee or unfairly treated whistle-blowers generally.<sup>56</sup>

In 2004, SEBI further amended Clause 49 in response to the Murthy Committee's recommendations.<sup>57</sup> However, the implementation of these changes was delayed until January 1, 2006, due primarily to industry resistance and lack of preparedness to accept such wide-ranging reforms. While there were many changes to Clause 49 as a result of the Murthy Report, governance requirements with respect to corporate boards, audit committees, shareholder disclosure, and CEO/CFO certification of internal controls constituted the largest transformation of the governance and disclosure standards of Indian companies.

### *C. Attempted Reforms – the MCA and the Companies Act Amendments*

#### 1. The MCA's Committees

Following the addition of Clause 49 to the Listing Agreement, the MCA appointed its own separate committees to recommend corporate governance reforms to be incorporated into an amendment of the Companies Act. The first

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50 *Id.*

51 *Id.* §§ 3.8.1.1, 3.8.1.2.

52 *Id.* § 3.5.2.4.

53 *Id.* § 3.5.1.7.

54 MURTHY REPORT, *supra* note 44, § 3.2.2.3.

55 *Id.* § 3.4.1.5.

56 *Id.* §§ 3.11.1.3, 3.11.2.4.

57 SEBI, ISSUES UNDER CLAUSE 49 AND PROPOSED AMENDMENTS 1 (2003), available at <http://www.sebi.gov.in/commreport/clause49.html>.

committee appointed by the MCA was formed in August 2002, following the enactment of Sarbanes-Oxley in the United States in July 2002. Chaired by Shri Naresh Chandra, a former Cabinet secretary, the committee was charged with undertaking a wide-ranging examination of corporate auditing and independent directors, although its report focused primarily on auditing and disclosure matters.<sup>58</sup> The Chandra Committee made a series of recommendations regarding, among other matters, the grounds for disqualifying auditors from assignments, the type of non-audit services that auditors should be prohibited from performing, and the need for compulsory rotation of audit partners. In addition, the Chandra Committee recommended greater consultations between SEBI and the MCA, noting that the overlap has “‘adverse consequences’ . . . with investors, companies and other stakeholders ‘falling between the cracks.’”<sup>59</sup> Despite much fanfare, the recommendations of the Chandra Committee did not result in legislative changes, although certain of its recommendations were incorporated in the report put forth by the Murthy Committee.

The MCA again sprang into action to attempt to revise the Companies Act after the appointment of the Murthy Committee by SEBI and revision of Clause 49. In December 2004, the MCA convened the Irani Committee.<sup>60</sup> The committee was led by J.J. Irani, a director of Tata Sons, Ltd., the primary shareholder in the large business conglomerate, the Tata Group.<sup>61</sup> The Irani Committee was charged with evaluating the Companies Act, with a focus on combining internationally accepted best practices in corporate governance with attention to the particular needs of the growing Indian economy.

The Irani Committee concluded that the best approach to corporate governance in India would be to construct a single framework of governance provisions applying to all companies so that all companies would be required to comply with a uniform set of rules.<sup>62</sup> However, the Irani Committee resisted the view that the regulation of public companies should be handed over entirely to SEBI, and argued that the central government should play an important role with respect to corporate governance matters.<sup>63</sup>

Unlike the two SEBI-appointed committees, the Irani Committee recognized that requirements of special or small companies be accounted for

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58 NATIONAL FOUNDATION, *supra* note 27, at 8.

59 Sucheta Dalal, *Mouthing the DCA's Views*, FIN. EXPRESS, Mar. 10, 2003, available at <http://www.financialexpress.com/news/mouthing-the-dcas-views/76027/> (quoting Chandra Committee).

60 JAMSHED J. IRANI ET AL., EXPERT COMMITTEE ON COMPANY LAW, REPORT OF THE EXPERT COMMITTEE TO ADVISE THE GOVERNMENT ON THE NEW COMPANY LAW 3 (2005), available at <http://www.primedirectors.com/pdf/JJ%20Irani%20Report-MCA.pdf> [hereinafter IRANI REPORT].

61 Tata Group-Our Businesses-Tata Sons, <http://www.tata.com/company/profile.aspx?sectid=DpOT+Lbrdvg=> (last visited Jan. 8, 2010).

62 IRANI REPORT, *supra* note 60, at 8-9.

63 *Id.* at 10-11.

through a series of exemptions, so that new small businesses are not burdened with the same level of compliance cost as larger, established corporations. In keeping with this theme, the Irani Committee recommended a wider set of classifications for companies than just the public or private labels, as the committee believed that the binary system of classification was too narrow to account for the varying needs of companies with different sizes and resources. The Committee's goal was to expand the system of classifications and exemptions to tailor compliance costs to needs, while maintaining sufficient regulatory stringency for large listed companies that access public capital.<sup>64</sup> Furthermore, significant differences existed between the proposals contained in the Irani report and the requirements of Clause 49. In particular, the proposals differed with respect to employment requirements, requisite number, and age and term limits of independent directors.

## 2. Clause 49 and Amendment of the Companies Act

A major criticism regarding SEBI's attempts at governance reform involved its decision to reform the Listing Agreement rather than advocate for amendment of the Companies Act. SEBI's conflicts with the MCA led it to bypass the legislative route preferred by the MCA and attempt to regulate through the Listing Agreement. SEBI was criticized in particular for revising Clause 49 while many similar reforms were arguably included in then-pending legislation, the Companies (Amendment) Bill of 2003.

The criticism grew sharper following withdrawal of the Companies (Amendment) Bill in 2003. Many industry insiders felt SEBI should have suspended its Clause 49 revisions until the reforms could be fully considered legislatively.<sup>65</sup> Groups such as the Federation of Indian Commerce and Industry and the CII advocated that SEBI immediately withdraw the Clause 49 amendments.<sup>66</sup> When SEBI instead seemed to self-validate its actions through the Murthy Committee, which endorsed many of SEBI's Clause 49 revisions, some questioned whether SEBI's rule-making jurisdiction even covered its actions.<sup>67</sup> Even SEBI's own Murthy Committee, while not condemning Clause 49 specifically, recommended that any differences between the Listing

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64 *Id.* at 11-12.

65 *Corporates Train Their Guns on Listing Clause*, HINDU BUS. LINE, Oct. 22, 2003, available at [http://www.thehindubusinessline.com/bline/2003/10/23/stories/200310230268\\_0100.htm](http://www.thehindubusinessline.com/bline/2003/10/23/stories/200310230268_0100.htm).

66 *Corporates Train Their Guns*, *supra* note 65.

67 See T.N. Pandey, *SEBI Move: Clause and Effect*, REDIFF.COM, Dec. 29, 2003, available at <http://www.rediff.com/money/2003/dec/29/guest3.htm> (arguing that SEBI's actions went beyond the scope of the power conferred by Section 11(1) of SEBI Act and Section 10 of Securities Contracts (Regulation) Act); S. Balakrishnan, *SEBI, A Law Unto Itself*, HINDU, Oct. 10, 2005, at 19, available at <http://www.hindu.com/2005/10/10/stories/2005101000441700.htm>.

Agreement and the Companies Act be harmonized by legislative amendment.<sup>68</sup>

After the failure of the first attempt to amend the Companies Act, the government again attempted to amend the Act pursuant to the Irani Committee's recommendations. However, this process also stalled. After years of delay, the Companies (Amendment) Bill was introduced in the Indian Parliament in October 2008.<sup>69</sup> However, the bill failed to become law in 2008.

On August 5, 2009, the Companies Bill, 2009 was introduced in the Lok Sabha, the directly elected lower house of the Indian Parliament, in the same form in which it was presented in 2008.<sup>70</sup> Commentators were shocked that the Bill did not undergo any changes (except for the Bill and Republic year) in light of the Satyam scandal.<sup>71</sup> As of the end of 2009, the Indian government was still in the process of considering comments and suggestions received. Commentators expect changes to the Bill before it is finally passed. Recent articles suggest that the Indian government will try to synchronize the December 2009 voluntary corporate governance norms with the revised Companies Act<sup>72</sup> and is studying the possibility of modifying the proposed Companies Bill, 2009 to the guidelines.<sup>73</sup> It is expected that the Companies Bill will be further amended as a result of an August 2010 Report by the Standing Committee on Finance of Parliament which examined the 2009 Bill in great detail.

### III. PHASE TWO (?): THE SATYAM SCANDAL AND THE PUSH FOR FURTHER CORPORATE GOVERNANCE REFORMS

#### A. *The Satyam Scandal*<sup>74</sup>

India's corporate community experienced a significant shock in January 2009 with damaging revelations about colossal fraud in the financials of Satyam Computer Services. Satyam was publicly traded, listed on the Bombay Stock

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68 *Id.* ("Major differences between the requirements of the listing agreement and the provisions of the Act should be identified and SEBI should then recommend to the Government that the provisions of the Act be changed to bring it in line with the requirements of the listing agreement.") (quoting MURTHY COMMITTEE REPORT).

69 Press Release, Ministry of Corporate Affairs (India), Bill Intends to Modernize Structure for Corporate Regulation in This Country, (Oct. 23, 2008), available at <http://www.pib.nic.in/release/release.asp?relid=44114>.

70 See Chakshu Roy & Avinash Celestine, *Legislative Brief: The Companies Bill, 2009*, PRS LEGISLATIVE RESEARCH (Aug. 18, 2009), available at <http://www.prsindia.org/uploads/media/Company/Legislative%20Brief—companies%20bill%202009.pdf>.

71 Umakanth Varottil, *Companies Bill Reintroduced in Parliament*, Indian Corporate Law Blog, Aug. 4, 2009, <http://indiacorplaw.blogspot.com/2009/08/companies-bill-reintroduced-in.html>.

72 *India: Govt may harmonise voluntary corp governance norms in Cos Bill*, DAILY PAK BANKER, Mar. 11, 2010.

73 *Id.*

74 For more information and analysis of the Satyam scandal, see Umakanth Varottil, *Evolution and Effectiveness of Independent Directors in Indian Corporate Governance*, 6 HASTINGS BUS. L. J. 281 (2010) [hereinafter Varottil, *Evolution of Independent Directors*].



Exchange (BSE) and the National Stock Exchange (NSE) in India, and cross-listed on the New York Stock Exchange (NYSE) in the United States. Remaining on these exchanges required Satyam to comply with Clause 49, Sarbanes Oxley, and NYSE Listed Company Manual. Satyam's promoters, represented by Mr. Ramalinga Raju and his family, held 8% shares in the company at the end of 2008.<sup>75</sup> The company, however, had a majority independent Board of Directors, comprised of various luminaries in India, thus complying with the requirements of Clause 49.<sup>76</sup> As scholar Umakanth Varottil notes, "At a board level, it can be said that very few Indian boards can lay claim to such an impressive array of independent directors."<sup>77</sup>

### 1. The Maytas Transaction & Fraud in Financial Statements

Satyam was rocked by two related scandals in early 2009, the first an aborted related party transaction involving the company's promoters, the second the uncovering of colossal fraud in the company's financial statements.<sup>78</sup> The Satyam scandal led to significant commentary about and criticism of India's corporate governance norms. It also highlighted India's prevailing corporate governance concern, potential oppressive or opportunistic behavior by controlling shareholders or promoters.<sup>79</sup> The section below provides a short overview of the Satyam scandal.

On December 16, 2008, Satyam's Board convened a meeting to consider the proposed acquisition of Maytas Infra Limited and Maytas Properties Limited, companies focused on real estate and infrastructure development.<sup>80</sup> Two major issues in the proposed transaction surfaced. First, the Maytas companies were focused on real estate and infrastructure development – two industries unrelated to Satyam's core IT business.<sup>81</sup> Second, the Raju family owned approximately 30% of the Maytas companies.<sup>82</sup> At this time, Ramalinga Raju served as

75 See *Id.* at 53; see also *Who directs directors*, FIN. EXPRESS, Dec. 16, 2009, available at <http://www.financialexpress.com/news/feeditorialwhodirectsdirectors/554498/>.

76 See Vikramaditya Khanna & Shaun J. Mathew, *The Role of Independent Directors in Controlled Firms in India: Preliminary Interview Evidence*, 22 NAT. L. SCH. IND. REV. 35, 41 (2010).

77 Varottil, *Evolution of Independent Directors*, *supra* note 74, at 54.

78 See Rajesh Chakrabarti & Subrata Sarka, *Corporate Governance in an Emerging Market – What Does the Market Trust?*, 2 (unnumbered working paper 2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1615960](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1615960).

79 Corporate law scholars have long recognized that potential agency costs that arise in the controlled company context. See, Luca Enriques, Henry Hansmann & R. Kraakman, *The Basic Governance Structure: Minority Shareholders and Non-Shareholder Constituencies*, in THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 89 (R. Kraakman et al. eds., 2d ed. 2009); R.J. Gilson & J.N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 785 (2003).

80 See Omkar Goswami, *Satyam: The Tasks Ahead*, BUS. STANDARD, Jan. 21, 2009, available at <http://www.business-standard.com/india/news/omkar-goswami-satyamtasks-ahead/346676/>.

81 Varottil, *Evolution of Independent Directors*, *supra* note 74, at 334.

82 *Id.* at 334.



Chairman of the Board, and B. Rama Raju served as the Managing Director and Chief Executive Officer.<sup>83</sup> This made the proposed deal a “related party transaction.” If effected, “the transaction would have resulted in a significant amount of cash flowing from Satyam . . . to its individual promoters, the Raju family.”<sup>84</sup>

At the December 16, 2008 Board meeting, independent directors questioned the proposed transaction. Dr. Mangalam Srinivasan questioned the initiative and timing of the proposal.<sup>85</sup> She also suggested that the Board be involved in the transaction from the beginning to avoid the impression that the Board was being used as “rubber stamp to affirm the consequent or decision already reached.”<sup>86</sup> Professor M. Rammohan Rao and Vinod K. Dham were concerned about Satyam venturing into a wholly unrelated business.<sup>87</sup> Others were concerned with verifying the benefits to shareholders if the transaction was completed, especially due to the related parties in the transaction.<sup>88</sup>

Despite these concerns, the Board adopted (“without any dissent whatsoever”) a unanimous resolution to proceed with the proposed acquisition. Satyam notified the stock exchanges of the board approval as required under the listing agreement.<sup>89</sup> The market reacted badly to the news. Almost immediately, the stock price of Satyam’s American Depository Receipts collapsed.<sup>90</sup> Within eight hours of the announcement, Satyam was compelled to withdraw the Maytas proposal.<sup>91</sup>

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83 See *The men who certified Satyam’s fudged account*, ECON. TIMES, Jan. 10, 2009, available at <http://economictimes.indiatimes.com/infotech/software/The-men-who-certified-Satyams-fudged-account/articleshow/3955882.cms>; A. Saye Sekhar, *Satyam chief admits to fraud, quits*, HINDU, Jan. 8, 2009; see also *Satyam turns out to be a big lie*, ECON. TIMES, Jan. 11, 2009.

84 Varottil, *Evolution of Independent Directors*, supra note 74, at 334.

85 *Id.*; see also Satyam Computer Services Limited, Minutes of the Meeting of the Board of Directors of the Company Held on Tuesday, Dec. 16, 2008 at 4:00 p.m. at Satyam Infocity, Hitech City, Madhapur, Hyderabad – 500 081, available at <http://online.wsj.com/public/resources/documents/satyam01115.pdf>.

86 Varottil, *Evolution of Independent Directors*, supra note 74, at 335.

87 See *id.* at 335; *Satyam Board Minutes*, supra note 85, at 4.

88 See Varottil, *Evolution of Independent Directors*, supra note 74, at 335; *Satyam Board Minutes*, supra note 74, at 335.

89 See Varottil, *Evolution of Independent Directors*, supra note 74, at 335; see also N Balasubramanian, *Is corporate governance mere lip service?*, ECON. TIMES, Dec. 23, 2008, available at <http://economictimes.indiatimes.com/articleshow/3877025.cms>; *Satyam independent directors watching situation*, HINDU, Dec. 27, 2008.

90 See *Corporate round-up*, ECON. TIMES, DEC. 23, 2008; *Raju family’s stake in Satyam halves*, BUS. STANDARD, Dec. 30, 2008.

91 See Varottil, *Evolution of Independent Directors*, supra note 74, at 335; Somasekhar Sundaresan, *Year of Al-Pervasive Poor Governance*, BUS. STANDARD, Dec. 29, 2008, available at <http://www.business-standard.com/india/news/yearall-pervasive-poor-governance/01/06/344577/>; see also S. Nagesh Kumar, *Independent Directors Put Tough Questions, But Gave Blank Cheque*, THE HINDU, Jan. 14, 2009.

Unfortunately, this botched transaction was not the only issue with Satyam. On January 7, 2009, Satyam's Chairman of the Board, Ramalinga Raju, confessed to falsifying the financial statements of the company, including balance sheet errors showing fictitious cash assets of over US \$ 1 billion.<sup>92</sup> The confession furthered revealed that the proposed Maytas acquisitions were "just illusory transactions intended to manipulate the balance sheet of Satyam and to wipe out inconsistencies therein."<sup>93</sup> As a result of this information, Satyam's stock price dropped another 70%, essentially obliterating the wealth of the Satyam shareholders.<sup>94</sup>

## 2. The Aftermath

As a result of the scandal, the MCA, Government of India, and SEBI initiated investigations.<sup>95</sup> The police arrested the Chairman, Ramalinga Raju, Satyam's Managing Director, and CFO within a few days of the confession.<sup>96</sup> Two Partners from Lovelock & Lewis, an Indian affiliate of PriceWaterhouseCoopers and Satyam's auditor, were also arrested.<sup>97</sup>

Further, the Government nominated and replaced remaining Satyam board members with candidates of its choice.<sup>98</sup> Under the new leadership, Satyam was able to make a remarkable turnaround.<sup>99</sup> In April 2009, Tech Mahindra purchased the company through a global bidding process. The Transaction "received uniform adulation for the alacrity with which the various players . . . acted to resuscitate the company and protect the interests of its stakeholders."<sup>100</sup>

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92 See *It was like riding a tiger, not knowing how to get off without being eaten*, Fin. Express, Jan. 8, 2009, available at <http://www.financialexpress.com/news/it-was-like-riding-a-tiger-not-knowing-how-to-get-off-without-being-eaten/407917/>; Mandar Nimkar, *How much is Satyam's stock actually worth?*, ECON. TIMES, Jan. 8, 2009 available at <http://economictimes.indiatimes.com/articleshow/3960070.cms?prtpage=1>; Heather Timmon & Jeremy Kahn, *Indian Company in a Fight to Survive*, N.Y. Times, Jan. 9, 2009,

93 Varottil, *Evolution of Independent Directors*, *supra* note 74, at 337.

94 *Id.*

95 See Oomen A. Ninan, *Satyam Episode: SEBI Enquiries Will Focus on Three Areas*, THE HINDU BUS. LINE, Jan. 16, 2009, available at <http://www.hindu.com/2009/01/16/stories/2009011660111800.htm>; Souvik Sanyal, *Government Refers Satyam Case to Serious Frauds Investigation Office*, THE ECON. TIMES, Jan. 13, 2009.

96 See *Satyam Fraud: Raju Sent to Central Prison; CFO Vadlamani Arrested*, ECON. TIMES, Jan. 10, 2009, available at <http://economictimes.indiatimes.com/infotech/software/Satyam-fraud-Raju-sent-to-central-prison-CFO-Vadlamani-arrested/articleshow/3961163.cms> ; *Satyam's Raju Brothers Arrested by AP Police*, ECON. TIMES, Jan. 9, 2009, available at [http://economictimes.indiatimes.com/Infotech/Software/Satyams\\_Raju\\_brothers\\_arrested\\_by\\_AP\\_Police/articleshow/3957655.cms](http://economictimes.indiatimes.com/Infotech/Software/Satyams_Raju_brothers_arrested_by_AP_Police/articleshow/3957655.cms) .

97 See Jackie Range, *Pricewaterhouse Partners Arrested in Satyam Probe*, WALL ST. J. ASIA, Jan. 25, 2009.

98 Mukesh Jagota & Romit Guha, *India Names New Satyam Board*, WALL ST. J., Jan. 12, 2009, available at <http://online.wsj.com/article/SB123165785513571443.html>.

99 Varottil, *Evolution of Independent Directors*, *supra* note 74, at 338.

100 *Id.* at 59.

It is clear that the concerns raised by the Satyam scandal reverberated in corporate India beyond the company itself. For example, in a recent study of independent directors in Indian firms, the authors found evidence of mass resignations of independent directors of Indian firms following Satyam with “at least 620 independent directors” resigning in 2009 alone “a figure that is, to our knowledge, by far without precedent globally.”<sup>101</sup>

### *B. Corporate Governance Responses to Satyam*

Despite wide-ranging reforms in Indian law and policy, Indian corporate law scholars and analysts have expressed important concerns regarding Indian corporate governance mechanisms.<sup>102</sup> In the aftermath of the Satyam scandal, some commentators believe that regulators have done little to remedy the myriad of corporate governance issues facing Indian companies.<sup>103</sup> Others have argued that the government has been responsive to some of the concerns raised by recent scandals and has chosen “to adopt a more careful approach by avoiding any knee-jerk reactions.”<sup>104</sup>

#### 1. Industry Responses

Similar to their role in the first phase of corporate governance reforms, in the post-Satyam period, Indian corporate groups have once again advocated for reconsideration of India's corporate governance rules and advocated for reforms. Shortly after news of the scandal broke, the CII began examining the corporate governance issues arising out of the Satyam scandal.<sup>105</sup> Other industry groups also formed corporate governance and ethics committees to study the impact and lessons of the Satyam scandal.<sup>106</sup>

In late 2009, the CII task force put forth corporate governance reform recommendations.<sup>107</sup> In its report the CII emphasized the unique nature of the Satyam scandal, noting that “Satyam is a one-off incident . . . The overwhelming majority of corporate India is well run, well regulated and does business in a

101 Khanna and Mathew, *supra* note 76, at 36; see also Rajesh Chakrabarti, Krishnamurthy Subramanian, & Frederick Tung, *Independent Directors and Firm Value: Evidence from an Emerging Market 2* (June 28, 2010), available at <http://ssrn.com/abstract=1631710> (detailing exodus of independent directors following the Satyam scandal).

102 See, e.g., Afsharipour, *supra* note 1; Varottil, *A Cautionary Tale*, *supra* note 7; Varottil, *Evolution of Independent Directors*, *supra* note 74.

103 *The heat now turns on independent directors*, ECON. TIMES, Dec. 14, 2009, available at <http://economictimes.indiatimes.com/Infotech/Software/The-heat-now-turns-on-independent-directors/articleshow/5334710.cms?curpg=2>.

104 Varottil, *Evolution of Independent Directors*, *supra* note 74, at 345.

105 See *CII Sets Up Task Force on Corporate Governance*, BUS. STANDARD, Jan. 12, 2009.

106 See *NASSCOM Announces Formation of Corporate Governance and Ethics Committee*, BUS. STANDARD, Feb. 11, 2009, available at <http://www.business-standard.com/india/news/nasscom-announces-formationcorporate-governanceethics-committee/348728/>.

107 See Naresh Chandra, *Report of the CII Task Force on Corporate Governance 2* (November 2009), available at [http://www.mca.gov.in/Ministry/latestnews/Draft\\_Report\\_NareshChandra\\_CII.pdf](http://www.mca.gov.in/Ministry/latestnews/Draft_Report_NareshChandra_CII.pdf) [hereinafter CII, 2009 Report].

sound and legal manner.”<sup>108</sup> Despite its belief that most Indian corporations are well-run and comply with good corporate governance, the CII task force put forth important recommendations.

In its recommendations, the CII task force attempted to strike a balance between over-regulation and promotion of strong corporate governance norms by recommending a series of voluntary reforms. In the preamble of its report, the task force reinforced this message:

Large, highly visible and publicised corporate scandals often provoke legislative and regulatory actions. CII advocates caution against overregulating. It needs to be recognised that while the super-structure of corporate governance is built on laws and regulations, these cannot be anything more than a basic framework. Much of best-in-class corporate governance is voluntary – of companies taking conscious decisions of going beyond the mere letter of law. The spirit of this Task Force Report is to encourage better practices through voluntary adoption - based on a firm conviction that good corporate governance not only comes from within but also generates significantly greater reputational and stakeholder value when perceived to go beyond the rubric of law. Therefore, it is only natural that this report should focus on recommendations, which are being placed before corporate India for adopting voluntarily. It is the belief of CII that Indian Industry would respond spontaneously and help set standards, which would define global benchmarks in the medium term.<sup>109</sup>

In addition to the CII, a number of other corporate groups have joined the corporate governance dialogue. The National Association of Software and Services Companies (NASSCOM, self described as (“the premier trade body and the chamber of commerce of the IT-BPO industries in India”)<sup>110</sup> also formed a Corporate Governance and Ethics Committee chaired by Mr. N. R. Narayana Murthy, one of the founders of Infosys and a leading figure in Indian corporate governance reforms.<sup>111</sup> The Committee issued its recommendations in mid-2010, focusing on stakeholders in the company.<sup>112</sup> The report emphasizes

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108 *Id.* at 1.

109 *Id.* at 2.

110 NASSCOM, *About Us*, available at <http://www.nasscom.in/Nasscom/templates/NormalPage.aspx?id=5365>.

111 NASSCOM, *NASSCOM Governance And Ethics Committee Releases IT's Recommendations For The IT-BPO Industry*, April 27, 2010, available at <http://www.nasscom.in/Nasscom/templates/NormalPage.aspx?id=59083>; see also Afsharipour, *supra* note 1, at 371-372.

112 Umakanth, Varotil, *Nasscom on Corporate Governance*, Indian Corporate Law Blog, May 12, 2010, available at <http://indiakorplaw.blogspot.com/2010/05/nasscom-on-corporate-governance.html>

recommendations related to the audit committee and a whistleblower policy.<sup>113</sup> The report also addresses improving shareholder rights.<sup>114</sup> Moreover, the Institute of Company Secretaries of India (ICSI) has also put forth a series of corporate governance recommendations.<sup>115</sup>

## 2. Government Responses

### a. SEBI Reforms

SEBI's response to the Satyam scandal has been somewhat muted when compared to its primary role in Indian corporate governance reforms over the past ten years. In 2009, SEBI made several announcements regarding disclosure and accounting reforms that could result in changes to the Listing Agreement. In September 2009, the SEBI Committee on Disclosure and Accounting Standards published a discussion paper seeking public comment on several governance issues.<sup>116</sup> The committee's paper addressed proposed reforms directed, among other matters, to the role and function of the audit committee and of external auditors, including the appointment of the chief executive officer (CEO) by the audit committee and the rotation of audit partners every five years. In November 2009, SEBI announced that they would amend the Listing Agreement to address disclosure and accounting concerns. SEBI instituted these amendments in early 2010, although they appear to be somewhat minimal with respect to substantive changes in corporate governance norms.<sup>117</sup>

### b. The MCA and Promotion of Voluntary Guidelines for Corporate Governance

The MCA has increasingly supplanted SEBI in reform efforts following the Satyam scandal.<sup>118</sup> Inspired by industry recommendations, including the influential CII recommendations, in late 2009 the MCA released a set of voluntary guidelines for corporate governance.<sup>119</sup> The MCA Guidelines address a myriad

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113 Dilip Maitra, *Be Open and Ethical to Earn Respect*, DECCAN HERALD, July 6, 2010, available at <http://www.deccanherald.com/content/68534/be-open-ethical-earn-respect.html>.

114 *Nasscom Scripts New Corporate Governance Bible*, FIN. EXPRESS, Apr. 28, 2010.

115 See Institute of Company Secretaries of India, *ICSI Recommendations to Strengthen Corporate Governance Framework* (Dec. 2009), available at [http://www.mca.gov.in/Ministry/latestnews/ICSI\\_Recommendations\\_Book\\_8dec2009.pdf](http://www.mca.gov.in/Ministry/latestnews/ICSI_Recommendations_Book_8dec2009.pdf).

116 See SEBI Committee on Disclosures and Accounting Standards, *Discussion Paper on Proposals Relating to Amendments to the Listing Agreement* (Sep. 2009), available at <http://www.sebi.gov.in/commreport/amendproposal.pdf>.

117 See Securities and Exchange Board of India, Circular No. CIR/CFD/DIL/1/2010 (Apr. 5, 2010), available at <http://www.sebi.gov.in/circulars/2010/cfddilcir01.pdf>; see also Umakanth Varottil, *India's Corporate Governance Voluntary Guidelines 2009: Rhetoric or Reality?* 13 (2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1634821](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1634821) [hereinafter Varottil, *Rhetoric or Reality*].

118 See Varottil, *Rhetoric or Reality*, *supra* note 117, at 12.

119 For detailed evaluation of the substance of the voluntary guidelines and whether a voluntary approach is the correct approach, see Varottil, *Rhetoric or Reality*, *supra* note 117.

of corporate governance matters including independence of the boards of directors, responsibilities of the board, the audit committee, auditors, secretarial audits, and mechanisms to encourage and protect whistle-blowing.<sup>120</sup> Important provisions include:<sup>121</sup> (i) issuance of a formal appointment letter to directors; (ii) Separation of the office of chairman and the CEO; (iii) institution of a nomination committee for selection of directors; (iv) limiting the number of companies in which an individual can become a director; (v) tenure of directors; (vi) remuneration of directors; (vii) training of directors; (viii) performance evaluation of directors; and (ix) additional provisions for statutory auditors.

The MCA Guidelines make important contributions to the corporate governance debate in India and address, at least in part, one of the glaring omissions of Clause 49 reforms, i.e. addressing the agency problems between majority shareholders or promoters and minority shareholders.<sup>122</sup> However, as noted by Indian corporate law scholar Umakanth Varottil, the approach of the MCA Guidelines with respect to this agency issue remains incomplete since the guidelines “do not provide for additional mechanisms such as cumulative voting for election of independent directors or approval of related party transactions by a committee consisting only of independent directors or by independent shareholders.”<sup>123</sup>

The MCA Guidelines’ voluntary nature is another important break with prior corporate governance reforms in India. For the past ten years, corporate governance norms in India have been a mandatory requirement for large listed companies through Clause 49. The MCA Guidelines have been described as following the “comply-or-explain” approach followed in the United Kingdom.<sup>124</sup> Although the guidelines are “voluntary,” companies “are obligated to comply or explain [why they are not complying]” with the hope that such explanation will provide motivation for compliance.<sup>125</sup> In discussing the voluntary nature of the guidelines, Corporate Affairs Secretary, R. Bandyopadhyay, stated that the MCA did not want to enact a rigid, mandatory law.<sup>126</sup> Although, the MCA has indicated

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120 See Voluntary Guidelines, *supra* note 3.

121 *Id.*

122 See Varottil, *Rhetoric or Reality*, *supra* note 117, at 12. Indian companies for a large part display concentrated shareholding which has led to significant agency costs between controlling stockholders or promoters and minority stockholders. For example, the Satyam scandal was in essence a corporate governance debacle that arose out of a related party transaction with a promoter. See Varottil, *Evolution of Independent Directors*, *supra* note 74, at 333-336.

123 See Varottil, *Rhetoric or Reality*, *supra* note 117, at 11-12.

124 See Umakanth Varottil., *Voluntary Nature of Corporate Governance Norms* (Mar, 9, 2010), <http://indiacorplaw.blogspot.com/2010/03/voluntary-nature-of-corporate.html>.

125 Arun Duggal, *What Have We Learned in the Year Since Satyam*, Wall St. J., Feb. 7, 2010, available at <http://online.wsj.com/article/SB126560328884842541.html>.

126 Corporate Affairs Secretary R. Bandyopadhyay: ‘CSR is not Charity — it’s a Win-Win Situation’, India Knowledge at Wharton, available at <http://knowledge.wharton.upenn.edu/india/article.cfm?articleid=4488>.



that the guidelines are a first step and that the option remains open to perhaps move to something more mandatory.<sup>127</sup>

It remains to be seen whether such an approach will be effective.<sup>128</sup> The voluntary guidelines do not provide a perfect solution. For example, when recently asked about the new voluntary corporate governance guidelines, Deepak Parekh, Chairman of the Housing Development Finance Corporation (HDFC), India's leading housing finance company, noted, "You can frame any amount of rules, regulations and guidelines and laws. But corporate governance must come from within . . . . It has to be voluntary, it should come from the top, and it should percolate down to the entire organization."<sup>129</sup> Mandatory requirements may work better in certain contexts, but they are of little use without effective enforcement. Of course it may be that for the Indian context the best approach to corporate governance would combine mandatory rules (minimums) with flexible voluntary guidelines.<sup>130</sup>

As discussed above, the MCA has also announced that the ministry will consider changes to the Companies Bill 2009. Further potential reforms include mandatory disclosure of share pledges by promoters and amendments to the SEBI Takeover Code in order to exempt potential acquirers from making open tender offers.<sup>131</sup> Some commentators, however, have argued that in regard to post-Satyam government action, "[n]othing meaningful has been done to prevent more Satyam-like scams, nor will it ever be."<sup>132</sup>

#### IV. THE CONTINUING CHALLENGES OF THE INDIAN CORPORATE GOVERNANCE FRAMEWORK

##### *A. Compliance and Enforcement Efforts*

Clause 49 of the standard listing agreement with India's stock exchanges is a key component of India's "top-notch governance framework."<sup>133</sup> However,

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127 *Id.*

128 See Varottil, *Rhetoric or Reality*, *supra* note 117, at 12-19; see, also, Sridhar Arcot, et al., *Corporate Governance in the UK: Is the Comply or Explain Approach Working?* (July 1, 2009, INT'L REV. L. & ECON., Forthcoming), available at <http://ssrn.com/abstract=1532290> (finding that the Combined Code of Corporate Governance in UK fostered compliance, but that firms that did not comply with the Code often did a very poor job of providing explanations or did not provide any explanations for their non-compliance).

129 *Inside Story: How they Saved Satyam*, News Center, Jan. 26, 2010, available at [http://www.moneycontrol.com/news/business/inside-story-how-they-saved-satyam\\_432170.html](http://www.moneycontrol.com/news/business/inside-story-how-they-saved-satyam_432170.html).

130 See Khanna, *supra* note 9, at 186.

131 Umakanth Varottil, *The Year That Was: A Round-up of 2009*, India Corporate Law Blog, Dec. 31, 2009, <http://lindiacorplaw.blogspot.com/2009/12/year-that-was-round-up-of-2009.html>.

132 *No meaningful reform yet to prevent another Satyam*, HINDUSTAN TIMES, Jan. 12, 2010, available at <http://www.hindustantimes.com/No-meaningful-reform-yet-to-prevent-another-Satyam/Article1-496321.aspx>.

133 Joe Leahy, *Corporate Governance: Sustained Growth Needs Better Company Practices*, FIN. TIMES, Jan. 24, 2008 (quoting Manesh Patel, Partner, Ernst & Young), available at <http://>

compliance and enforcement with this framework leave much to be desired. While many of the largest independent public companies appeared to have little difficulty complying, public sector undertakings (“PSUs”)<sup>134</sup> and smaller companies have struggled to meet Clause 49’s requirements.

### 1. Compliance

Despite the fact that Clause 49 requirements have been in place for listed companies since 2006, compliance remains a mixed bag.<sup>135</sup> Clause 49 compliance is reported by listed companies themselves. Under Clause 49, companies must submit a quarterly report, signed by the CEO or the Compliance officer, to stock exchanges within fifteen days from the close of quarter.<sup>136</sup> Moreover, the company’s annual report must contain a separate section on corporate governance. To date, companies listed on the NSE, which has grown rapidly in the past several years, have more fully complied with Clause 49 regulations than have BSE-listed companies.<sup>137</sup> As of December 31, 2009, 88 of the companies listed on the NSE, or approximately 6%, have failed to submit Clause 49 compliance reports, while 1103 of the companies listed on the BSE have failed to submit Clause 49 corporate governance reports.<sup>138</sup> This compliance ratio of BSE companies is quite low, at approximately 50%, when one considers that a large proportion of BSE companies are either suspended or placed under the “Z” group of BSE.<sup>139</sup>

The top private sector firms have largely complied with Clause 49. Unlike the reaction to corporate governance reforms in other developing countries, Clause 49 was not initially met with much resistance, partly because of industry’s leading role in the reform process. Not only were industry leaders intricately involved in developing and drafting India’s corporate governance reforms, but

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[www.ft.com/cms/s/0/762d26ac-c946-11dc-9807-000077b07658.dwp?\\_uuiid=56c2aff4-be8c-11dc-8c61-0000779fd2ac.html](http://www.ft.com/cms/s/0/762d26ac-c946-11dc-9807-000077b07658.dwp?_uuiid=56c2aff4-be8c-11dc-8c61-0000779fd2ac.html).

134 PSUs are state-owned enterprises and represent the Indian government’s socialist policies prior to 1991. See Lawrence Sáez & Joy Yang, *The Deregulation of State-Owned Enterprises in India and China*, 43 COMP. ECON. STUD. 69, 76 (2001).

135 For an illuminating study of the compliance of Indian listed companies with the director independence requirement of Clause 49, and the effectiveness of such directors, see Varottil, *Evolution of Independent Directors*, *supra* note 74, at 343-374.

136 CLAUSE 49 (2004) *supra* note 2, § VI(ii).

137 NSE, LISTING OF SECURITIES 38 (2009), available at [http://nseindia.com/content/us/fact2009\\_sec3.pdf](http://nseindia.com/content/us/fact2009_sec3.pdf).

138 Corporate Filing & Dissemination System, Companies Not Complying with Clauses 49 & 40A, available at <http://www.corpfiling.co.in/notcomplying/links.aspx> (last visited April 6, 2010). As of December 2009, 4955 companies were listed on the BSE. BSE, Key Statistics, available at [http://bseindia.com/about/st\\_key/list\\_cap\\_raised.asp](http://bseindia.com/about/st_key/list_cap_raised.asp) (last visited April 6, 2010). As of March 2009, 1432 companies were listed on the NSE. NSE, LISTING OF SECURITIES 38 (2009), available at [http://nseindia.com/content/us/fact2009\\_sec3.pdf](http://nseindia.com/content/us/fact2009_sec3.pdf).

139 See Directors Database, <http://directorsdatabase.com/>; V. Venkateswara Rao, *Clause 49: Needed, better compliance*, BUS. LINE, May 27, 2009, available at <http://www.thehindubusinessline.com/2009/05/27/stories/2009052750430800.htm>.



investors of these firms also viewed the Clause 49 reforms positively.<sup>140</sup> In fact, what is shocking is how little opposition there was to the corporate governance reforms initially proposed through Clause 49. Despite the fact that the most active proponents of these reforms were large firms who could more easily bear their implementation costs, smaller firms voiced little opposition to the reforms.

Larger Indian firms in particular seemed to welcome Clause 49's reforms because they appear to have benefited from the more robust corporate governance rules imposed by Clause 49. In their event study of the impact of Clause 49 reforms on the market value of Indian firms, Professors Black and Khanna found a significant rise in the share price of large firms following SEBI's initial announcement to adopt corporate governance reforms similar to those proposed by the CII. This result reflected investor expectations that corporate governance reforms would "increase the market values of larger Indian public firms."<sup>141</sup> Furthermore, Professors Black and Khanna found that fast-growing and cross-listed firms both reacted more positively than other firms, consistent with the theory that "faster-growing firms are more likely to raise equity capital, and may benefit more from the bonding to good governance" and "cross-listed firms may have greater investment by governance-sensitive foreign investors."<sup>142</sup>

While large corporate entities have been relatively successful in implementing Clause 49's reforms, PSUs and small- and medium-sized enterprises have struggled with the implementation process. One of the biggest failures of corporate governance reforms in India has been the inability of corporate governance reforms to reach these entities. Many experts believe that despite India's formal governance standards, the "fundamental reality of Indian business" – most are still controlled by family shareholders or are government-controlled – undermines the effectiveness of these standards.<sup>143</sup>

The bulk of the compliance problem appears to rest with PSUs and companies outside of the top private sector firms. As explored in Parts C and D below, this is in part due to political pressures regarding the PSUs and in part due to the traditional closed ownership structure of Indian firms. In January 2006, when revisions to Clause 49 went into effect, the top ten private sector companies were all in compliance.<sup>144</sup> In marked contrast to top private sector companies, PSUs were mostly noncompliant with Clause 49 by large margins

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140 Black & Khanna, *supra* note 4, at 18.

141 *Id.* at 1.

142 *Id.*

143 Leahy, *supra* note 133. See also Marianne Bertrand, Paras Mehta & Sendhil Mullainathan, *Ferretting Out Tunneling: An Application to Indian Business Groups*, 2002 Q.J. ECON. 121.

144 *PSUs Fail SEBI's Clause 49 Test*, FIN. EXPRESS, Jan. 10, 2006, available at <http://www.financialexpress.com/news/story/152510/>.

at the time it went into effect.<sup>145</sup> And so they have remained; as of December 2009, 21 of 43 listed PSUs do not have the required number of independent directors required by SEBI and thus are noncompliant with Clause 49.<sup>146</sup>

The Satyam scandal is a reminder that formal compliance does not mean that the companies have necessarily implemented strong corporate governance and financial controls. According to a 2009 study by Prithvi Haldea of Prime Database, “less than a fourth of all independent directors are really independent in the sense that they have no connection with the promoters.”<sup>147</sup> In addition, “more than 3,000 people who were on the boards of various companies on January 1, 2006 were re-designated as independent directors to comply with” Clause 49 and “in around 30 per cent of the companies, promoters simply re-designated themselves – calling themselves non-executive chairmen meant their companies could get by with a smaller proportion of independent directors (one-third, instead of half).”<sup>148</sup>

The Satyam scandal has had both positive and negative repercussions for Clause 49 compliance. The Satyam scandal has acted as a wakeup call in enhancing board practices.<sup>149</sup> Recently, Arun Duggal<sup>150</sup> observed in the Wall Street Journal that:

The first reaction of corporate boards when Satyam blew in January 2009 was to have an independent verification that the cash, bank deposits and financial investments recorded in the company’s books were accurate. The board of directors, particularly independent directors, met with the external and internal auditors to assure themselves that the reported financial statements were true and accurate and that the auditors were independent and diligent. Over 100 independent directors resigned from various boards as they realized that with directorship come certain responsibilities and obligations.

Over the last year, there has been a steady improvement in the functioning of boards. The audit committee function has become

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145 *Id.*

146 *PSUs Fail to Meet SEBI Criterion on Directors*, BUS. STANDARD, Dec. 26, 2009, available at <http://www.business-standard.com/india/news/psus-fail-to-meet-sebi-criteriondirectors/380762>.

147 *Clause 49, RIP?* BUS. STANDARD, May 29, 2009. For further detailed information on directorships at BSE companies, see [http://directorsdatabase.com/default\\_indir.asp](http://directorsdatabase.com/default_indir.asp).

148 *Id.*; see also Prithvi Haldea, *The Naked Truth About Independent Directors* (2009), available at [http://www.directorsdatabase.com/IDs\\_Myth\\_PH.pdf](http://www.directorsdatabase.com/IDs_Myth_PH.pdf).

149 *Enhanced Corporate Governance Practices*, India Corporate Law Blog, Feb. 10, 2010, <http://indiacorplaw.blogspot.com/2010/02/enhanced-corporate-governance-practices.html>.

150 Arun Duggal, *What Have We Learned in the Year Since Satyam*, WALL ST. J., Feb. 7, 2010, available at [http://online.wsj.com/article/SB126560328884842541.html?mod=googlenews\\_wsj](http://online.wsj.com/article/SB126560328884842541.html?mod=googlenews_wsj).

more thorough and meetings have become more substantial and longer. Some audit committees meet for half a day or longer rather than a superficial one-hour meeting as in the past. They also meet with the auditors without the management being present. Related party transactions are scrutinized in greater depth and promoters have to disclose if they have pledged their shares to raise financing.<sup>151</sup>

The efforts of some boards following the Satyam scandal have obviously strengthened corporate governance standards for some companies. However, the Satyam scandal has also alarmed some independent board members to the extent that they have resigned from their positions. According to a recent report, as a result of Satyam, over 500 independent directors have removed themselves from Indian boards “influenced apparently by the realization that they potentially incur reputational and other risk by being on the boards of companies where they may not be fully aware of what is going on- as happened in Satyam.”<sup>152</sup>

## 2. Enforcement

Not only has compliance with Clause 49 been weak, enforcement has also been lacking. Clause 49 contained certain penalty provisions for noncompliance. While the initial penalty for failure to comply with Clause 49 was delisting, severe financial penalties for directors of non-compliant firms were introduced in 2004.<sup>153</sup> However, as argued by the ACGA, India has “a penchant for setting up official committees and enacting new regulations, but under-investing in enforcement and implementation. Neither SEBI nor MCA seem [sic] to have enough competent staff who truly understand the capital markets . . . it will be quite a while before serious changes are seen.”<sup>154</sup>

Perhaps because it has observed the difficulties companies have had in complying with Clause 49, SEBI's enforcement philosophy has changed since Clause 49's effective date. Early statements from Chairman Damodaran indicated that SEBI would prosecute noncompliant companies with enthusiasm; in fact, SEBI anticipated the receipt of compliance reports from the stock exchanges within a month of Clause 49's effective date.<sup>155</sup> Not only was it eager to track down noncompliant companies, but it also seemed anxious to

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151 *Id.*

152 *Clause 49, RIP?* BUS. STANDARD, May 29, 2009. For further detailed information on directorships at BSE companies, see [http://directorsdatabase.com/default\\_indir.asp](http://directorsdatabase.com/default_indir.asp).

153 *See* The Securities Laws (Amendment) Act, 2004 § 11, No. 1, Acts of Parliament, 2005, available at <http://indiacode.nic.in/fullact1.asp?tfnm=200501>; *see also* Dharmapala & Khanna, *supra* note 12 (finding a large and significant positive effect on the value of firms as a result of Clause 49 reforms and the 2004 sanctions).

154 Asian Corporate Governance Association, *infra* note 165.

155 *SEBI Gets Tough with Corp Governance Defaulters*, ECON. TIMES (India), Jan. 11, 2006, available at 2006 WLNR 538409.

impose a severe penalty; Chairman Damodaran threatened that SEBI was developing delisting standards while it waited for the noncompliant list.<sup>156</sup> However, within a few months of Clause 49's effective date, SEBI had toned down its message. By late 2006, recognizing the potential harm to investors accompanying delisting, SEBI's early eagerness appeared to further give way to a more tempered approach to enforcement.<sup>157</sup> SEBI indicated that it would focus its enforcement efforts on those companies that possessed the means to comply, but that had failed to take the necessary steps to do so, while companies that had made a good faith effort to comply, but had fallen short, would be encouraged to complete compliance rather than be prosecuted.<sup>158</sup>

There is little reliable information regarding enforcement of Clause 49 as SEBI has not provided much disclosure to the public regarding these efforts. What is known, at least with respect to large entities, is that there has been little use by SEBI of the delisting enforcement measure provided under Clause 49, even for companies that have failed to comply with Clause 49's board independence rules. For example, in 2007, SEBI brought adjudication proceedings against only twenty out of the hundreds of noncompliant companies. Though it did not disclose all of the names of the companies, SEBI indicated that fifteen were private companies and five were PSUs.<sup>159</sup> However, SEBI later abandoned the enforcement actions against the PSUs after significant political pressure.<sup>160</sup>

SEBI has come under much fire for its lack of enforcement, particularly in light of the Satyam scandal. In a recent interview, when asked about enforcement actions, Deepak Parekh lamented that many companies don't follow Clause 49 guidelines, but no action is taken "because there are far too many corporations listed on the exchange and the SEBI staff is too small."<sup>161</sup> He further noted that the rules are meaningless if there is no enforcement, and argued that SEBI needs to delist those companies and force promoters to pay back the money to the shareholders. "Today, everyone goes scot-free if you don't follow any SEBI rules or any listing requirements . . . You must close some companies and delist some, and throw some promoters out. You have to

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156 *Id.*

157 'No Exemption from Clause 49 Compliance,' HINDU BUS. LINE, Aug. 30, 2006, available at <http://www.thehindubusinessline.com/2006/08/31/stories/2006083103700900.htm>.

158 *Id.*

159 Press Release, SEBI, SEBI Initiates Adjudication Proceedings Against 20 Companies for Non-Compliance of Clause 49 Norms (Sept. 11, 2007), available at <http://www.sebi.gov.in/press/2007/2007257.html>.

160 During October and November 2008, SEBI passed a series of orders involving several government companies, viz. NTPC Limited (8 October), GAIL (India) Limited (27 October), Indian Oil Corporation Limited (31 October) and Oil and Natural Gas Corporation Limited (3 November), all available at <http://www.sebi.gov.in>.

161 *Inside Story: How they Saved Satyam*, NEWS CENTER, Jan. 26, 2010, available at [http://www.moneycontrol.com/news/business/inside-story-how-they-saved-satyam\\_432170.html](http://www.moneycontrol.com/news/business/inside-story-how-they-saved-satyam_432170.html).

give a lesson.”<sup>162</sup>

While SEBI's enforcement efforts have been somewhat meager, it may be the only real avenue for enforcement. There is little enforcement of corporate governance norms through private litigation. Despite India's sophisticated investor-protection laws, litigants may never be able to meaningfully access the courts.<sup>163</sup> As the World Bank found in its 2005 report, “it is not unusual for the first hearing to take six years and the final decision up to 20 years.”<sup>164</sup> With the weak possibility of enforcement through the courts, enforcement has essentially been relegated to the activities of SEBI. Section B.2 below provides further discussion of the inability of investors to use the courts to address corporate governance shortcomings.

### *B. The Political Economy of Reform Efforts*

Despite efforts by India's corporate elite to shape and control corporate governance reform efforts, India's complicated politics have continued to stymie such efforts. India's corporate governance regime has remained weak despite the enactment of Clause 49.<sup>165</sup> There are numerous factors that contribute to continuing weakness in India's corporate governance regime. This section examines the reasons for the flawed implementation and enforcement process that proceeded from the enactment of Clause 49.

#### 1. Inter-Agency Struggles in Reform Efforts

Since the late 1990s, the MCA has been engaged in what has been termed a “turf war” with SEBI over the process for and substance of corporate governance reform, among other things.<sup>166</sup> A number of commentators have challenged SEBI's authority to promulgate extensive corporate governance rules.<sup>167</sup> Despite SEBI's long-term involvement in formulating corporate governance standards, such debates do persist. For example, in a recent editorial,

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162 *Id.*

163 The Companies Act states that it:

[C]onfers rights to shareholders in matters of oppression by the majority or mismanagement. The lesser of 100 shareholders or those representing 10 percent of shareholders can apply to the CLB for redress. CLB can instruct management to buy out dissenting shareholders, terminate or modify agreements entered into by the company or remove/appoint directors to the board. CLB's decisions may be appealed to the high and supreme courts.

WORLD BANK & INT'L MONETARY FUND, REPORT ON THE OBSERVANCE OF STANDARDS AND CODES, at 6 (2004), available at [http://www.worldbank.org/ifa/rosc\\_cg\\_ind.pdf](http://www.worldbank.org/ifa/rosc_cg_ind.pdf) [hereinafter WORLD BANK REPORT].

164 *Id.*

165 Asian Corporate Governance Association, Library, Country Snapshots, India, available at [http://www.acga-asia.org/content.cfm?SITE\\_CONTENT\\_TYPE\\_ID=11&COUNTRY\\_ID=264](http://www.acga-asia.org/content.cfm?SITE_CONTENT_TYPE_ID=11&COUNTRY_ID=264).

166 See Sucheta Dalal, *Irani Panel Hasn't Helped Small Investors*, FIN. EXPRESS, June 6, 2005, available at [http://www.financialexpress.com/old/fe\\_full\\_story.php?content\\_id=92958](http://www.financialexpress.com/old/fe_full_story.php?content_id=92958).

167 For a more detailed discussion of debates over SEBI's authority, see Afsharipour, *supra* note 1, at 356-58.

a Special Secretary to the Ministry of Finance noted that “SEBI must accept that its powers are limited and subordinate to the MCA and not coextensive with it, and hence, has to refrain from framing its own rules concerning corporate governance.”<sup>168</sup> According to the author, SEBI may adopt rules that stem from the Companies Act regarding listing agreements, “but cannot frame independent rules in this regard coextensive or more than what is there in the Companies Act” and then try to say that non-compliance would result in delisting.

One of the most significant issues with respect to the reform process related to SEBI’s conduct vis-à-vis the MCA and SEBI’s decision to pursue corporate governance reform through amendments to the Listing Agreement, rather than through revisions to the Companies Act with participation from the legislative branch. Accordingly, throughout the Clause 49 adoption and amendment process, rather than engaging with SEBI on corporate governance standards, the MCA responded by establishing its own separate committee. While the Companies Act certainly needs to be amended to better account for corporate governance issues, the MCA’s process, however, has been fraught with tensions with SEBI which appear to be unhelpful in any process to amend the Companies Act.

One of the reasons that corporate governance reforms were pursued through SEBI was that, as an independent market regulator, SEBI provided some flexibility to a corporate governance regime primarily characterized by a need for constant amendment of the Companies Act. The promulgation of comprehensive reforms in the form of Clause 49 demonstrates this. Although SEBI has had long-standing tensions with the MCA over who should be handling the various tasks involving reform and enforcement of corporate governance standards, it is worth noting that since SEBI’s inception, it has taken significant steps to pursue adoption of corporate governance reforms through changes to the Listing Agreement, while MCA’s proposed reforms of the Companies Act have languished in drafting and review.

Despite SEBI’s ability to push Clause 49 through, the MCA’s resistance to its provisions, including recommendations by MCA-appointed committees that conflicted with Clause 49, has significantly undermined SEBI’s authority and lifted much of the pressure from non-complying companies. Many commentators view the conflicts between SEBI and the MCA as a leading cause of lax enforcement of corporate governance standards.<sup>169</sup> Experts have

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168 T. N. Pandey, *Distortions in SEBI’s Enforcement of Corporate Governance Norms*, Jul. 9, 2009, available at <http://www.lawyersclubindia.com/articles/Distortions-in-SEBI-s-Monitoring-of-Corporate-Governance-Nor/1325/>.

169 Ambarish Mukherjee, *Delayed Action Against Errant Co—Turf War Between SEBI and DCA*, HINDU BUS. LINE, July 16, 2001, available at <http://www.hinduonnet.com/businessline/2001/07/16/stories/14161830.htm> (noting turf war caused delay of investigations).

noted that the “[I]ack of cooperation and coordination between key government departments, in particular MCA and SEBI,” further weakened enforcement and implementation efforts, resulting in “overlap of jurisdiction or regulatory gaps.”<sup>170</sup>

Corporate governance leaders in India have recognized the negative externalities of these inter-agency struggles. In a recent interview, former SEBI chairman Damodaran commented on the nature of corporate governance standards.<sup>171</sup> When asked about agency problems and the enforcement of Clause 49, Damodaran noted that the major question is: “Who is responsible for ensuring corporate governance?” He noted in some places the securities market regulator would be responsible for ensuring corporate governance and in others the Ministry of Corporate Affairs would take on that role. Moreover, he recognized that corporate governance reform efforts cannot be implemented through SEBI alone. Damodaran expressed that certain corporate governance reforms related to the protection of minority shareholders need to be incorporated in some sort of legislation, such as the Companies Act: “Going forward, we should see provisions in the Companies Act that stipulate what needs to be done by way of structural arrangements rather than leaving it to the Listing Agreement, which would not have the same legislative strength as the Companies Act.”<sup>172</sup>

## 2. Access to Courts

One of the factors behind the continuing shortcomings in the enforcement of India's corporate governance reforms is the lack of meaningful enforcement through the courts. The Indian judicial system is characterized by staggering delays in adjudication. Moreover, Indian investors are reluctant to bring class action suits given the high costs of such suits and the unavailability of a contingency fee system.<sup>173</sup>

Recently, SEBI has made efforts to assist select investor associations in investor education and awareness programs and in bringing securities class action suits.<sup>174</sup> For example, in 2009, SEBI agreed to fund an Indian investors association that sought to bring a securities class action suit against Satyam,

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170 Asian Corporate Governance Association, *supra* note 165.

171 M. Damodaran, *The Courage of Conviction is More Evident Today*, INDIA KNOWLEDGE AT WHARTON, available at [http://knowledge.wharton.upenn.edu/india/articlepdf\\_4429\\_.pdf?CFID=500856&CFTOKEN=75360366&jsessionid=a83042d418eff89b91026127358482c217b1](http://knowledge.wharton.upenn.edu/india/articlepdf_4429_.pdf?CFID=500856&CFTOKEN=75360366&jsessionid=a83042d418eff89b91026127358482c217b1).

172 *Id.* at 2.

173 See Umakanth Varottil, *Shareholder Activism and Class Action Lawsuits*, Indian Corporate Law Blog, June 1, 2009, <http://indiakorplaw.blogspot.com/2009/06/shareholder-activism-and-class-action.html>.

174 See SEBI (Investor Protection and Education Fund) Regulations, 2009 and the SEBI (Aid for Legal Proceedings) Guidelines, 2009, available at <http://investor.sebi.gov.in/>; Anindita Dey, *SEBI Proposes to Fund Class Action Suits*, BUSINESS STANDARD, Jun. 1, 2009.



and its former promoters, auditors, and directors.<sup>175</sup> In the class action context, SEBI's funding is limited to seventy-five percent of the total expenditure by the association in such legal proceedings and to cases where at least one thousand investors are affected, or likely to be affected, by issues such as misstatements in offer documents or fraudulent and unfair trade practices or market manipulation.<sup>176</sup> However, SEBI will not fund cases where it has initiated enforcement action.<sup>177</sup> It is too early to tell whether SEBI's recent efforts will lead to marked increase in securities class action litigation.

Indian investors are also reluctant to access the courts due to the significant delays in adjudication. According to a report by the World Bank, the process under which cases brought pursuant to the Companies Act is adjudicated has been mired in delay and ineffectiveness. For example the Company Law Board (CLB), the primary judicial authority for enforcement of the Companies Act, experienced significant delays and a large backlog of cases.<sup>178</sup> The delays at the CLB level were further compounded by the ability of parties to appeal CLB decisions to the high courts and Supreme Court.

Efforts to address these shortcomings have themselves been thwarted by litigation.<sup>179</sup> In order to ameliorate the extreme backlog of corporate law cases and to consolidate various duties previously allocated to several different government bodies, in 2002, the Indian Parliament amended the judicial structure with respect to corporate law matters. Under the Companies (Second Amendment) Act, 2002 (2002 Act), the government created a new National Company Law Tribunal (NCLT), along with its appellate body, the National Company Law Appellate Tribunal (NCLAT), to enforce the provisions of the Companies Act.<sup>180</sup> The government's hope was that corporate governance

175 *SEBI to Fund Class Action Suit Against Satyam*, ECON. TIMES, July 17, 2009, <http://economictimes.indiatimes.com/sebi-to-fund-class-action-suit-against-satyam/articleshow/4787131.cms>.

176 See SEBI (Investor Protection and Education Fund) Regulations, *supra* note 174, at clause (g) of sub-regulation (1) of regulation 2 (definition of legal proceedings includes "any proceedings before a court or tribunal where one thousand or more investors are affected or likely to be affected by: (i) mis-statement, misrepresentation or omission in connection with the issue, sale or purchase of securities; (ii) non-receipt of securities allotted or refund of application monies paid by them; (iii) non-payment of dividend; (iv) default in redemption of securities or in payment of interest in terms of the offer document; (v) fraudulent and unfair trade practices or market manipulation; (vi) such other market misconduct which in the opinion of [SEBI] may be deemed appropriate.").

177 *See id.*

178 See WORLD BANK REPORT, *supra* note 163, at 21.

179 Umakanth Varottil, *The Year That Was: A Round-up of 2009*, Indian Corporate Law Blog, Dec. 31, 2009, <http://indiacorplaw.blogspot.com/2009/12/year-that-was-round-up-of-2009.html>.

180 The Companies (Second Amendment) Act, 2002, No. 11, Acts of Parliament, 2003. There is debate as to whether establishing these tribunals will provide speedy and fair resolution of cases. See Kumkum Sen, *SC's NCLT Decision Welcome, Despite Concerns on Speedy and Fair Trial*, BUS. STANDARD, May 24, 2010, available at <http://www.business-standard.com/india/news/sc%5Csc-nclt-decision-welcome-despite-concernspeedyfair-trial/395843/>; *NCLT Would Speed Up*

reforms could be enforced by this new judicial body.<sup>181</sup>

Unfortunately, this judicial reform process has been mired in controversy. The establishment of the NCLT and NCLAT was the subject of constitutional litigation in the Madras High Court and the Indian Supreme Court. In 2004, the Madras High Court declared the NCLT to be an unconstitutional infringement upon the independence of the judiciary.<sup>182</sup> Since the issues involved would have serious implications for the balance of power between the branches of the Indian government, the case was given to a five-judge Constitution Bench of the Court to decide.<sup>183</sup> The Supreme Court completed its hearings in 2009.<sup>184</sup> In the appeal, the Madras Bar Association (MBA) put forth a number of challenges to the NCLT, contending that: Parliament could not create a tribunal to perform a function that has traditionally been carried about by the courts; the NCLT infringes upon separation of powers and independence of the judiciary, which form part of the basic structure of the Constitution; the Constitution does not list tribunals with company law jurisdiction among the list of permissible tribunals; and various portions of Chapters IB and IC of the Companies Act violate principles of rule of law.<sup>185</sup>

After a lengthy deliberation, in mid-2010, the Indian Supreme Court held that the provisions of the Companies Act creating the NCLT and NCLAT were unconstitutional as written, though the tribunals could be created if the provisions were amended.<sup>186</sup> The Supreme Court ruled that Parliament did have the legislative competence to create the NCLT.<sup>187</sup> The court also found that Parliament has the competence to transfer power from the High Courts to a tribunal.<sup>188</sup>

Turning to constitutional limits on the tribunals, the Supreme Court rejected the government's argument that once legislative competence to establish tribunals

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*Corporate Disputes Redressal: Experts*, BUS. STANDARD, May 16, 2010, available at <http://www.business-standard.com/india/news/nclt-would-speed-corporate-disputes-redressal-experts/94493/on>; *SC Clears Way for Tribunal to Speed up Corporate Cases*, ECON. TIMES, May 12, 2010, available at <http://economictimes.indiatimes.com/news/economy/policy/SC-clears-way-for-tribunal-to-speed-up-corporate-cases/articleshow/5919613.cms>

181 See Afsharipour, *supra* note 1, at 360-363 for an examination of the purpose of the NCLT.

182 *National Company Law Tribunal Held Unconstitutional*, HINDU BUS. LINE, Apr. 11, 2004, available at <http://www.thehindubusinessline.com/2004/04/11/stories/2004041101480100.htm>.

183 *SC Refers NCLT Issue to Constitutional Bench*, ECON. TIMES (INDIA), May 18, 2007, available at [http://economictimes.indiatimes.com/News/Politics/Nation/SC\\_refers\\_NCLT\\_issue\\_to\\_constitutional\\_bench/articleshow/2059145.cms](http://economictimes.indiatimes.com/News/Politics/Nation/SC_refers_NCLT_issue_to_constitutional_bench/articleshow/2059145.cms).

184 *Union of India v. R. Gandhi*, President Madras Bar Association (Sup. Ct. 2010) available at [http://www.barandbench.com/userfiles/files/File/national\\_company\\_law\\_tribunal.pdf](http://www.barandbench.com/userfiles/files/File/national_company_law_tribunal.pdf).

185 *Id.* at 2.

186 *Id.* at 86.

187 *Id.* at 52.

188 *Id.* at 53.

divesting High Courts of jurisdiction was established, no further inquiries need be made.<sup>189</sup> The Supreme Court reasoned it could analyze judicial independence and separation of powers concerns under the rule of law challenge.

The Court found that one of the central problems with the NCLT is the appointment of bureaucrats as judicial and technical members of the tribunal. The Supreme Court stated that the low requirements to become a technical member on the NCLT dilute the standards for those qualified to perform judicial functions.<sup>190</sup> The Court repeatedly stressed legitimacy and the perception of legitimacy, stating that technical members must be able to “ensure that justice is not only done, but also seen to be done.”<sup>191</sup> The Court argued that the lack of high standards adversely impacts independence, which exists only “when persons with competence, ability and independence with impeccable character man the judicial institutions.”<sup>192</sup> The Supreme Court was also troubled by the lack of tenure, citing the short three year terms, the provision for suspension pending inquiry, and lack of immunity.<sup>193</sup>

The Court provided a number of remedies which would allow for creation of the tribunals, such as amendments with respect to the qualifications of judicial members and technical members for the tribunal and the constitution of the selection committee.<sup>194</sup> The MCA has reportedly sought out the law ministry’s advice on implementing the Supreme Court’s suggestions.<sup>195</sup> The Economic Times reports that the challenge now is in “swift selection of [NCLT’s] members and constituting the forum with proper infrastructure and resources.”<sup>196</sup>

### *C. Neglecting Minority Shareholders*

For many Indian firms, management is generally tied to a controlling block of inside shareholders who have control rights in excess of their ownership rights. Ownership structures of firms in India were a primary factor behind the lack of disclosure and governance requirements under the Companies Act. Even today, the most significant challenge for India’s corporate governance reforms remains the closed ownership structure of Indian firms<sup>197</sup> and the failure

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189 *Id.* at 15.

190 *Id.* at 71, 72.

191 *Id.* at 70.

192 *Id.* at 69.

193 *Id.* at 82.

194 *Id.* at 82-84.

195 *MCA Seeks Law Ministry Help to Make New Tribunal SC-Compliant*, ECON. TIMES, May 26, 2010, available at <http://economictimes.indiatimes.com/articleshow/5974875.cms>

196 *Figuring Out What Shape the National Company Law Tribunal (NCLT) Will Take*, ECON. TIMES, May 27, 2010, available at <http://economictimes.indiatimes.com/articleshow/5978966.cms>.

197 India’s experience with corporate ownership resembles that of most emerging economies. Jayati Sarkar & Subarata Sarkar, *Debt and Corporate Governance in Emerging Economies: Evidence from India*, 16 ECON. OF TRANSITION 293, 295 (2008); see also Ananya Mukherjee Reed & Darryl Reed, *Corporate Governance in India: Three Historical Models and Their Development*

of existing reforms to address both the potential oppression of minority shareholders and the extensive power of promoters in Indian companies.

For the vast majority of Indian businesses, including companies listed on the stock exchanges, ownership has been concentrated in the hands of family business groups, and to a lesser extent, state-owned enterprises and promoters.<sup>198</sup> Ownership of Indian firms has followed a complex pattern, with family ownership (and its accompanying control and conflicts of interest issues) being the mainstay of India's corporate landscape.<sup>199</sup> Even today, a significant portion of the largest companies in India remain family-managed and promoted, although sometimes the controlling family may have only modest ownership control.<sup>200</sup> Even companies at the very top of India's corporate sector reflect family control.<sup>201</sup> Some well-known examples of family-owned corporate groups are the Tatas, the Birlas, and the Ambanis.<sup>202</sup>

In conjunction with the prevalence of family ownership, "promoters" play an important and pervasive role in Indian corporate governance.<sup>203</sup> Prior to the 1990s, as a result of the support of public financial institutions, the prominent industrial families were typically able to maintain operational control of large private companies even with minimal diversification in shareholdings.<sup>204</sup> However, with the 1990s came a change in strategy. As the economy became more liberalized, the various corporate promoters were faced with the threat of losing control in the face of significant increases in foreign investment.<sup>205</sup> These promoters began increasing their respective stakes in the companies they controlled, so much that a 2005 study of over 3000 companies found that nearly half the market capitalization of those companies was directly held by the promoters.<sup>206</sup> This study additionally suggested that the actual holdings likely

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*Impact, in CORPORATE GOVERNANCE, ECONOMIC REFORMS, AND DEVELOPMENT: THE INDIAN EXPERIENCE* 25, 31-36 (Darryl Reed & Sanjoy Mukherjee eds., 2004).

198 See Varottil, *Evolution of Independent Directors*, *supra* note 74, at 286-289; Chakrabarti et al., *supra* note 18, at 59; see also *Family Businesses Raise Corporate Governance Concerns*, *Says Moody's*, *INDIAN EXPRESS*, Oct. 23, 2007, available at <http://www.indianexpress.com/story/231282.html> [hereinafter *Moody's*].

199 See Satheesh Kumar T. Narayanan, *Indian Family-Managed Companies: The Corporate Governance Conundrum*, 5 *ICFAI J. CORPORATE GOVERNANCE* 20 (2006), available at <http://ssrn.com/abstract=1093230>. For a more detailed overview of the corporate governance concerns that arise in these businesses, see Varottil, *Evolution of Independent Directors*, *supra* note 74, at 286-289.

200 See *id.* at 21; Chakrabarti et al., *supra* note 18, at 59.

201 Narayanan, *supra* note 199, at 20.

202 *Moody's*, *supra* note 198.

203 A promoter is any person or persons that have, directly or indirectly, control of the company. See Chakrabarti et al., *supra* note 18, at 61.

204 K.S. Chalapati Rao & Atulan Guha, *Ownership Pattern of the Indian Corporate Sector: Implications for Corporate Governance* 1, 11 (Inst. for Studies in Indus. Dev., Working Paper No. 2006/09, 2006), available at <http://isidev.nic.in/pdf/wp0609.pdf>.

205 *Id.* at 11-14.

206 *Id.* at 13.

exceed half, given that promoter shareholding is often hidden in the form of other corporate bodies or individual shareholders. Regardless of how frequent such hidden holdings actually are, it is clear that concentrated ownership still dominates the Indian corporate landscape. However, this concentration of ownership in India is slowly shifting. For example, non-promoter institutional investors, both Indian and foreign, are making significant inroads into the ownership of large Indian firms.<sup>207</sup>

The closed ownership structure of many Indian firms explains the compliance discrepancy between top private sector companies and other private companies. While top companies have strong incentives to increase transparency and compliance as they are competing for foreign direct investment, smaller private companies continue to face many compliance obstacles.<sup>208</sup> The traditional closed or government-controlled ownership structures of Indian firms have resulted in weak boards and weak board practices. As identified by the World Bank, “a key missing ingredient in India today is a strong focus on director professionalism.”<sup>209</sup>

The closed ownership structure of Indian firms has also meant that there is little shareholder activism in India, and investors spend little time communicating their concerns to the board of directors or the management of a firm.<sup>210</sup> In India, there are no significant shareholder associations, and minority shareholders have minimal avenues for protecting their rights.<sup>211</sup> Even large “institutional investors show minimum involvement in corporate governance issues.”<sup>212</sup>

The family business structure of many Indian firms compounds this difficulty; family control can contribute to issues of adaptability and transparency, and many family businesses do not have nomination committees.<sup>213</sup> One of the main concerns regarding Clause 49 has been whether it can be effective given the structure of many Indian businesses, where board members may be reluctant

207 See Chakrabarti et al., *supra* note 18, at 62. But see Rao & Guha, *supra* note 204, at 18.

208 ‘Punish Cos for Clause 49 Non-Compliance,’ BUS. LINE (MUMBAI), Feb. 20, 2007, available at <http://www.blonnet.com/2007/02/20/stories/2007022005030100.htm>.

209 Michael F. Carter, Country Director, India, The World Bank Group, Address at the National Conference on Corporate Governance Trends in India (Oct. 18, 2004), available at [http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTGOVANTI\\_CORR/0,,contentMDK:20269936~menuPK:3036142~pagePK:64020865~piPK:149114~theSitePK:3035864,00.html](http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTGOVANTI_CORR/0,,contentMDK:20269936~menuPK:3036142~pagePK:64020865~piPK:149114~theSitePK:3035864,00.html) (emphasis omitted).

210 See Jayati Sarkar & Subrata Sarkar, *Large Shareholder Activism in Corporate Governance in Emerging Economies: Evidence from India*, 1:3 INT’L REV. FIN. 161 (2000); M.C. Vijayanthi, *Shareholder Activism*, HINDUSTAN TIMES, Dec. 26, 2007, available at <http://www.hindustantimes.com/StoryPage/StoryPage.aspx?id=4b5beaf0-3847-47ad-994b-38f92a294d22&&Headline=Shareholder+activism>.

211 This may gradually change with recent SEBI efforts to recognize and support investor associations. See *supra* notes 173-177 and accompanying text.

212 Vijayanthi, *supra* note 210.

213 Leahy, *supra* note 13333.

to question leaders of family run businesses. For example, many argue that it is highly unlikely that a board would ever oust leaders like Ratan Tata of the Tata Group.<sup>214</sup> Thus, “family control . . . [raises] corporate governance concerns in areas including adaptability, leadership transition, checks and balances and transparency.”<sup>215</sup>

India's corporate governance reforms, while laudable, do not address the fundamental corporate governance issues that arise in closely held businesses. In a recent article examining India's corporate governance reforms and the ownership structure of Indian firms, scholar Umakanth Varottil has comprehensively demonstrated that “due to the concentrated ownership structures in Indian companies, it is the minority shareholders who require the protection of corporate governance norms from actions of the controlling shareholders. Board independence, in the form it originated, does not provide a solution to this problem.”<sup>216</sup> In fact, even those that argue that listed companies in India “are well regulated” admit that “oppression and mismanagement will remain always and [need] to be tackled carefully.”<sup>217</sup>

A number of experts have put forth suggestions to address the potential for oppression of minority shareholders.<sup>218</sup> These suggestions include: (i) alterations in the nomination and appointment process for independent directors; (ii) changes in the election of independent directors to give greater role to minority shareholders; (iii) encouraging investor activism; (iv) clarifying the advisory and monitoring role of independent directors; and (v) principles to help increase the qualifications and commitments of independent directors.

Some of the most recent and interesting set of recommendations have been put forth by the Asian Corporate Governance Association.<sup>219</sup> The ACGA's goal is to help address critical corporate governance areas that (ACGA) thus far “remain to be addressed- particularly relating to the accountability of promoters (controlling shareholders), the regulation of related party transactions, and the governance of the audit profession.”<sup>220</sup> According to the ACGA, “a key challenge at the heart of the governance problem” is “the accountability of promoters to other shareholders.”

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214 *Id.*

215 *Id.*

216 Varottil, *Evolution of Independent Directors*, *supra* note 74.

217 See *Satyam Lessons and Corporate Reforms*, Pushkar Chandna, Feb. 13, 2010, <http://pushkarchandna.sulekha.com/blog/post/2010/02/satyam-lessons-and-corporate-governance-reforms.htm>.

218 See, e.g., Varottil, *Evolution of Independent Directors*, *supra* note 74.

219 ACGA *White Paper on Corporate Governance in India*, available at [http://www.acga-asia.org/public/files/ACGA\\_India\\_White\\_Paper\\_Final\\_Jan19\\_2010.pdf](http://www.acga-asia.org/public/files/ACGA_India_White_Paper_Final_Jan19_2010.pdf).

220 *Id.* at 5.

In order to increase this accountability, the ACGA presents a number of important reform suggestions including: (i) to better improve shareholder meetings and to empower institutional investors by providing for more systematic voting, greater disclosure prior to meetings; (ii) address related-party transactions by giving independent shareholders the power to approve large transactions; and (iii) requiring the appointment of an independent financial advisory and an independent board committee to determine whether the transactions are fair and reasonable to all shareholders.<sup>221</sup>

#### *D. Public Sector Undertakings (PSUs) and the Governance Struggle*

PSUs, which are state-owned enterprises, represent major remnants of the Indian government's socialist policies prior to 1991. PSUs have long occupied a dominant position in the Indian economy- India's public sector consists of over 1300 PSUs, which employ over seventy percent of the total industrial workforce.<sup>222</sup> Many listed PSUs "are larger in size, sales and value than their private sector counterparts."<sup>223</sup> Beginning in the 1990s, as a part of India's economic liberalization, the government began large-scale privatization of PSUs.<sup>224</sup>

Despite this privatization effort, the PSUs have resisted corporate governance reform. The PSUs have argued that their non-compliance is due to the allegedly onerous independent director requirements of Clause 49.<sup>225</sup> Part of the explanation for such noncompliance is that SEBI has long maintained that government nominees on PSU boards are not independent per Clause 49's requirements.<sup>226</sup> Some PSU leaders have argued that Clause 49's independent director requirements are unnecessary for PSUs because, as highly regulated entities, accountability at PSUs is higher than at private firms.<sup>227</sup> The PSUs have advocated that SEBI should instead enforce the J.J. Irani Committee on Company Law's recommendation that only a third of their directors be independent.<sup>228</sup>

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221 *Id.*

222 See Lawrence Sáez & Joy Yang, *The Deregulation of State-Owned Enterprises in India and China*, 43 COMP. ECON. STUD. 69, 76 (2001).

223 Goswami, *supra* note 43, at 135.

224 PANAGARIYA, *supra* note 13, at 302-303.

225 *PSUs Fail to Meet SEBI Criterion on Directors*, *supra* note 126.

226 *SEBI Cracks Whip on 20 Firms for Clause 49 Violation*, BUS. STANDARD, Sept. 12, 2007, available at <http://www.business-standard.com/india/news/20-firms-in-focus-for-clause-49-violation/297650/>.

227 Richa Mishra, *ONGC Faces Threat of Delisting*, HINDU BUS. LINE, Nov. 12, 2007, available at 2007 WLNR 22305224.

228 K.R. Srivats, *'Independent Directors Should Form 1/3 of Board' Irani Panel Submits Report on Company Law*, HINDU BUS. LINE, June 1, 2005, available at <http://www.blonnet.com/2005/06/01/stories/2005060102690100.htm>.



According to other PSU leaders, while they recognize the need for more independent directors, the process for appointments takes significantly more time than private company appointments because the government must appoint these directors.<sup>229</sup> Former SEBI Chairman M. Damodaran has suggested the government is dragging its heels in appointing independent directors because it does not want to lose control over PSU companies.<sup>230</sup> He was particularly concerned that if people were investing in Indian companies based on the perception that "Indian corporates are trying to get their act together on corporate governance," Indian companies should follow through on that perception.<sup>231</sup>

Recently, the government has begun to consider a proposal to restrict the role of administrative ministries in the appointment of independent directors and to give more autonomy to state-owned companies in the selection of independent directors, as it prepares them for listing on the stock exchanges.<sup>232</sup> The proposal is intended to encourage better corporate governance among PSUs and to benefit all PSUs looking for early listing.<sup>233</sup> In addition, in March 2010, the Indian government announced that all Central Public Sector Enterprises (CPSEs), a proportion of PSUs, will be required to comply with the corporate governance norms, some of which mirror those required by Clause 49. While commentators have welcomed these reform efforts, "the mandatory guidelines may be of no avail if they continue to perpetuate the dominance of the controlling shareholder, being the Government."<sup>234</sup>

## V. CONCLUSION

Since the late 1990s, significant efforts have been taken by Indian regulators, as well as by Indian industry representatives and corporations, to achieve an overhaul of corporate governance in Indian firms. Not only were reform measures put into place prior to discovery of major corporate governance scandals, but both industry groups and government actors have sprung into action following the Satyam scandal. Despite these commendable efforts, the actual implementation and enforcement of corporate governance reforms remain challenging. As discussed in this article, these challenges arise because of a

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229 'PSUs Must Meet Clause 49 Norms,' BUS. STANDARD, Jan. 3, 2008, available at 2008 WLNR 96448.

230 *No Exemption for Listed PSUs on Independent Director Norms*, HINDU BUS. LINE, Jan. 3, 2008, available at 2008 WLNR 93975. See also 'PSUs Must Meet Clause 49 Norms,' *supra* note 229; *SEBI Won't Budge on Clause 49 Norms*, FIN. EXPRESS, Jan. 2, 2008, available at <http://www.financialexpress.com/news/Sebi-wont-budge-on-Clause-49-norms/257004/>.

231 *No Exemption for Listed PSUs*, *supra* note 230.

232 Dheeraj Tiwari, *PSUs to get leeway in independent directors' selection*, ECON. TIMES, Jan. 23, 2010, available at <http://economictimes.indiatimes.com/news/economy/indicators/PSUs-to-get-leeway-in-independent-directors-selection/articleshow/5490712.cms>

233 *Id.*

234 Umakanth Varottil, *Corporate Governance Norms for Central PSUs*, available at <http://indiacorplaw.blogspot.com/2010/03/governance-norms-for-central-psus.html>.

number of social, political and economic conditions in India. While this short article cannot expand in further detail the potential solutions to these challenges, it is hoped that further research can help develop solutions that take them into account.

# FUNDAMENTAL RIGHTS AND PUBLIC INTEREST LITIGATION IN INDIA: OVERREACHING OR UNDERACHIEVING?

Varun Gauri\*

## I. INTRODUCTION

The global reputation of Indian courts, and perhaps their national reputation as well, as judicial innovators and as defenders of the interests of the disadvantaged and downtrodden, rests largely on Public Interest Litigation (PIL), a new set of procedures for expanding access to justice that were developed some thirty years ago. Although assessments of PIL in India range from the laudatory to the cynical, recent scholarship has developed a widely held narrative that runs as follows.<sup>1</sup> PIL or “social action litigation,” as some call it, originated in the late 1970s when the judiciary, aiming to recapture popular support after its complicity in Indira Gandhi’s declaration of emergency rule, encouraged litigation concerning the interests of the poor and marginalized, and to do so loosened rules and traditions related to standing, case filing, the adversarial process, and judicial remedies. The Supreme Court pronounced a number of landmark social justice judgments in the 1980s and early 1990s, including key rulings on the rights of prisoners, bonded laborers, pavement dwellers, and children.<sup>2</sup> The frequency of PIL cases in the Supreme Court and the High Courts increased as claimants and their lawyers learned how to take advantage of the more liberal procedures associated with PIL.<sup>3</sup> By the middle to late 1990s,

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\* Senior Economist, The World Bank, Washington D.C. The author would like to thank Afroza Chowdhury, Kabir Duggal, Kaushik Krishnan, and Yamini Jaishankar for excellent research assistance. This paper has also benefited from very helpful comments from Daniel Brinks, Vikram Raghavan, Arun Thiruvengadam, and the participants in a session of the Law and Social Sciences in South Asia Conference in New Delhi in 2009. The views presented in this paper are those of the author alone and do not necessarily represent the views of the World Bank or its Executive Directors.

1 Elements of this broad narrative are supported in UPENDRA BAXI, *THE INDIAN SUPREME COURT AND POLITICS* (1980); *JUDGES AND THE JUDICIAL POWER: ESSAYS IN HONOUR OF JUSTICE V.R. KRISHNA IYER* (Rajeev Dhavan et al. eds., 1985); S. P. SATHE, *JUDICIAL ACTIVISM IN INDIA: TRANSGRESSING BORDERS AND ENFORCING LIMITS* 25-62 (Oxford University Press 2002); J. Cassels, *Judicial Activism and Public Interest Litigation in India: Attempting the Impossible?*, 37 AM. J. COMP. L. 495, 496-97 (1989); Arun K. Thiruvengadam, *Evaluating Contemporary Criticisms of ‘Public Interest Litigation’: A progressive Conception of the Role of a Judge* (2009) (paper presented at the 2009 inaugural LASSNET Conference, New Delhi).

2 *See, e.g.*, Sunil Batra v. Delhi Administration (1978) A.I.R. 1978 S.C. 1675 (prison conditions); Upendra Baxi v. State of Uttar Pradesh (1983) 2 S.C.C. 308 (prison conditions); People’s Union for Democratic Rights v. Union of India, A.I.R. 1982 S.C. 1473 (bonded labor); Bandhua Mukti Morcha v. Union of India, A.I.R. 1984 S.C. 802 (bonded labor); Olga Tellis v. Bombay Municipal Corporation, A.I.R. 1986 S.C.180 (pavement dwellers); Sheela Barse v. Union of India (1986) 3 S.C.C. 596 (rights of children).

3 *See, e.g.*, J. Cassels, *Judicial Activism and Public Interest Litigation in India: Attempting the Impossible?*, 37 AM. J.COMP. L. 495, 508 (1989) (“Perhaps of more immediate consequence, the relaxed test of standing and the expedited fashion in which cases can be brought in public interest matters put enormous strains on already extremely scarce judicial resources. Some High Courts are reported to receive 50 to 60 public interest letters per day. In the fifteen months from 1 January 1987 to 31 March 1988, the Supreme Court received 23,772 letters.”).

the range of issues the courts were addressing had expanded to include complex environmental concerns, such as urban pollution and solid waste disposal, as well as explicitly political issues, such as official corruption and elections. More recently, PIL has also addressed social issues, such as the decriminalization of homosexuality in India.<sup>4</sup> At the same time, some claimants and their lawyers learned to “dress up” private disputes as PIL. Human rights activists began to grow disenchanted with courts’ failure to enforce sweeping directives. Many have questioned the appropriateness of judicial intervention in the legislative and executive spheres, as well as the constitutionality of the courts’ efforts to implement many of their expansive orders.<sup>5</sup>

Drawing on that narrative, concerns regarding the value and impact of PIL now take a number of forms. These will be described in more detail below, but in general terms, they can be categorized into two groups – questions related to the separation of powers, and a set of queries regarding judicial attitudes. The first group of concerns asks whether courts should be involved in environmental, social, and economic matters at all. Are not the legislative and executive branches better equipped to address these matters? Does not “judicial activism,” precisely because the courts do not and cannot enforce many of their broad directives in these areas, erode the legitimacy of the courts? Are not PIL cases draining substantial resources from an already overburdened legal system in which ordinary civil cases can languish in courts for many years? Since many PIL cases are patently frivolous and many others never enforced, is not PIL a device for the judiciary to expand its own powers and autonomy under the mantle of a popular social justice agenda? A separate set of questions involves the beneficiaries of PIL: Do PIL cases continue to benefit the poor and disadvantaged, or have not lifestyle issues and middle class concerns become predominant in PIL cases? Are not judges manifestly less disposed to the interests of the poor and marginalized than they were two decades ago, during the “heroic” years when PIL originated?

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4 Manoj Mitta & Smriti Singh, *India decriminalizes gay sex*, TIMES OF INDIA, July 3, 2009, available at <http://timesofindia.indiatimes.com/articleshow/4726608.cms>.

5 PIL has sparked concerns regarding judicial encroachment and the separation of powers that actually go back to the early days of the Indian Republic. Soon after independence, the Congress government enacted the First Amendment, creating the Ninth Schedule deemed beyond judicial review, out of concern that the judiciary would find planned land reforms unconstitutional, a belief soon to be substantiated in a set of cases in which the Supreme Court did just that. This back and forth over land reform, and over the Ninth Schedule, continued for decades. Famously, the Court held that Parliament did not have the power to amend the Constitution if such amendments abridged the fundamental rights guaranteed in the Constitution (*Golaknath v. State of Punjab*, A.I.R. 1967 S.C. 1643) and/or altered the “basic structure” of the Constitution itself (*Kesavananda Bharati v. State of Kerala*, A.I.R. 1973 S.C. 1461), to which the Indira Gandhi government responded by departing from the seniority tradition in judicial appointments and attempting to dissolve the *Kesavananda* majority. On “judicial sovereignty” in India, see P.B. Mehta, *The Rise of Judicial Sovereignty*, 18 J. DEMOCRACY 70 (2007).

These queries regarding PIL are fundamentally normative claims, and are based on principled understandings of the role of judges and courts in India's democracy. At the same time, the validity of some of them rests on facts, albeit complex ones. For instance, the challenge related to separation of powers raises questions about judicial capacity – critics charge that courts cannot monitor and supervise complex “polycentric disputes”<sup>6</sup> whereas others respond that they can, or at least as well as parliaments can.<sup>7</sup> The relative effectiveness of judicial supervision, if observed accurately and at scale, could help resolve this disagreement, at least for a subset of cases and in certain contexts. Similarly, whether or not PIL cases still address the concerns of the poor, and whether decisions are as supportive of their interests as in the past, are empirical questions. To date, the debate over PIL has largely been abstract (with some exceptions, to be described below). It has helped generate a set of normatively significant questions, but at this stage of the research cycle, empirical work may be more pressing. This paper contributes to that task by assessing PIL with empirical data.

The next section of this paper analyzes the argument that PIL constitutes a case of judicial overreach. The contention that PIL weakens policy formulation and implementation in the legislative and executive branches is typically “dressed up” as a separation of powers concern, but a more apt framework involves an assessment of the impact of PIL on sectoral governance, which is fundamentally an empirical matter, not a doctrinal one. The following section describes the charge that PIL favors middle class interests rather than the concerns of the poor and marginalized. The section then presents estimates, based on original data taken from Supreme Court records and online legal database, to assess that claim.

## II. PUBLIC INTEREST LITIGATION: IS THE JUDICIARY OVERREACHING?

An old-fashioned view of legal rights holds that most social and economic matters do not involve genuine rights because they require positive actions, not merely restraint, and have no single, identifiable duty holder. Positive obligations, moreover, entail significant expenditures that are the purview of the other branches of government. Courts, therefore, should steer clear of the social, economic, and environmental concerns at the heart of PIL. More contemporary views<sup>8</sup> hold that “for their fulfillment, all rights require restraint, protection, and

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6 L. L. Fuller & K. I. Winston, *The Forms and Limits of Adjudication*, 92 HARV. L. REV. 353, 359 (1978).

7 Thiruvengadam, *supra* note 2.

8 STEPHEN HOLMES & CASS R. SUNSTEIN, *THE COST OF RIGHTS: WHY LIBERTY DEPENDS ON TAXES* (1999); HENRY SHUE, *BASIC RIGHTS: SUBSISTENCE, AFFLUENCE, AND U.S. FOREIGN POLICY* (2d ed. 1996).

aid from the entity from whom rights are claimed, and that a reasonably effective and well funded state is a *sine qua non* for all rights.”<sup>9</sup>

Most of the criticisms of PIL in the Indian courts have not taken this somewhat old-fashioned form, perhaps because in a country where the scale of needs is so large it is hard to say that social and economic priorities are less commanding than civil and political ones. They have rather argued that the social and economic domain should largely be the prerogative of the other branches of government, which are better equipped to analyze, formulate, and implement complex policies, and that much of PIL is inappropriate judicial “activism” or “adventurism.” For instance, in an assessment of the activities of the Supreme Court in the *M.C. Mehta v. Union of India (Delhi Vehicular Pollution)* and *Almitra Patel v. Union of India (Municipal Solid Waste Management)* cases,<sup>10</sup> Rajamani admonishes that “policy, environmental and social, must emerge from a socio political process and must be considered in a legitimate forum not a judicial one.”<sup>11</sup> Citing cases in which courts formulated explicit guidelines, such as cases related to vehicular pollution, the management of the Central Bureau of Investigation, adoption by foreign nationals, custodial torture, and sexual harassment, Desai and Muralidhar note that “while in some cases, the Court has expressed its reluctance to step into the legislative field, in others it has laid down detailed guidelines and explicitly formulated policy”.<sup>12</sup> In their 2003 article, Rosencranz and Jackson welcome the environmental and health impact of the Supreme Court’s 2001 decision<sup>13</sup> requiring the Delhi government to convert its commercial vehicles to a fleet running on Compressed Natural Gas (CNG), but then plead for leadership on the part of the regulatory and legislative authorities: “Some of the roadblocks to CNG implementation could have been avoided, or at least minimized, had the conversion been originally mandated through the normal legislative process.”<sup>14</sup> Thiruvengadam documents a spate of similarly motivated criticism of PIL as an incursion into lawmaking from sitting and former judges of India’s Supreme Court and High Courts, including comments from Justice Hidayatullah in 1984,<sup>15</sup> Justice Srikrishna in

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9 Varun Gauri, *Social Rights and Economics: Claims to Health Care and Education in Developing Countries*, 32 *WORLD DEVELOPMENT* 465, 467 (2004).

10 A.I.R. 1991 S.C. 1132 & A.I.R. 1998 S.C. 993 respectively. For a commentary on these cases, see Lavanya Rajamani, *Public Interest Environmental Litigation in India: Exploring Issues of Access, Participation, Equity, Effectiveness and Sustainability*, 19 *J. ENVTL. L.* 293, 296 (2007).

11 *Id.* at 319.

12 Ashok H. Desai & S. Muralidhar, *Public Interest Litigation: Potential and Problems*, in *SUPREME BUT NOT INFALLIBLE: ESSAYS IN HONOUR OF THE SUPREME COURT OF INDIA 14* (B. N. Kirpal et al. eds., 2000), available at <http://www.ielrc.org/content/a0003.pdf> (last visited April 30, 2010)

13 *M. C. Mehta v. Union of India*, A.I.R. 1991 S.C. 1132.

14 Armin Rosencranz & Michael Jackson, *The Delhi Pollution Case: The Supreme Court of India and the Limits of Judicial Power*, 28 *COLUM. J. ENVTL. L.* 223, 252 (2003).

15 Justice M. Hidayatullah, *Highways and Bye-Lanes of Justice*, (1984) 2 *SCC J-1*.

2005,<sup>16</sup> and, perhaps most intemperately, Justice Katju in 2008,<sup>17</sup> who said PIL “has developed into an uncontrollable Frankenstein.”<sup>18</sup>

A motivation for some of this criticism is a suspicion that the courts have used their post-Emergency popularity, to which PIL has significantly contributed, to expand their own powers and shield themselves from scrutiny and accountability. To some, it appears as though the courts may be spending time on frivolous and ineffectual PIL cases at the expense of the real administration of justice, and choose to do so because PIL burnishes their popularity.<sup>19</sup> Reported instances of frivolous PIL include prayers to rename India “Hindustan,”<sup>20</sup> rename the Arabian Sea “Sindhu Sagar,”<sup>21</sup> and replace the national anthem for one offered by the petitioner<sup>22</sup> (and partly sung before the Chief Justice).<sup>23</sup> At the same time, the systems of civil and criminal justice suffer enormous delays and arbitrary pre-trial detentions.

These concerns are echoed widely enough that there is now visible a clear backlash against this perceived usurpation of powers by the courts, including a Bill tabled in the Rajya Sabha in 1996 to regulate PIL,<sup>24</sup> a 2007 statement by the Prime Minister warning against judicial overreach,<sup>25</sup> recent calls from the Bench to set parameters for PIL,<sup>26</sup> and efforts to establish the National Judicial Council, a body to investigate complaints against judges. Some of these

16 B.N. Krishna, *Skinning a Cat*, (2005) 8 SCC (J) 3, available at [http://www.ebc-india.com/lawyer/articles/2005\\_8\\_3.htm](http://www.ebc-india.com/lawyer/articles/2005_8_3.htm) (last visited April 30, 2010).

17 Tannu Sharma, *Court monitoring committees illegal...stop PIL blackmail: Justice Katju slams his own*, INDIAN EXPRESS, Apr. 12, 2008, available at <http://www.indianexpress.com/news/court-monitoring-committees-illegal...stop-pil-blackmail-justice-katju-slams-his-own/295916/0>.

18 Thiruvengadam, *supra* note 2, at 22.

19 *See, e.g.*, Madhav Khosla, *Bitter PIL*, INDIAN EXPRESS, Nov. 18, 2008 (“The Supreme Court has failed to differentiate between frivolous petitions and appropriate representation.”).

20 *Petition To Rename India, Arabian Sea* <http://heartx.sulekha.com/blog/post/2007/07/petition-to-rename-india-arabian-sea-3.htm> (last visited Apr. 30, 2010).

21 *Id.*

22 *Id.*

23 Arun Thiruvengadam, *Recent PIL cases decided by the Supreme Court*, (2007), <http://lawandotherthings.blogspot.com/2007/07/recent-pil-cases-decided-by-supreme.html> (last visited Apr 30, 2010).

24 Geetanjali Jha, *Problems facing public interest litigation in India*, [http://www.legalservicesindia.com/articles/pil\\_ind.htm](http://www.legalservicesindia.com/articles/pil_ind.htm) (last visited Apr. 30, 2010); Ashok H. Desai & S. Muralidhar, *supra* note 12, at 15.

25 Shylashri Shankar & Pratap Bhanu Mehta, *Courts and Socioeconomic Rights in India*, in *COURTING SOCIAL JUSTICE: JUDICIAL ENFORCEMENT OF SOCIAL AND ECONOMIC RIGHTS IN THE DEVELOPING WORLD* 146 (Varun Gauri & Daniel M. Brinks eds., 2008). *See also*, *Line dividing activism and overreach is a thin one: PM's caution to Bench*, INDIAN EXPRESS, Apr. 9, 2007.

26 *See, e.g.*, Sachidanand Pandey v. State of West Bengal, Should appear as A.I.R 1987 S.C. 1109 (“Public interest litigation has now come to stay. But one is led to think that it poses a threat to courts and public alike. Such cases are now filed without any rhyme or reason. It is, therefore, necessary to lay down clear guide-lines and to outline the correct parameters for entertainment of such petitions. If courts do not restrict the free flow of such cases in the name of Public Interest Litigations, the traditional litigation will suffer and the courts of law, instead of dispensing justice, will have to take upon themselves administrative and executive functions.”).



complaints involve corruption: there have been allegations that about twenty percent of judges are corrupt.<sup>27</sup> Related complaints include the use of the law of privileges and contempt on the part of courts to shield themselves from criticism, resistance to efforts to require sitting judges to disclose their financial assets, and the uncomfortably close relationship between some members of the judiciary and the Bar.<sup>28</sup> Roy goes so far as to assert that judicial accountability is so low that “we live in a sort of judicial dictatorship.”<sup>29</sup>

A few comments about separation of powers are in order. First, policy formulation by the courts or its agents is, to some extent, inevitable. Judicial review of any sort requires ongoing commentary on laws and policies, including guidelines regarding their proper content. Because dispute resolution entails an elaboration and application of the normative structures of society as the necessary ground for the dispute resolver’s decision, judges inevitably involve themselves in rule making, which is a form of lawmaking whether in common law or civil law jurisdictions.<sup>30</sup> Courts have not traditionally been significant actors in the area of social and economic policy; and resistance to PIL and the court directives it prompts in these areas may stem more from the novelty of the phenomenon than from anything like a real “judicial dictatorship.” Reluctance on the part of the Indian judiciary to be held accountable for performance and probity is certainly problematic – from the point of view of democratic theory, it limits the power of the people to review public action. The expansion of judicial power in the area of social and economic concerns, on the other hand, catalyzes legislative and executive activity more often than it paralyzes it. That is because, as an empirical matter the world over, PIL typically spurs judicial dialogue with the other branches: rarely do courts issue all-or-nothing demands, backed with common law contempt power or its civil law counterparts,<sup>31</sup> in a way that requires the state to restructure its policy framework. “Courts’ decisions do not so much stop or hijack the policy debate as inject the language of rights into it and add another forum for debate.”<sup>32</sup> As Fredman puts it, PIL allows the judicial forum to become, potentially, a space for democratic deliberation among equal citizens,

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27 Rajeev Dhavan, *Judicial Corruption*, THE HINDU, Feb. 22, 2002, available at <http://thehindujobs.com/thehindu/2002/02/22/stories/2002022200031000.htm>.

28 Upendra Baxi, *Structural Adjustment of Judicial Activism*, Inaugural Lecture at the West Bengal National Academy of Juridical Sciences (10 June 2006).

29 Arundhati Roy, *Scandal in the Palace*, (2007), available at <http://www.zmag.org/znet/viewArticle/14376> (last visited Apr. 30, 2010).

30 Alec S. Sweet, *Judicialization and the Construction of Governance*, 32 COMP. POL. STUD. 147 (1999).

31 These would include the *astreinte* in France; the *amparo* in Mexico and Venezuela; the *tutela* in Colombia; and the *mandado de segurança* in Brazil.

32 Daniel M. Brinks & Varun Gauri, *A New Policy Landscape: Legalizing Social and Economic Rights in the Developing World*, in *COURTING SOCIAL JUSTICE*, 304 (Varun Gauri & Daniel M. Brinks eds., 2008).

rather than a place of interest group bargaining, which prevails in the legislature.<sup>33</sup>

In addition, an important use of PIL is to make public and scrutinize hidden or obfuscating information, including cost of potential social programs, which the state and corporate entities on occasion have reasons to exaggerate or hide. In India, PIL during droughts in Rajasthan and Orissa in 2001 disclosed the extent of unreleased government grain stocks,<sup>34</sup> and subsequent PIL disclosed that state governments could in fact afford to widen several statutory food and nutrition programs, including the midday meals scheme in schools, despite official protests to the contrary.<sup>35</sup> In the Delhi vehicular pollution debate, the Delhi Health Minister claimed that air pollution did not increase the risks of heart or lung disease; the Delhi government said that the timely installation of CNG stations would be impossible; the Ministry of Petroleum and Natural Gas argued that CNG bus conversion would not be sustainable in the long run; producers of commercial vehicles stated that the conversion to CNG was not economically cost-effective; and others argued that CNG is explosive. The Court, largely by empowering certain technical committees, played a significant role in helping to ascertain accurate information on these issues. It was, moreover, not an instance of judicial fiat but rather a judicial-executive branch collaboration: "Government experts essentially became advisors to the Court as it drove policy implementation forward."<sup>36</sup>

The argument that PIL constitutes judicial overreach, resulting in poor or inefficient decision making, is not really a separation of powers claim. The balance of power among government organs, as Madison conceived it, was not primarily about a strict separation of powers but "the partial interpenetration of relatively autonomous and balanced powers."<sup>37</sup> In other words, the separation of powers was not conceived as a design for the promotion of efficient decision making by preventing undue encroachment from one institution upon the prerogatives of another, but rather a check on the ability of any group or faction to dominate government from its enclave in a specific organization. The doctrine of separation of powers seeks to accomplish this precisely by opening certain governmental tasks to competing competences and concurrent powers of review. Despite occasionally hyperbolic claims on the part of critics, Indian judges and their professional social classes are not using the courts as a staging ground to

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33 S. FREDMAN, *HUMAN RIGHTS TRANSFORMED: POSITIVE RIGHTS AND POSITIVE DUTIES* 149 (2008).

34 See Human Rights Features, *Right to Food: The Indian Experience*, available at <http://www.hrdc.net/sahrdc/hrfeatures/HRF58.htm> (last visited Apr. 30, 2010).

35 *Id.*

36 Ruth G. Bell et al., *Clearing the Air: How Delhi Broke the Logjam on Air Quality Reforms*, 46 *ENVIRON.* 22, 35 (2004).

37 Guillermo O'Donnell, *Horizontal Accountability: The Legal Institutionalization of Mistrust*, in *DEMOCRATIC ACCOUNTABILITY IN LATIN AMERICA* 41 (Scott Mainwaring & Christopher Welna eds., 2003).

threaten the Indian state. There have been specific rulings, such as *Kesavananda Bharati*<sup>38</sup> or *Advocates-on-Record*,<sup>39</sup> or the ruling on the Jharkhand legislative procedures,<sup>40</sup> in which courts assumed powers not delineated in the Constitution. Even in those cases, it is arguable that in so doing the Court restored a constitutional balance because the executive and legislature had themselves been engaging in extra-constitutional activities.

These criticisms regarding separation of powers are better cast as concerns related to the impact of judicial intervention on sectoral governance. Does judicial involvement through PIL improve state performance in a given sector? Is forest policy, for example, more equitable, efficient, and effective as a result of court involvement? That is an empirical question, but most treatments of the issue do not take the empirical challenge seriously. Rosencranz and L  l   believe that the Supreme Court’s intervention following the *Godavarman v. Union of India*<sup>41</sup> “hurts the process of governance,” but adduce little evidence about the capacity and authority of central and state executive agencies prior to and after the Court’s assumption of powers.<sup>42</sup> Writing in 2003 on the *Delhi Vehicular Pollution case*, Rosencranz and Jackson speculated that strengthening the Pollution Control Boards (PCBs), rather than Supreme Court action, “would seem to provide the most effective long-term solutions [to air pollution in India]” and worried that “the Court’s action seems likely to impede capacity building in the pollution control agencies, and thereby to compromise the development of sustained environmental management in India.”<sup>43</sup> This is fundamentally an empirical claim, and one can examine whether PCBs are weaker now than they were before the Court proceedings in the *Delhi Vehicular Pollution case*. A cursory review suggests that it is not obvious that they are weaker – the budget of the Central Pollution Control Board has nearly tripled since the year of the Court’s order in 2002, and a number of efforts are underway to strengthen them and fill staffing vacancies in Central and State PCBs.<sup>44</sup> Another problem with criticisms like these is that they compare an ideal or hypothetical legislative intervention to a real judicial one when it is often the

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38 *Kesavananda Bharati v. State of Kerala*, A.I.R. 1973 S.C. 1461.

39 Satya Prakash, *SC rap for advocates-on-record*, HINDUSTAN TIMES, Apr. 5, 2010, available at <http://www.hindustantimes.com/rssfeed/india/SC-rap-for-advocates-on-record/Article1-527171.aspx>.

40 See generally J. Venkatesan, *Supreme Court’s indelible record*, THE HINDU, Dec. 30, 2005, available at <http://www.hindu.com/2005/12/30/stories/2005123003391600.htm>.

41 T.N. Godavaraman Thirumulpad v. Union of India, (2008) 1 M.L.J. 997 (S.C.).

42 A. Rosencranz & S. L  l  , *Supreme Court and India’s Forests*, 43 ECON. POLIT. WKLY. 11, 13 (2008).

43 Rosencranz & Jackson, *supra* note 15, at 240, 249.

44 The sanctioned budget was Rs 1592.58 lakhs 2001-02, and 4500.00 lakhs for 2007-08. These budgets are available at: [http://www.cpcb.nic.in/upload/AnnualReports/AnnualReport\\_6\\_annualreport2001-02.pdf](http://www.cpcb.nic.in/upload/AnnualReports/AnnualReport_6_annualreport2001-02.pdf) (last visited Apr. 30, 2010) and [http://www.cpcb.nic.in/upload/AnnualReports/AnnualReport\\_34\\_final-report-06-07-A.pdf](http://www.cpcb.nic.in/upload/AnnualReports/AnnualReport_34_final-report-06-07-A.pdf) (last visited Apr. 30, 2010).

real-world failings of the other branches that prompted litigation in the first place. Thiruvengadam describes the deliberative failings of India's Parliament, noting that of the total 36 Bills passed in 2008, "sixteen were passed in less than twenty minutes, most without any debate whatsoever."<sup>45</sup>

Why do analysts tend to describe issues of sectoral governance with the language of the separation of powers? The motivation stems in part from a belief, sometimes inarticulate, that governance should look similar the world over. In this case, courts, in order to be courts properly understood, must limit their tasks to interpreting laws, rather than writing or enforcing them. But it is a mistake to speak of "courts" as such. The task of judicial institutions depends on the way they interact with the other institutions of their society. It is less useful to assess judicial activity against a preconceived institutional design than to evaluate, using "normative benchmarks," the (positive or negative) contribution of courts to the key tasks of governance in any specific sector.<sup>46</sup> In the same way that careful studies of the institutional foundations of economic growth in East Asia have challenged the rule of law orthodoxy, showing that successful market-sustaining institutions need not take the specific form that courts, corporate boards, and bureaucratic agencies have taken in, say, the United States or the United Kingdom;<sup>47</sup> studies of PIL should recognize that courts may play a variety of roles in different settings. There is less institutional convergence in the world than believed, and it is important "not to confuse institutional *function* and institutional *form*" (emphasis in original).<sup>48</sup>

What, then, are the normative benchmarks that should be used to assess the contribution, or lack thereof, of courts toward sectoral governance? Those depend on the sector, of course – they would look different in health than in forestry. But, generalizing, one can identify three key elements of governance for the broad category of tasks in government service delivery: the capacity and authority of the organizations charged with delivery or oversight, the availability of information and transparency regarding service delivery, and state accountability for performance. An empirically minded assessment of PIL in India, then, would take the form of a series of case studies based on those normative benchmarks. The case studies would focus on these questions: Did the capacity and authority of institutions tasked with addressing the social problems increase or decline as a result of PIL? Was accurate information on sectoral concerns more widely available before or after judicial intervention?

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45 Thiruvengadam, *supra* note 2, at 32.

46 MICHAEL J. TREBILCOCK & RONALD J. DANIELS, *RULE OF LAW REFORM AND DEVELOPMENT: CHARTING THE FRAGILE PATH OF PROGRESS* (2008).

47 TOM GINSBURG, *JUDICIAL REVIEW IN NEW DEMOCRACIES: CONSTITUTIONAL COURTS IN ASIAN CASES* (2003).

48 Dani Rodrik, *Growth Strategies* 26 (National Bureau of Economics Research, Working Paper No. 10050, 2003).

Were mechanisms of accountability, including legal and hierarchical oversight, markets and the power of actors to pursue their own interests, and social assessments of the motives of public officials, functioning more effectively before or after judicial intervention?

### III. DOES PUBLIC INTEREST LITIGATION BENEFIT MARGINALIZED INDIVIDUALS AND GROUPS?

The purpose of PIL in India, like most social causes, was likely over-determined; but most commentators agree that it was partly an effort on the part of the courts to speak to the poverty-ridden, socially excluded, and powerless majority of citizens in India who continue to suffer.<sup>49</sup> Several commentators suspect, however, that this objective of PIL has not been realized, or indeed has been lost.<sup>50</sup> These criticisms take two forms. The first focuses on *beneficiary inequality*: the concern that the middle classes have more organizational and financial resources than the poor, which facilitate easier access to courts, and results in more benefits from PIL for them than for the poor. In some countries,<sup>51</sup> the Bar develops a *pro bono* practice that, to some extent, mitigates this inequality of access, but this has not emerged in a significant way in India. Compounding this problem, NGOs and social movements in India are wary of courts, and largely do not utilize litigation strategies to achieve their objectives.<sup>52</sup>

The second is *policy area inequality*: this is the concern that judges, because of their social class and ideological dispositions, are more alert to the concerns of the middle classes and the wealthy. This is evident, critics argue, in the demonstrable urban and middle-class bias of their rulings. Baxi believes that the interests of global economic elites now colour the thinking of the Indian judiciary, resulting in rulings that benefit those global elites, such as decisions in the cases involving WTO accession, Union Carbide's liability for toxic emissions in Bhopal, and the construction of the Narmada dam.<sup>53</sup> Similarly, Rajagopal believes that the Indian courts have adopted the statist and development mindsets associated with the Indian state itself, and that the universal privileging of civil

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49 In a letter to the author dated December 5, 2008, former Justice of the Supreme Court and Member of the National Human Rights Commission, Hon'ble Justice Mrs. Sujata Manohar opined: "Public Interest Litigation was conceived as a means of providing to the underprivileged and downtrodden an access to the judicial system for redressal of wrongs." She also states that, "The *raison d'être* [sic] behind public interest litigation is as valid to-day as it was when such an action was first permitted. . . . What is required is better regulation of Public Interest Litigation to make it more effective. It serves a vital public need and must be strengthened rather than discarded."

50 Ashok H. Desai & S. Muralidhar, *supra* note 12, at 12-17.

51 See, e.g., *The Bar Pro Bono Unit*, <http://www.barprobono.org.uk/overview.html> (last visited Apr. 30, 2010) (for an instance of the bar pro bono efforts in the United Kingdom).

52 Jayanth K. Krishnan, *Social Policy Advocacy and the Role of the Courts in India*, 21 AM. ASIAN REV. 91 (2003); Shankar & Mehta, *supra* note 26, at 153.

53 Baxi, *supra* note 2.

and political rights over socio-economic rights has affected the thinking of the Indian judiciary.<sup>54</sup> In a related vein, Ramanathan writes that “increasingly, the constituency on whose behalf the enhancement of judicial power has been strengthened began to emerge as the casualty of the exercise of that power.”<sup>55</sup>

These claims tend to be based on a set of exemplary cases, rather than a systematic review of PIL case law and implementation. It is also important to realize that judges, and the courts that they constitute, are creatures of their environment, and that patterns of judicial recruitment and appointment will almost always ensure that courts reflect the dominant political trends of their countries.<sup>56</sup> Some argue that the Indian courts are an exception to this rule, having obtained as much, if not more, autonomy regarding judicial appointments than any other courts in the world. But that constitutional autonomy is constrained by the Indian civil service traditions under which courts operate, as well as the social dependence of judges on the Bar and on political and economic elites. “Leaders of the Indian Bar,” writes Baxi, “whether elected or otherwise, have always wielded historically disproportionate influence over the Justices.”<sup>57</sup> In addition to the embedding of judges in their social and political milieu, strategic factors also limit judicial autonomy: courts in every country depend on the other branches of government for their political survival, so they will, by and large, take care that their decisions garner sufficient support from key political actors.<sup>58</sup> In short, because ideological orientations in the larger Indian political economy have drifted rightward over the past two decades or so, it is to be expected that the courts will have followed. Assessments of the extent to which PIL supports the poor, then, need to develop an implicit benchmark of what can be expected of courts in the specific contexts in which they operate.<sup>59</sup>

To fill in some of the information needed for a more complete assessment of PIL in India, four different samples of PIL and fundamental rights cases at the Supreme Court level were examined: (i) cases that, according to the Supreme Court Registrar’s office, the Court has itself classified as PIL from 1988-2007 (some 2800 “cases” overall); (ii) all Supreme Court cases in the Manupatra database<sup>60</sup> that involved fundamental rights and that addressed concerns regarding women and children rights, whether or not explicitly admitted as PILs

54 Balakrishnan Rajagopal, *Pro-Human Rights but Anti-Poor?: A Critical Evaluation of the Indian Supreme Court from a Social Movement Perspective*, 18 HUM. RTS. REV. 157, 168-177 (2007).

55 Usha Ramanathan, *Of Judicial Power*, 19 FRONTLINE (2002), available at <http://www.thehindu.com/fline/fl1906/19060300.htm> .

56 Robert Dahl, *Decision-Making in a Democracy: The Supreme Court as a National Policy-Maker*, J. PUB. LAW 279 (1957).

57 Baxi, *supra* note 29, at 10.

58 LEE EPSTEIN & JACK KNIGHT, *THE CHOICES JUSTICES MAKE* (CQ Press, 1998).

59 For an extended discussion of inequality in social and economic rights litigation, see Daniel M. Brinks & Varun Gauri, *supra* note 32, at 334-342.

60 Manupatra is a popular online legal database.



(86 cases); (iii) all Supreme Court cases in the Manupatra database that involved fundamental rights and were related to issues regarding Scheduled Castes/ Scheduled Tribes/ Other Backward Classes (SC/ST/OBCs), whether or not explicitly admitted as PILs (180 cases); (iv) all Supreme Court cases in the Manupatra database that the Supreme Court explicitly called a PIL (44 cases).

For the set of cases involving women and children's rights, these search terms, among others, were used: "women" and "children" and "abuse"; "violence" and "women" and "neglected children"; "juvenile justice" and "Article 21"; "trafficking" and "women" and "Article 21"; "labour" "children" and "Article 14"; "custodial violence" and "children"; "education" and "fundamental right" and "Article 14"; "gender and fundamental right"; "prison rights and children"; "rape" and "Article 21"; "emancipation" and "women and children." The SC/ST/OBC search used the terms "scheduled caste" or "scheduled tribe" or "other backward classes" in conjunction with cases that addressed fundamental rights and constitutional concerns. Note that the data from the Supreme Court were a listing of orders related to PIL cases, and not necessarily a list of cases *per se*. But an examination of the names of the cases revealed that of the 2,800 separate orders, instances of duplicate or once repeating nearly identical plaintiff and defendant names occurred fourteen times, triplicates once, and quadruplicates once. Still, because of uncertainty regarding the basis for the listings, this paper refers to this list as constituting "cases" rather than cases *per se*. The Manupatra database captures about 80-90% of Supreme Court cases for which judgments are reported.<sup>61</sup> While this results in something less than complete compendium of court decisions and orders in the selected topic areas, there is no evidence that the database censors certain categories of cases in a systematic fashion. There is no evidence, in other words, of significant sample bias.

Figure 1 shows the number of PIL "cases" instituted per year, whether brought to the court for admission ("admission matters" in the Court's terms) or argued on the merits ("regular matters"), from 1997-2007, based on data from the Supreme Court itself. The figure shows that there has been a slight upward trend in PIL matters over the last ten years. It also shows that there are some 260 "cases" instituted per year, on average. This compares to about 60,000 "cases" per year overall, based on data publicly available in the Supreme Court's "Court News" publication. So, on average, some 0.4% of "cases" before the Court involve PILs. This suggests that PIL does not drain significant court resources from the administration of day-to-day justice, contrary to the claims of some critics; but it also suggests that the outside reputation of the Supreme Court's PIL work belies its modest scale. And, contrary to popular conceptions,

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61 Shankar & Mehta, *supra* note 26, at 152.



the large majority of the 260 or so PIL “cases” instituted in the Supreme Court each year are brought through formal channels; of the tens of thousands of letters and handwritten petitions that the Supreme Court receives from ordinary people each year, only a handful are converted into cases.<sup>62</sup>

The Court instituted a classification system for PILs in 1988. This might be used to determine whether the concerns cited in PILs have changed over the years, and if the “cases” that appear before the Court have shifted to the concerns of the middle classes. Table 1 shows the breakdown by “case” type and year. Unfortunately, the large majority of “cases” fall in the category of “other,” so the classification scheme is not useful for tracking changes in PIL composition over time. Noteworthy, however, is the increase in “cases” related to election commissions, and the relatively low share of “cases” involving bonded labor and criminal justice, two of the concerns crucial in the early justifications for PIL.

Have increasing numbers of cases involved middle class concerns? It is difficult to say for PILs more generally because an identifiable record of PIL cases is not available. To address this question, the paper used the set of fundamental rights cases described above. Fundamental rights cases, at least those related to women and children’s rights and SC/ST/OBC concerns, may in fact underestimate the orientation of PILs to the middle classes because they exclude issues like urban quality of life that have been the concern of recent prominent litigation.

Figure 2 shows the number of cases in categories related to women and children’s rights or to SC/ST/OBC issues, or which the SC explicitly called a PIL, as reported in Manupatra, in which the claimant was likely to have been, on the basis of a review of the written opinion, a member of the “advantaged classes.” For purposes of the coding, a member of the advantaged classes included a professional (doctors, teachers, members of the armed services, etc.), a landowner or business person, or someone otherwise in the global middle class (including formal sector workers and civil service employees not designated as workers or laborers). Those not in the advantaged classes included those belonging to a scheduled caste or scheduled tribe or a member of the other backward classes (unless otherwise designated a member of an advantaged class), peasants, laborers, and those detained in the criminal justice system. Where groups or publicly minded individuals made claims in courts, and where there was no obvious plaintiff, the coders attempted to identify the general social class of the individuals whose interests were being advocated or defended. In 48 of the 310 cases in the sample (some 23%), the social class of the

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62 Interviews with officers of the PIL section, Supreme Court, in New Delhi (Jan. 13, 2009).

claimant(s) could not be discerned from the written opinion; or, and this was the more frequent problem, the social class was diffuse. Examples of this included cases concerning environmental protection of rivers and forest, challenges to the constitutionality of judicial action, and challenges to the statutory definition of rape. For these cases, the calculations and figures below considered the observation to have a missing value for social class. For every case, an effort was made to identify the individual or class of individuals on whose behalf the case was instituted – in some instances the lawyer or some other publicly minded individual is listed as the plaintiff/complainant in official records, but the claimant coded was the person or class of persons whose interests the case was seeking to advance (e.g., child bonded laborers).

Figure 2 plots the number of cases involving fundamental rights in the categories described above, and the number of cases in which the claimant was a member of the advantaged classes. Simple Ordinary Least Squares estimates are used to identify trend lines, which are inserted in the figure. The trend lines show that the number of claimants from advantaged classes has increased at almost the same rate as the overall number of fundamental rights cases in these categories. This suggests that class bias concerns that stem from the organizational advantages of the advantaged class are not as pronounced as some have feared.

Another way to examine this problem of inequality in organizational resources is to look at the share of fundamental rights cases in which the rights violation originated in the BIMARU states (Bihar, Madhya Pradesh, Rajasthan, and Uttar Pradesh).<sup>63</sup> Figure 3 plots the share of cases originating in the BIMARU states. (In 14% of the cases, the location of the rights violation was national or otherwise impossible to pinpoint.) Figure 3 shows that although the number of cases originating in rights violations in the BIMARU states has been increasing, it remains below the share of the national population residing in those states (some 40%). This suggests that inequalities related to middle class legal mobilization, though real according to this measure, are declining.

Finally, the data allow a third way to examine the issue of middle class legal mobilization advantage – one can identify for each year the share of cases initiated by or involving an NGO or cooperative group. Cases that involve an NGO or cooperative are more likely to involve the concerns of the poor than the middle class, and are also more likely to result in generalized benefit than

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63 The BIMARU states are states that continue to face severe poverty and socio-economic challenges in the country. See, e.g., 'Bimaru' States hampers India's Growth, TIMES OF INDIA, Sept. 7, 2005, available at <http://timesofindia.indiatimes.com/articleshow/1223697.cms>; B. S. Raghavan, BIMARU or bimari?, THE HINDU, Aug. 12, 2005, available at <http://www.thehindubusinessline.com/2005/08/12/stories/2005081200521000.htm>.

cases brought on behalf of individual private claimants by private lawyers.<sup>64</sup> Overall, 15% of cases were filed by cooperatives, groups, or NGOs, while 80% were filed by individual litigants (4% of cases were unclear). Figure 4 shows that the annual number of cases filed by a cooperative/group and reported in Manupatra has been more or less flat since the 1970s, with a median number of about one per year, and has not grown as fast as cases involving fundamental rights filed by individuals. This suggests that although the absolute number of fundamental rights claims brought on behalf of disadvantaged classes has been increasing, as shown in Figure 2, this increase is not due to greater mobilization by NGOs/Civil Service Organizations; rather, it appears to have been the result of increased mobilization by private individuals.

To examine policy area inequality, which is related to the content of judicial rulings on the cases that reach them, the study examined win-loss rates, both in general and for subsets of claims from advantaged classes, disadvantaged classes, members of SC/ST/OBC, and the middle and upper castes. Figures 5 and 6 show that claimants in cases involving women's and children's rights were more likely to win than claimants in cases involving SC/ST/OBC matters. Overall, the win rate for claimants in fundamental rights cases involving women's and children's rights was 84%, compared to 51% for cases involving SC/ST/OBC, and 72% for the explicit PIL cases. In addition, the trend line for the win rate of claimants in SC/ST/OBC cases was sloped downward. That suggests that judges may now be less favorably disposed to SC/ST/OBC claims than they were in the past.

But it is hard to tell whether this indicative trend is a function of the change in the composition of the claimants or a change in judicial attitudes; in other words, it is possible that judges are as favorably disposed to SC/ST/OBC concerns as they were in the past, and that win rates in SC/ST/OBC cases have declined only because most claimants in these cases are now members of the advantaged classes. So the cases were further disaggregated on the basis of the social class of the claimant. Overall, 67% of claimants in SC/ST/OBC cases were themselves members of SC/ST/OBC; but this falls to 60% for cases admitted after 2000, indicating a recent increase in claims related to SC/ST/OBC by members of the middle and upper castes. For women's and children's rights cases, overall 72% of claimants were members of the advantaged classes.

Figure 7 graphs the win rates in all fundamental rights cases for claimants who were and were not members of advantaged classes. It shows that the average annual win-rate for claimants from advantaged classes was below

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64 Varun Gauri & Daniel M. Brinks, *The Elements of Legalization, and the Social and Economic Rights Triangle*, in *COURTING SOCIAL JUSTICE* 22-23 (2008).

the win rate of claimants who were not from advantaged classes until the late 1980s. Now claimants from advantaged classes have higher win rates than claimants not from advantaged classes. For example, advantaged class claimants had a 73% probability of winning a fundamental rights claim for cases in which an order or decision was rendered from years 2000-2008, whereas the win rate for claimants not from advantaged classes for the same years was 47%. For the 1990s, rates were 68% and 47%, respectively. But in the years prior to 1990, claimants not from advantaged classes enjoyed higher success rates than those from advantaged classes. The differences for the 1990s and 2000s are significantly different from each other, based on a simple chi-square test and a simple probit estimation (see Tables 2a and 2b).<sup>65</sup> Similarly, when one divides the claimant into those that are identified as members of SC/ST/OBC and those that are not, the same pattern emerges: Figure 8 shows that claimants who are not SC/ST/OBC now have a higher win rate than those who are. Even in the subset of cases involving SC/ST/OBC concerns, claimants who were not from SC/ST/OBC began to have higher average annual win rates than those who were starting around 1990 (see Figure 9).<sup>66</sup>

These findings are consistent with the claim that judicial receptivity in the Supreme Court to fundamental rights claims made on behalf of poor and excluded individuals has declined in recent years. There are other explanations, however. The decline in the win rates for marginalized individuals could be attributed to the fact that cases brought on their behalf are weaker, on the merits, than they used to be, perhaps as a result of changes in statutes, decisions to litigate more challenging cases, or weaker legal representation. Each of these possibilities warrants careful scrutiny. Still, the data demonstrate not only a decline in the win rate for marginalized individuals but a simultaneous increase in the win rate for advantaged individuals. Though not impossible, it is unlikely that the quality of legal representation has simultaneously increased for the advantaged and decreased for the marginalized, and sufficiently to explain the significant reversal in win rates. Similarly, it is conceivable but not likely that advantaged clients started to select a less challenging set of cases at the same time that marginalized claimants did the reverse. The data here constitute a prima facie validation of the concern that judicial attitudes are less favorably inclined to the claims of the poor than they used to be, either as the exclusive result of new judicial interpretations or, more likely, in conjunction with changes in the political and legislative climate.

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65 The chi square test is used to examine whether distributions of categorical variables differ from one another. The probit model is used to study the factors related to a binary outcome variable (in this case, winning or losing a case).

66 The social class of the claimant was not discernible in 1% of the cases related to SC/ST/OBC, 34% of cases related to women's and children's rights, and 45% of explicit PIL cases.

#### IV. CONCLUSION

A number of criticisms of PIL have been voiced in recent years, including concerns related to separation of powers, judicial capacity, and inequality. While critics have been persuasive when pointing to particular cases, the sheer number of cases, as well as the variation in tendencies over time and among court benches, have made reaching a general conclusion difficult. This paper has argued that complaints related to separation of powers concerns are better understood as criticisms of the impact of judicial interventions on sectoral governance, and that structured case studies of sectoral governance are necessary to assess those criticisms. On the issue of inequality, this paper contributes to an overall assessment by systematically examining the relative magnitude, case composition, and geographical origins of, as well as legal representation and the claimant's social class in, PIL and fundamental rights cases that reached the Indian Supreme Court.

The analysis of PIL "cases" shows that they do not appear to consume a significant share of the resources of the Supreme Court; they constitute less than 1% of the overall case load. The subject matter of PIL cases and orders remains difficult to discern because over 70% of them are classified as "other," which is problematic from the point of view of judicial transparency. Concerns regarding inequality appear to be validated by some of the quantitative data on fundamental rights cases. On the one hand, although the number of fundamental rights cases related to women's and children's rights and to the concerns of SC/ST/OBC, as well as cases explicitly called a "PIL" in the Court's written opinions, appear to have increased; and the rate of increase has been similar for claimants belonging to both marginalized and advantaged population segments. The share of cases from BIMARU states also appears to be climbing. On the other hand, a very low share of the cases are brought by cooperative entities, such as NGOs, which is a useful predictor of the likelihood that benefits will generalize to the larger population. Most striking, win rates for fundamental rights claims are now significantly lower when the claimant is from an advantaged social group than when he or she is from a marginalized group. That constitutes a social reversal both from the original objective of public interest litigation and from the relative win rates in the 1980s.

**Table 1**

Fundamental Rights cases in the Indian Supreme Court, % of Cases Submitted by Subject Matter

Subject	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Child Labour Matters Including Neglected Children		0.4						0.49		0.73	
Air Pollution Matters, i.e. Industrial, Vehicular, Power Stations etc.	2.58	2.8	2.58	2.34	5.32	8.3	5.78	2.44	2.89	2.19	2.88
Water Pollution: Industrial, Domestic, Sewage, Rivers&Sea	1.94	6.4	2.58	4.3	2.84	0.72	2.22	1.46	8.18	2.19	1.44
Noise Pollution: Industry and Vehicular	0.65	1.2	0.43		0.35	1.81	1.33		0.83	1.46	
Ecological Imbalance: Protection and Conservation of Forests throughout the Country, Protection of Wild Life, Ban on Felling of Trees and Falling of Under Ground Water Level	8.39	3.2	3.43	2.73	3.19		4.44	5.85	7.85	16.06	12.98
Bonded Labour Matters relating to	2.58	0.4	1.29			4.33					0.48
Custody Harassment, Jails, Complaint of Harassment, Custodial Death, Speedy Trial, Premature Release, Inaction by Police etc.	3.87	2	1.72	1.56	0.35		0.44			0.36	0.96
Matters relating to Harassment of SC/ST/OBC and Women.	0.65	0.4			1.42	0.36	0.89	0.49		0.36	0.48
Matters relating to Unauthorized Constructions including Encroachments, Sealing, Demolitions, Urban Planning	3.23	3.6	1.72	5.47	2.84		1.33	0.98	2.07	2.92	1.44
Matters relating to Election Commissions	1.29	1.6	1.72	0.39	1.42	3.25	0.44	7.8	3.72	3.28	5.77
Scam Matters	1.94		0.43	0.39		0.36		0.98	0.83	0.36	0.48
Others	72.9	78	84.12	82.81	82.27	80.87	83.11	79.51	63.64	70.07	72.6
Natural and Man Made Disasters Including Riots											0.48
Numbers are in Percentages											

**Table 2a:** Win rates in selected fundamental rights cases before the Indian Supreme Court, Claimants from Advantaged and Disadvantaged social classes

Social class	1961-1989	1990-1999*	2000-2008*
Advantaged	57.9%	68.1%	73.3%
Disadvantaged	71.4%	47.1%	47.2%

\* probability of  $\chi^2 < 0.05$

**Table 2b:** Probit estimation of win rates for advantaged classes in fundamental rights cases before the Indian Supreme court, by decade

	1961-1989	1990-1999	2000-2008
Advantaged class	-0.37 (0.29)	0.54* (0.25)	0.69* (0.32)
Constant	0.57* (0.21)	-0.07 (0.15)	-0.07 (0.21)
Observations	80	114	66
Pseudo R <sup>2</sup>	0.02	0.03	0.05

Standard errors in parentheses; \*significant at  $p < 0.05$

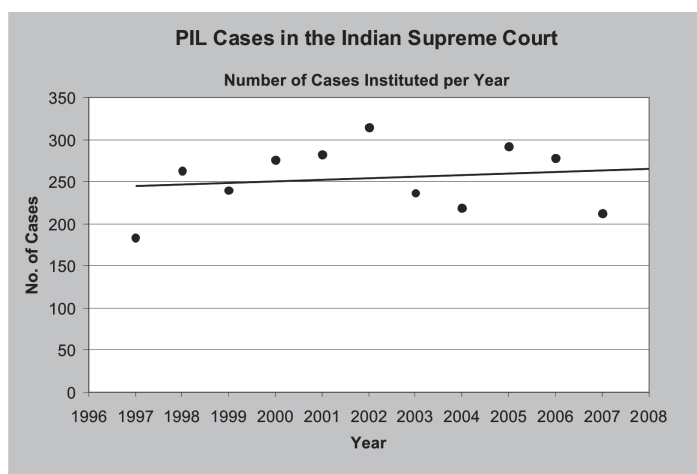
**Figure 1**



Figure 2

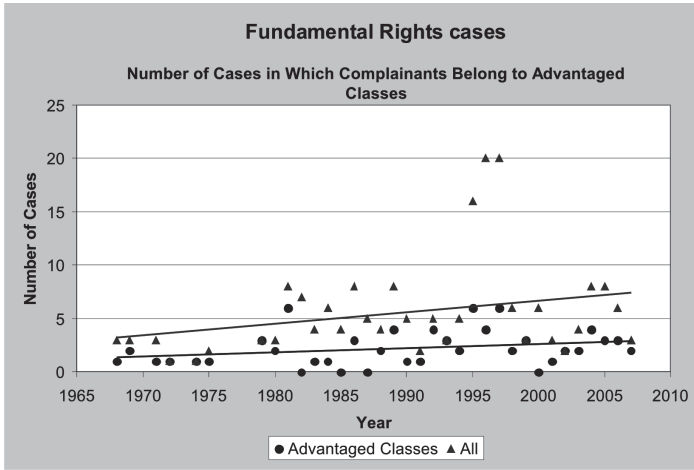


Figure 3

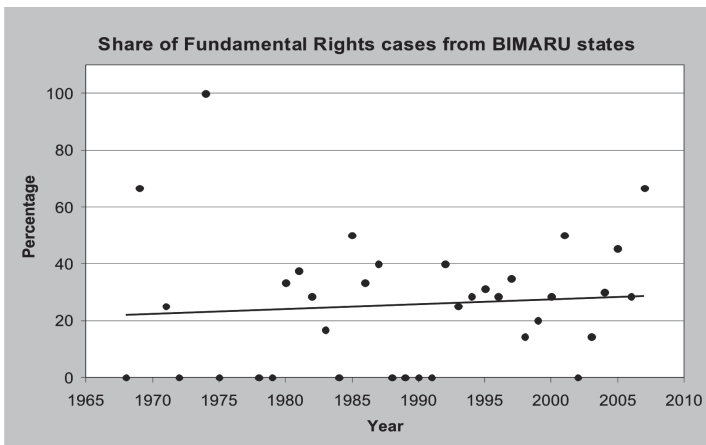


Figure 4

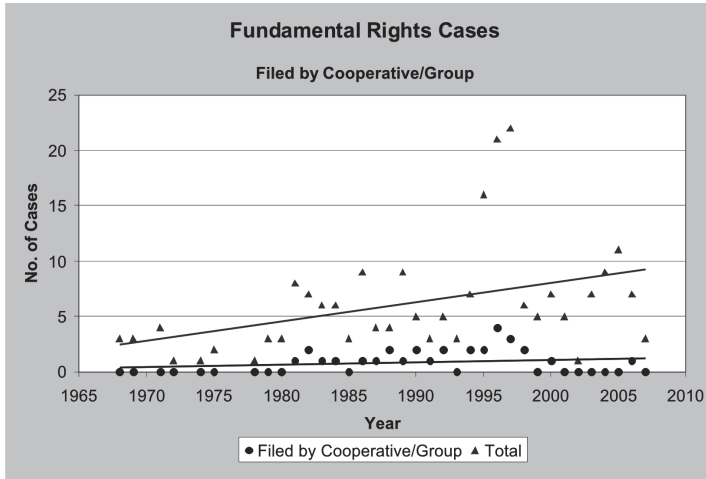


Figure 5

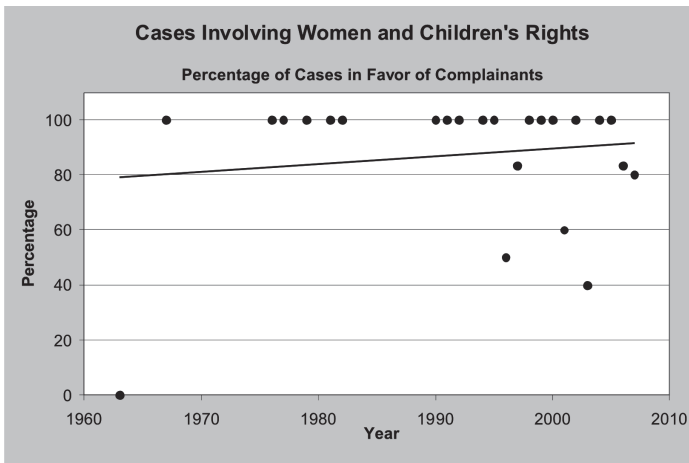


Figure 6

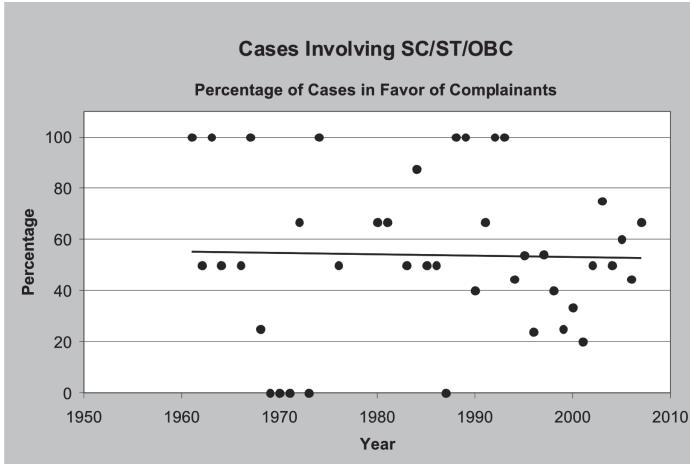


Figure 7

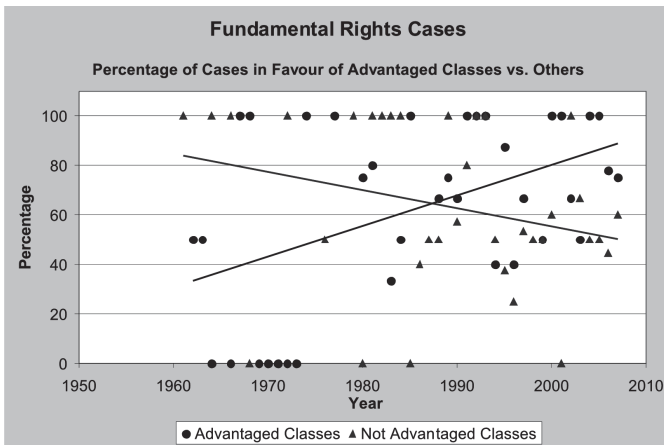


Figure 8

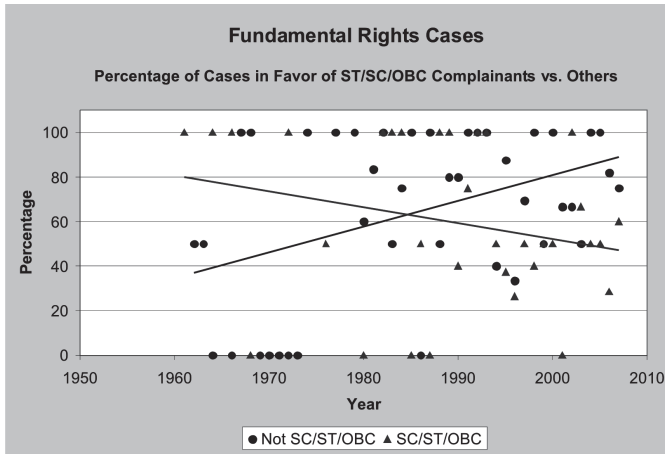
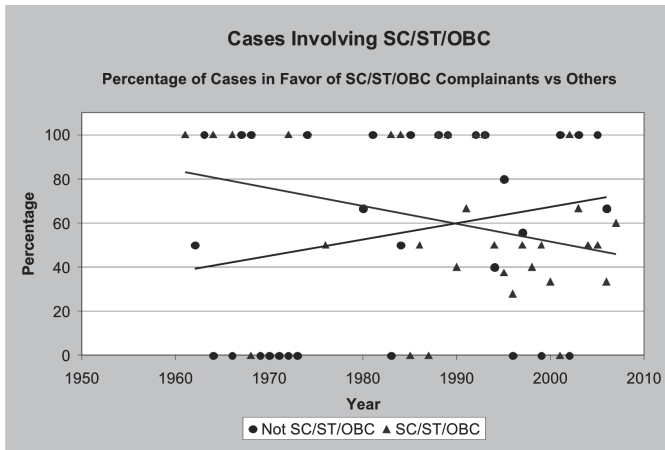


Figure 9



# CARBON LOCK-IN IN THE AUTOMOBILE INDUSTRY: A CASE FOR REGULATION?

Vikas N.M.\*

## I. INTRODUCTION

It is universally accepted that there is a growing need to control environmental pollution. Several international agreements, including the recently concluded Copenhagen Accord, recognise the critical impact of increasing pollution and call upon nations to take steps necessary to control this.<sup>1</sup> The relative abundance of resources such as air, water and soil, and the difficulty associated in pricing these commodities has meant that traditional market forces of price and quantity have proven ineffective in accounting for the true social cost of such resources.<sup>2</sup> There has consequently been a more than optimal consumption of such resources and an almost negligible attempt at replenishing them. It is for this reason that classic theories of regulation would classify environmental pollution as an externality; a disutility generation which is not internalised in the cost structure facing individuals, consequently resulting in excessive production of the disutility.<sup>3</sup>

This failure of the market seems intuitively to provide sufficient justification for state agencies to intervene. There has unsurprisingly been a lot of debate surrounding the desirability of such intervention and the extent to which such intervention may be necessary. Sufficient scholarship has been devoted to understanding the problem and various measures have been devised to address its different attributes. Most of these measures rely more heavily on using market machinery to achieve an optimal result, while a few others tend to favour a greater degree of intervention from state machinery.<sup>4</sup>

Unfortunately, the choice and effective application of any such measure to control pollution at the ground level is plagued with difficulties. To illustrate, the ban on chlorofluorocarbons (CFCs) proved extremely effective in shifting the refrigeration industry away from this pollutant. States, in this instance, used

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\* Master of Laws (EMLE), B.A., LL.B (Hons.) [NLSIU].

1 United Nations Climate Change Conference, Dec. 18, 2009, *Copenhagen Accord*, FCCC/CP/2009/L.7 at 1-3.

2 A. V. Kneese, *Environmental Pollution: Economics and Policy*, 61(2) THE AMERICAN ECONOMIC REVIEW 153, 153-155 (1971).

3 JAMES E. MEADE, THE THEORY OF ECONOMIC EXTERNALITIES – THE CONTROL OF ENVIRONMENTAL POLLUTION AND SIMILAR SOCIAL COSTS 15, (1979).

4 For a comparison of some of these suggestions see J. Foulon, P. Lanoie & B. Laplante *Incentives for Pollution Control: Regulation or Information?*, 44(1) JOURNAL OF ENVIRONMENTAL ECONOMICS AND MANAGEMENT 169 (2002).

fully their coercive abilities to achieve the desired result.<sup>5</sup> But would a similar measure prove as effective in a different sector? Could one realistically envisage a similar ban on all polluting fuels from being used in automobiles? Even if one were to momentarily ignore the political unfeasibility of such a decision, would the State, having imposed such a ban, be in a position to effectively implement it? Probably not!

The inability of a ban on automobile pollutants similar to that on CFCs to achieve the desired effect (of a reduction in pollution) stems in large part from a fundamental difference in the nature of the problem sought to be cured in each instance - the move away from CFCs was facilitated largely by the availability of alternatives, the ability of manufacturers to implement the change with little friction to their production processes and the almost negligible effect of such a change on anyone other than the industries sought to be regulated by such a move.<sup>6</sup> Contrast that with the automobile industry and the reason why the measure would be unfeasible seems obvious.

It is these differences inherent across polluting sectors that render a one-size-fits-all approach thoroughly inadequate. The choice of a measure is for that reason an extremely important decision. The first step in choosing a measure that best addresses the peculiarities of an industry must therefore be one that is directed at understanding the complexities of the sector in question.

In its attempt to shed some light on pollution in the automobile sector, this essay will start by attempting to understand the peculiarities of this sector, which has easily been the single largest contributor towards air pollution worldwide.<sup>7</sup> In addition to the sheer volume of its influence, vehicular pollution exhibits an industry-specific interconnectedness – a concept I will discuss in greater detail below, which poses a complexity that deserves special treatment.

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5 K. F. Mulder, *Innovation by disaster: the ozone catastrophe as experiment of forced innovation*, 4(1) INTERNATIONAL JOURNAL OF ENVIRONMENT AND SUSTAINABLE DEVELOPMENT 88 (2005). See generally on regulation induced technology change A. Nentjes, F. P. de Vries and D. Wiersma, *Technology-forcing through environmental regulation*, 23(4) EUROPEAN JOURNAL OF POLITICAL ECONOMY 903 (2007).

6 Some of their production processes used for the production of CFCs could in fact be used even without further production of the actual products. Dr. James Foster, Dr. Harold Larson and Lewis McCulloch, *The Program on Science, Technology and Environmental Policy: A Research Agenda for the Next Generation of Environmental Regulation*, PSTEP WHITE PAPER, MASSACHUSETTS INSTITUTE OF TECHNOLOGY (2000) at 24.

7 R.N. Colvile, *The Transport Sector as a Source of Air Pollution*, in AIR POLLUTION SCIENCE FOR THE 21ST CENTURY 188 (Jill Austin et al. Eds., Elsevier 2002). The estimates are that cars in the United States produce up to 20 percent of the countries' carbon dioxide emissions, available at <http://www.edf.org/article.cfm?ContentID=6083> (last visited Feb. 20, 2010). The level is much higher and is close to 70 percent of the local carbon dioxide emissions in countries like India available at <http://www.indianationalstat.com/india/ShowData.asp?secid=445385&ptid=38414&level=3> (last visited Feb. 20, 2010).

While the essay does not seek to identify with precision the exact modes of intervention that would solve the problems posed in the sector, it will seek to provide a worldview of the problems which a government should wish to tackle if it has to effectively combat the problems that plague the industry. It will also seek to provide some understanding on how best to target any such intervention to achieve the most optimum results.

The essay will first seek to identify peculiarities in the automobile sector that have influenced the ability of the industry to tackle the problem of air pollution. It will then consider the electric car as a technological alternative, which could help reduce the environmental impact of the sector. It will, then seek to explain why, given the peculiarities of the sector, market forces would prove inadequate in adopting this technological alternative. The essay will then seek to make a case for heightened degrees of government regulation on the premise that the government is the only actor that will be able to accelerate the movement towards this goal. The essay will then seek to provide some current relevance to the discussion by considering the theory in the context of recent developments in the automobile sector in India.

## II. THE AUTOMOBILE SECTOR

It is fairly clear that to gain an understanding of the polluting attributes of an automobile, it is important to understand the technology it uses for its operation. To gain a holistic understanding of the current state of technology, it is important to understand also its historical evolution, and the role of supporting industries in its development.<sup>8</sup> Since institutional behaviour and social interdependencies also play their part in the evolution and consolidation of technology, a meaningful enquiry must necessarily consider these factors as well.<sup>9</sup> An analysis of the evolution of the engine design is a useful framework within which to capture the influence of each these factors.

### A. *The Rise of the Internal Combustion Engine*

The evolution, consolidation and sustenance of technology is widely considered as being a path dependant process – a process of evolution where the current state of technology is intrinsically linked to its immediate and distant past.<sup>10</sup> Technology evolves through consumer demand. Several competing technological variants emerge through inventions and innovations, to fill the void caused by such demand. These variants then compete for performance improvements and market share. Competition ends when one of the variants

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8 B. Arthur, *Competing Technologies, Increasing Returns and Lock-in by Historic Events*, 99 THE ECONOMIC JOURNAL 116, 116-117 (1989).

9 G.C. Unruh, *Understanding Carbon Lock-in*, 28 ENERGY POLICY 817, 818 (2000).

10 P. Anderson & M. Tushman, *Technological Discontinuities and Organizational Environments*, 35 (3) ADMINISTRATIVE SCIENCE QUARTERLY 439 (1986).



captures a ‘critical mass’ of the market and becomes a de facto standard.<sup>11</sup>

The development of the engine design in the automobile industry is a fairly typical example of this model. The historical evolution of automobiles can be traced back to the late 19<sup>th</sup> century where the Electric Car, the Internal Combustion Engine (ICE) and the Steam Engine provided the necessary competitive variants to meet an increasing consumer demand for quick modes of commuting. The poor performance of the Electric Battery and, the bulkiness of the Steam Engine, coupled with a fall in fuel prices and improvements in the design of the ICE over the years, catapulted the ICE to dominance thus steering the industry away from the Electric Car and the Steam Engine.<sup>12</sup>

### B. The Consolidation Phase

Once a dominant design is established, manufacturers responsible for its development seek to consolidate their dominance. The focus of research and development and competition amongst market participants shifts from product innovation to process innovation.<sup>13</sup> Once this stage is reached, infrastructure and organisations that create, employ and develop this variant emerge. Over time, they provide positive feedback to the newly emerged variant and create what Unruh calls a ‘Techno-Institutional Complex.’<sup>14</sup>

In addition to the path-dependence phenomenon, on certain occasions, an interaction of the dominant technology with other ancillary technologies also serves to entrench a given technology through channels of path-interdependency.<sup>15</sup> Cowan and Hulten (1996), while highlighting this attribute, identified three positive externalities associated with it: knowledge spill-overs, economies of scale through demand for the same inputs, and positive user externalities through technologies using the same infrastructure.<sup>16</sup>

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11 P. David, *Path Dependence and the Quest for Historical Economics: One More Chorus of the Ballad of QWERTY*, (University of Oxford, Discussion Papers in Economic and Social History, Number 20, November 1997), available at [www.nuff.ox.ac.uk/economics/history/paper20/david3.pdf](http://www.nuff.ox.ac.uk/economics/history/paper20/david3.pdf). The framework provided by David (1985) identifies two significant effects that emerge in the technological evolution process that explain this last phase – learning-by-doing and learning-by using. To this, Cowan (1990) adds another factor – learning-about pay-offs. See P. David, *Clio and the Economics of QWERTY*, 75 AMERICAN ECONOMIC REVIEW 332 (1985); and R. Cowan, *Nuclear Power Reactors: A Study in Technological Lock-in*, 50 JOURNAL OF ECONOMIC HISTORY 541 (1990).

12 R. Cowan & S. Hulten, *Escaping Lock-in: The Case of the Electric Vehicle*, 53(1) TECHNOLOGICAL FORECASTING AND SOCIAL CHANGE 61 (1996). See also “Timeline: Life & Death of the Electric Car,” available at <http://www.pbs.org/now/shows/223/electric-car-timeline.html>.

13 P. Anderson & M. Tushman, *supra* note 10, at 458-462.

14 Unruh, *supra* note 9.

15 A process of technological evolution where the development of one technology depends on the evolution of technologies it is in turn dependant on is frequently referred to as path interdependency. *Id.*

16 R. Cowan and S. Hulten (1996), *supra* note 12.

In the context of the ICE, the emergence to dominance was accompanied by an increased expenditure on research and development geared towards improving the technological capabilities of the engine. While it was obvious for the proponents of the dominant design to continue to dominate the market and consolidate their design, the peculiarity of the automobile industry also allowed the electric car manufacturers to survive – although in a significantly different role. As part of its broader engine design, the ICE required a battery that would assist in ignition. Manufactures of the electric car found some use for their technology in this department and hence snugly fit into the broader schematic of the dominant engine design – aiding and assisting its development. As a result, the focus of research and development shifted entirely to suit the ICE rather than to compete against it. This shifting of focus of a competitive variant towards enhancing the efficiencies of the ICE, caused as a result of the technical establishment of the engine design is another flag post that highlights the path dependency of the development cycle.<sup>17</sup>

The entrenchment of the ICE was also facilitated by gains through path-interdependency. In its early years, car manufacturers decided to follow a policy of mass production to lower costs and increase their reach amongst consumers. Due to the complexity of the automobiles built around the ICE, it was impossible for a single industry to produce all parts required for the construction of such cars; there was a need for ancillary industries, specialising in the production of spare parts, to develop.

The consolidation of the ICE gave entrepreneurs employing the dominant technology and ancillary technologies that were consolidated around it, an assurance of stability that encouraged further investment geared at benefiting from the dominance. A vast network of spare-part manufacturers each specialising in the manufacture of individual components emerged. This led to a fall in the prices of automobiles, which fuelled an increase in the demand for these automobiles, which in turn increased the demand for spare parts. This spiral, assisted with the economies of scale facing each of the smaller industries, gave the necessary stability to the system and led to a further entrenchment of the ICE.<sup>18</sup>

Another significant advantage the ICE enjoyed was the development of infrastructure to suit its needs. A vast network of petrol stations was constructed

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17 P. Anderson, Phillip and M. Tushman, *Technological Discontinuities and Dominant Designs: A Cyclical Model of Technological Change*, 35 ADMINISTRATIVE SCIENCE QUARTERLY 604 (1990).

18 On the other side of the coin, the strategy of Electric Car manufacturers to be more selective in their clientele resulted in a smaller market pool for such cars. Consequently, parts specifically designed and built for electric cars did not exist. The manufacturers were thus unable to take advantage of increasing returns to scale in custom part manufacture unlike their ICE counterparts. *Id.*

and the petroleum refining industry grew, both in size and in technical capability. The increasing need to commute long distances was thus made possible. In addition, constant servicing, break-down management and car repairs were increasingly becoming important, resulting in an increase in demand for mechanics. The dominant engine design made it easier for educational institutions to train people along this model and more people were trained in the ICE framework to meet this increasing demand. These networks in-turn added to the existing dominance of these engines.<sup>19</sup>

Since the emergence of this process of consolidation more than a century ago, this dominance within the automobile engine design industry has remained unchallenged and firmly entrenched. Economically speaking, an entrenchment of technology is ordinarily an extremely desirable phenomenon. It provides much needed stability in a volatile system, encourages investment, spurs innovation and consequently reduces cost. The entrenchment becomes problematic when it is caused as a result of a commitment of decision-makers to an ineffective course of action – a phenomenon more commonly referred to as a ‘lock-in.’ A lock-in serves to prevent a competing variant which is technologically superior, from entering the system.<sup>20</sup>

In the context of the ICE, it is true that significant advancements have been made. However, there have been equally significant shortcomings that are inherent in the design – the polluting attribute being the most relevant for current purposes. The result is an inertia in the system against change that prevents superior technologies that could cure this limitation, from entering the system.

### *C. Inertia Against Change*

David (1985) identified that during the lifetime of technological developments, several industries experience problems of inertia in moving in the direction of the most efficient technological alternatives.<sup>21</sup> He attributes this inertia to the path dependant process of technological evolution. He concludes that in a dominant design framework, unlike a pure economic model where optimising agents select the optimising technology, a superior technology does not necessarily gain precedence. Inferior designs may become locked-in through the path dependant processes in which timing, strategy and historic circumstances determine what technology ultimately prevails. The condition is exacerbated in the specific context of technologies that exhibit increasing returns to scale during their development. Since increasing returns are most influential during the early stages of development where a positive feedback can give a technology

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19 R. Cowan & S. Hulten, *supra* note 12.

20 Arthur, *supra* note 8.

21 P. David (1985), *supra* note 11.

advantages that can lead to market domination, they effectively keep out a later entrant. Unruh also identified the importance of path-interdependencies towards this inertia.<sup>22</sup>

In the context of the ICE, the existence of this inertia has been a cause for much concern. The inability of the industry to move away from this lock-in – and the consequent need for legislation to propel this move, was felt to an appreciable extent for the first time in the 90s in the United States.<sup>23</sup> Inspired by volatility in oil prices and increasing environmental awareness among consumers, this period witnessed a shift away from the fuel dependency of the then-current engines. Although most developments were sporadic, a major trend emerged with the California Air Resources Board (CARB) imposing a mandatory requirement on auto companies to produce a certain percentage of ‘zero emission cars.’<sup>24</sup> Car manufacturers in the US and outside upped the tempo and by 1997 an electric vehicle suited for everyday use emerged in the market.<sup>25</sup>

The most successful car under this venture in terms of mass appeal and affordability – the EV1 produced by General Motors emerged as quickly as it disappeared.<sup>26</sup> Despite its success, within a year of its entry into the market, the project was abandoned and all existing cars destroyed as part of a strategy by auto makers to oppose the CARB initiative on the grounds of ‘technological and economic unfeasibility’.<sup>27</sup> GM itself suggests that low profitability was the primary reason for shelving the EV1.<sup>28</sup> Critics of the decision use the market success of the EV1 and the widespread discontentment at the shelving of the project, to support their argument that lobbying by powerful oil companies, a lack of sufficient incentives on part of major car companies, an indecisive government and insufficiently developed alternative technologies were the reasons actually underlying the auto-makers decision to oppose the initiative.<sup>29</sup>

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22 Unruh, *supra* note 9.

23 R. Cowan & S. Hulten (1996), *supra* note 12, at 72-74.

24 CALIFORNIA AIR RESOURCES BOARD, 1990A, FINAL REGULATION ORDER, LOW-EMISSION VEHICLES AND CLEAN FUELS. CALIFORNIA EXHAUST EMISSION STANDARDS AND TEST PROCEDURES FOR 1988 AND SUBSEQUENT MODEL PASSENGER CARS, LIGHT-DUTY TRUCKS, AND MEDIUM-DUTY VEHICLES.

25 R. Cowan & S. Hulten (1996), *supra* note 12.

26 C. Paine, WHO KILLED THE ELECTRIC CAR? (Sony Pictures Classics 2006).

27 S. Shaheen, J. Wright & D. Sperling, *California's Zero Emission Vehicle Mandate - Linking Clean Fuel Cars, Carsharing, and Station Car Strategies*, Research Paper, UC Davis: Institute of Transport Studies, University (2001) available at <http://escholarship.org/uc/item/447386zj>. For the reasons forwarded by auto-makers from the opposition, see S. Sharma, *The GM EV1: What could have been*, THE ECONOMIC TIMES, October 23, 2008.

28 D. Levy and S. Rothenberg, *Heterogeneity and change in environmental strategy*, in ORGANIZATIONS, POLICY AND THE NATURAL ENVIRONMENT: INSTITUTIONAL AND STRATEGIC PERSPECTIVES 173 (Hoffman and Ventresca eds., Stanford University Press 2002).

29 Paine, *supra* note 26.

Economic theory reveals that there may be some weight behind the critics' argument. As Unruh suggests, producers are usually unwilling to switch technologies which they have developed to the level of domination by investing significant resources.<sup>30</sup> They benefit from production economies of scale and investments in research and development.<sup>31</sup> In addition, in an industry that depends on ancillary industries for supplying constituent components, the ability of established manufacturers to take advantage of existing relationships with parts and service suppliers makes it very difficult for a manufacturer to embrace a technological change.<sup>32</sup>

#### *D. Escaping the Lock-in*

As is clear from the discussion above, a routine improvement in engine design is insufficient to overcome the limitations of an inefficient lock in. A lock-in can only be overcome by the occurrence of an extraordinary event. Cowan and Hulten (1996) identify a few factors<sup>33</sup> in the context of the automobile engine, whose existence and relative strengths could contribute towards such an event: a crisis in the existing technology, technological breakthrough, scientific results, change in consumer tastes and regulation. 'Initiative' is another factor which could prove quite effective in overcoming the lock-in if employed by willing enterprises.

Of all of these, regulation as a factor can be seen as distinct from the rest because of the ability of political decision making to be immune to factors that market forces find themselves constrained by. The author will for this reason deal with regulation in the next section.

As regards the first of the factors, there appears to be no inefficiency that may be termed a crisis of such magnitude as would cause an upheaval of existing technology. It is true that the polluting attributes of the automobile still remains an aspect that is considered undesirable. But it is difficult to term this

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30 Arthur, *supra* note 8.

31 M. Beise and K. Rennings, *National Environmental Policy and the Global Success of Next-Generation Automobiles*, (Research Institute for Economics & Business Administration, Kobe University, Discussion Papers, Number 154, March 2004), available at <http://www.rieb.kobe-u.ac.jp/academic/ra/dp/English/dp154.pdf>.

32 The Electric Car engine, unlike the traditional ICE, employs minimal replaceable parts and requires very minimal servicing. The numerous suppliers of spare parts might thus become obsolete with the new technology. In addition, the revenues automobile manufacturers generate from after sale services and providing spare parts, substantial – all of which will be seriously affected with a move towards a cheaper technology. P. J. Singh et al., *Strategic supply chain management issues in the automotive industry: an Australian perspective*, 43(16) *IJPR* 3375 (2005).

33 Cowan & Hulten, *supra* note 12. Cowan and Hulten also identify niche markets as a factor responsible for bringing about change. However, since niche markets only serve as a platform for innovation and their primary role is to contribute to technological advancement, their influence is well captured within the factors listed above, as relevant to the context of the essay.

limitation in the functionality of the ICE which does not affect its primary purpose, i.e. facilitating commuting, a crisis.

As regards technological breakthrough and scientific results, there has over the years been significant advancement in greener technological alternatives. Hydrogen fuel cells and electric cars have emerged as two of the most viable alternatives available. However, given the difficulties and costs associated with extracting and storing hydrogen, and certain fundamental safety concerns involving the use of hydrogen fuel cells, the electric car has so far received greater support.<sup>34</sup> The electric engine is therefore currently touted to be the most viable alternative to the ICE.<sup>35</sup> However, since the analysis applied to electric cars fits as well into the context of hydrogen fuel cell cars, this essay will not attempt a definitive conclusion of their relative merits.

Most of the concerns raised by manufacturers against the electric car have been addressed to an appreciable extent in recent times. The *Tesla* and the *Tara Tiny* are among the latest developments in the field. The former is a symbol of superior engine performance, minimal servicing costs, minimal environmental damage and improved mileage per recharge,<sup>36</sup> while the latter is

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34 See Reuel Shinnar, *The Hydrogen Economy, Fuel Cells, and Electric Cars*, 25(4) TECHNOLOGY IN SOCIETY 455 (2003); Joseph Rom, *The Car and Fuel of the Future*, 34(17) ENERGY POLICY 2609 (2006).

35 Despite wide-ranging support for the idea that the electric car is indeed the most viable green alternative, there have been some issues raised against its use. It is argued that currently, most of the electricity generation is from power plants that burn coal for electricity generation. Connecting the electric car to the electricity grid, would, instead of reducing pollution, pass on the burden of power generation to coal-based systems, which are more inefficient than fossil fuel based technologies. (Chip Grebben, *Debunking the Myth of EVs and Smokestacks*, available at <http://www.electroauto.com/info/pollmyth.shtml>). The response to this objection is three-fold: empirically, it is proven that a centralized production of electricity, irrespective of the means, would cause lesser pollution than automobiles. An increase in demand would lead to expansion of the power plants and consequently economies of scale will result in production. Secondly, the cost of monitoring compliance of individual engines of the several million cars coming on to the streets every year is much higher than monitoring a more centralized power production facility. Even if a particular engine design is approved on grounds of acceptable pollution limits, the subsequent usage and maintenance of the car has important repercussions for the pollution it ultimately produces. Supervising such maintenance is either impossible, or only possible at very high costs. On the other hand, holding power production plants to improve their technology and supervising their maintenance of these levels is less expensive. Thirdly, a centralized power production plant is better able to find alternative sources of generation. The possibility of an extensive use of nuclear energy, or renewable sources of energy like tidal, wind or solar energy – most of which cannot be possible adopted by automobiles themselves, can serve to completely obviate the pollution problem. (Thomas Blakeslee, *Electric Cars Make Fuel-Free Power Grid Practical*, available at <http://www.renewableenergyworld.com/rea/news/reinsider/story?id=54046> (last visited Feb 20, 2010).

36 A. Cooper, *Charging Ahead*, <http://www.popsoci.com/cars/article/2008-12/charging-ahead> (last visited Feb 20, 2010).. For technological superiority, see <http://www.teslamotors.com/performance/>. The superiority is also demonstrated by a barrage of awards and accolades. The Tesla stood second in the list of Time's Best Inventions of 2008, available at <http://www.time.com/time/specials/packages/0,28757,1852747,00.html> (last visited Feb 20, 2010).

a live example of the economic feasibility of the electric car.<sup>37</sup> The question now is whether this advancement merely establishes the superiority of the electric car over the ICE or, whether it represents an improvement so drastic as to pull the industry out of its lock-in.

Given that technology ultimately functions within a market driven by consumer demand, the significance of technological advancements depends upon their perception by consumers. Consequently, a technological advancement will only be considered drastic if the consumers feel that the advancement is a significant improvement aligned to their preferences. As an illustration – David (1985) found that the Dvorak keyboard could make a 20-30% time saving in typing as against the existing QWERTY keyboards.<sup>38</sup> Even this significant advancement was incapable of bringing about change because the consumers did not believe the advancement was ‘significant enough’ for them to change their preferences. Since the issue of consumer preferences is also relevant to evaluate the influence of the fourth of the factors identified above – change in consumer tastes, it would be worthwhile to devote some time to understanding this crucial influence.

There has in recent times, been a surge in awareness and environmental consciousness across the globe. The need to move towards cleaner, greener technologies is universally accepted. The question however is – to what extent has this increase in environmental consciousness translated to a shift in preference to a greener alternative among consumers? The answer depends on an assessment of the respective costs and benefits associated with the transition. Consumers weigh the costs of perceived environmental harm and the benefits of a cleaner environment against the costs of transition to newer technologies and the benefits of *status quo*.

Unfortunately, economic theory suggests that in the context of the automobile engine design, this assessment is extremely unlikely to aid the transition necessary (and even if it does, it will certainly not do so at a time when it ideally should). This is because on the one hand the externality attribute of automobile pollution, like any form of pollution, results in an inaccurate valuation of its environmental harm. Despite a consensus on the importance of greener technology, at the individual level, the true costs of environmental harm are never internalised and are hence grossly undervalued.<sup>39</sup> On the other hand, the benefits of *status quo* and the costs of transition lean heavily against change.

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37 The Tata Tiny, said to be the most inexpensive electric car to hit the market is priced on par with the Tata Nano – which is currently the most inexpensive ICE engine driven car available in the market. See Ashoke Nag, *Tata International's Tiny joins Nano race with world's cheapest car*, THE ECONOMIC TIMES (INDIA), Feb 15, 2008.

38 P. David (1985), *supra* note 11.

39 Meade, *supra* note 3, at 10-25.



The more entrenched a given technology is in the existing framework, greater is the cost of transition, and more appealing the benefits of *status quo*.<sup>40</sup>

In the context of engine design, despite significant improvements in the technological viability of the electric car, certain fundamental problems still remain. Unlike the large number of refuelling stations that support the ICE, there exists no similar infrastructure for electric vehicles. This is especially true of areas lacking privately owned garages – which would include most cities and densely populated areas, which in fact are areas with the greatest need for environmentally friendly facilities- and where electric cars may accordingly not be a viable alternative. In addition, given that almost all mechanics are still trained in the working of the ICE; knowledge percolation through this community is likely to be slow and indeterminate without external stimulus. The costs of transition, and the bleak prospects of improvement in the near future, tend to lean consumers in favour of the safety net of a secure existing network. Consumers might not want to risk a greener technology at the cost of insufficient supporting infrastructure.<sup>41</sup>

This brings us to the last of the factors identified – Initiative. Unfortunately, this factor has not been considered to any appreciable level of detail in academic debates revolving around 'lock-ins.' Initiative – as the term is used in this essay, refers, tautologically, to the initiative of a market participant to pioneer change in a direction significantly different from one suggested by conventional economic theory. The more diverse the direction of the initiative is to existing trend, the higher is the risk of failure. However, if successful, the initiative provides a fertile ground for consolidating on early market entry and an opportunity to generate significant profits before others can catch up.<sup>42</sup>

Some of the biggest existing industries have emerged and flourished due to such initiatives. In fact, the beginning of the entrenchment of the ICE engine design started with an initiative of this sort. The mass production of the Oldsmobile Curved Dash in 1901 – a first for automobiles, in an environment where steam, electric and gasoline technologies were in close competition with each other, was an initiative that propelled gasoline cars ahead of competition and ultimately to the level of dominance.<sup>43</sup> The decision to mass produce cars in

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40 Arthur, *supra* note 8.

41 Reid Heffner & Kenneth Kurani, *Symbolism in California's Early Market for Hybrid Electric Vehicles*, 12(6) TRANSPORTATION RESEARCH PART D 396 (2008).

42 The degree to which the 'first-mover advantage' applies in the context of such an initiative largely depends on the sector under question. More generally however, the more difficult it is to mimic a successful market participant's strategy, the higher are the benefits from early entry. See R. A. Kerin, P. R. Varadarajan & R. A. Peterson, *First-Mover Advantage: A Synthesis, Conceptual Framework, and Research Propositions*, 56(4) JM 33(1992).

43 E. ECKERMAN, WORLD HISTORY OF THE AUTOMOBILE 25-30 (2001).

such an uncertain environment carried with it an inherent risk of serious failure. As history shows, however, the risk ultimately yielded rich dividends.

The question that then arises is whether such an initiative can be expected to pull the automobile industry out of the lock-in. The answer to this depends on the willingness of an enterprise – even one that takes an ‘initiative’- to risk introduction of an alternate technology in the context of a lock-in in the automobile industry. While enterprises taking ‘initiatives’ are generally willing to take upon themselves some risk, the risk seems to be of a nature that the entrepreneur can subsume within its activities or exert some influence over to change.<sup>44</sup> To illustrate, consider the introduction into the market of roller skates. Features such as designing the roller skate and making it safe are technical aspects – the risks of designing which any enterprise takes upon itself. However, an enterprise seeking to take an ‘initiative’ does more – it introduces the skates, for example, into a market where public acceptability of the device is not established. There is a risk that people might consider the idea absurd and refuse to accept it. But this is a risk that enterprises can influence through active advertising, test running or such similar steps. Consequently, an enterprise willing to take the ‘initiative’ may actually risk introducing the skates in the market. Now consider a situation where skates were a device that could hypothetically only be used on smooth surfaces, and the enterprise was looking to market it in a region where smooth pavements do not exist. Irrespective of efforts by the enterprise to improve product quality and influence public opinion, they would predictably fail to market their skates successfully. This is because the risk of introduction is of a nature they are entirely unable to influence.

In the context of the introduction of the electric car, enterprises have taken upon themselves the risk of exploring the technology of the electric car and advancing it to a requisite degree. Enterprises such as Tata (through their E-Nano), Tesla, Tata Nano and the whole multitude of hybrid car manufacturers<sup>45</sup> have expressed an interest to take the electric car one step beyond and market it. They have expressed their willingness to take the risk of introducing it in a

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44 Although instances of enterprises taking on a much higher level of risk, even in an environment where they are completely unable to influence the outcome or conditions relating to the outcome – are not infrequent, it is difficult to model such behaviour to yield any productive results. Most studies tend to assume a less radical appetite for risk on part of entrepreneurs – an approach that this paper chooses to follow as well. See E. Bernardo and I. Welch, *On the Evolution of Overconfidence and Entrepreneurs*, 10(3) JEMS 301 (2004).

45 The case of a hybrid car is indeed rather unique. While a hybrid engine’s ability to switch to the internal combustion engine on having run out of electric charge is a factor that helps keep fuel usage to the bare minimum, it still represents a mid-way point in the move towards green technology, where a polluting fuel is not fully weeded out. Having said that, the hybrid represents the full extent to which industries have been able to move in the direction of the electric car within their sphere of influence. So it is a venture that must be lauded while bearing in mind the limitations it brings with it.

market where the internal combustion engine has a stronghold. Even if these enterprises are capable of handling this risk and can successfully project the electric car as a viable and desirable commodity, the success of the electric car is not assured, because there is still a residuary risk – the uncertainty of coordination from supporting industries and the lack of supporting infrastructure - of a nature that these enterprises cannot influence. This risk could prove vital in dissuading enterprises despite their willingness to fully embark on this venture. So while taking new ‘initiatives’ appears promising, it seems unlikely by itself to bring about the necessary shift in automotive technology.

### III. A CASE FOR REGULATION?

As the previous section demonstrates, the complexity of lock-ins severely constrains the ability of businesses to move towards the most optimal solution. In these circumstances, it is trite to explore whether governments can offer a remedy, given the government’s ability to take decisions without being restricted by forces that constrain the market. However, in economies that have long moved away from centralisation of economic activity for this very reason, any case of government intervention must be made cautiously. Therefore, before making a definitive case for government intervention to address the problems of carbon lock-in in the automobile industry, it would be useful to consider whether the case falls under any of the following instances of market failure that economic theory typically identifies as circumstances where the government is better equipped to provide an optimal solution.<sup>46</sup>

#### A. Externalities

An externality is a phenomenon where activities have an impact on a party that is not directly involved in the transaction. In such a case, prices do not reflect the full costs or benefits in production or consumption of a product or service. Government intervention is considered legitimate when such an externality leads to a misallocation of resources.

As outlined in the previous sections of the paper, carbon lock-in in the automobile industry is a result of a path dependent process of development. All actors within the automobile industry – not merely those involved with the development of the technology - benefitted from this process and achieved reduction in their costs of production owing to systemic economies of scale. Since this industry-wide externality operates fundamentally through its influence on costs and prices, it falls within the category of a pecuniary externality.<sup>47</sup>

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46 The classification is based on the framework provided in A. OGUS, *REGULATION: LEGAL FORM AND ECONOMIC THEORY* (Oxford. Clarendon Press: The Clarendon Law Series, 1994).

47 A pecuniary externality is defined an effect of production or transactions on third parties through prices but not real allocations. See T. Scitovsky, *Two Concepts of External Economies*, 62 *JOURNAL OF POLITICAL ECONOMY* 143 (1954).

Pecuniary externalities have traditionally been treated separately from technical externalities because unlike the latter, they operate solely through their influence on costs and prices, rather than on resources. Ordinarily, no resource misallocation results from such externalities. Consequently, they are classified as belonging to a category of market behaviour where government intervention is considered undesirable.<sup>48</sup>

The question that then arises is whether on an application of this theory, the pecuniary externality of the automobile industry must belong outside the scope of regulation. Before answering this in the affirmative, it is important to consider whether classifying the externality as pecuniary fully describes the operation of the processes that result in the externality.

As is clear from the earlier sections of this essay, the processes that lead to the pecuniary externality in turn, through the operation of lower costs, facilitated a further embedding of polluting technology into the industry. Because pollution leads to a real misallocation of resources, it is a technical externality. Thus, while the categorisation of the processes operating within the automobile industry is in some senses a pecuniary externality, such a description fails to fully capture its ultimate effects. The ‘pecuniary externality’ *in turn causes* a technical externality. As a result, even the ‘pecuniary externality’ dimensions of the transaction lead indirectly to resource misallocation. A government seeking to combat the market inefficiency resulting from the lock-in in the industry must therefore also target its ‘pecuniary externality’ dimensions.

### *B. Coordination Problems*

Actions of individually rational actors may sometimes result in an action that is collectively less than optimal. A typical example of this is an act that necessitates cooperative behaviour between participants. The classic illustration of this is the prisoner’s dilemma,<sup>49</sup> where, the prisoners choose a strategy that is rational but not the most optimal for the class of prisoners as a whole. This sub-optimal situation results because the prisoners are unable to coordinate their actions in a manner that allows them to reach a collectively optimal solution.

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48 R.G. Holcombe & R.S. Sobel, *Public Policy towards Pecuniary Externalities*, 29(4) PUBLIC FINANCE REVIEW 304, 304-306 (2001).

49 A classic example of the prisoner’s dilemma is as follows: Two suspects are arrested by the police. The police have insufficient evidence for a conviction, and, having separated both prisoners, visit each of them to offer the same deal. If one testifies for the prosecution against the other and the other remains silent, the betrayer goes free and the silent accomplice receives the full sentence. If both remain silent, both prisoners are sentenced for a minor charge. If each betrays the other, each receives half the full term of the punishment. Each prisoner must choose to betray the other or to remain silent. Each prisoner, acting to maximise his own interests will choose to testify against the other. The ultimate result is therefore one where both prisoners confess and are sentenced to half the full term of the punishment. See *Prisoner’s Dilemma*, STANFORD ENCYCLOPAEDIA OF PHILOSOPHY (2007).

Applying this in the context of regulation, if market participants find themselves in such a situation where an optimal solution is not reached because of their inability to coordinate behaviour with other market participants, then regulation may be desirable if it can perform this role of coordination on behalf of the participants.<sup>50</sup>

The automobile industry is ready ground for such coordination problems to arise. The industry as it exists operates to a degree of specialisation where the undertaking of a venture necessitates a coordinated effort by each of the actors involved. Given the large number of actors, it is extremely difficult for the parties to coordinate their behaviour.<sup>51</sup> As the previous sections highlight, carbon lock-in in the industry poses a further risk that dissuades the parties to move away from status quo. The hesitation of each of the actors, together with the knowledge that the hesitation is likely to be universal, further increases the difficulty of coordinating the behaviour of the various actors in a direction away from existing technology.

As a result, automobile manufacturers are hesitant to venture into a high expenditure, mass production project for electric cars because they are unsure of demand; the consumers are hesitant to purchase the automobile because of the abysmally low level of electric cars already in the market and the fear of poor infrastructure to support the car; gas stations are reluctant to incur huge expenses in accommodating charging stations for electric cars because they fear there will be too few cars in the market, making the investment unprofitable, and so on.

In this scenario, if the government is able to coordinate the behaviour of the parties through its intervention, it can help solve this dimension of the shortcoming in the market. A suitably adopted instrument could serve as a signalling mechanism which can direct private players to proceed in a particular direction. The systemic assurance towards a technological alternative could provide the much needed assurance and encourage investment and consumption in that direction.

### *C. Public Goods*

A public good is a good which is non-excludable and non-rival.<sup>52</sup> Because of these attributes, private players cannot fully recover the value of their investment in the production of such goods. This results in the underproduction

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50 C.R. Sunstein, *The Functions of Regulatory Statutes*, in, *AFTER THE RIGHTS REVOLUTION: RECOVERING THE REGULATORY STATE* 51 (Massachusetts: Harvard University Press).

51 K. B. Clark, et al., *Product Development in the World Auto Industry*, 3 *BROOKINGS PAPERS ON ECONOMIC ACTIVITY* 729 (1987).

52 HAL R. VARIAN, *MICROECONOMIC ANALYSIS* 415 (1978).

of such goods in the market. The need for government intervention to encourage production of such goods is well recognised.<sup>53</sup>

In the context of the automobile industry and specifically in the context of this essay, there are two public goods that are relevant – clean air and supporting infrastructure. The public good dimension of clean air is well recognised.<sup>54</sup> What is more interesting in a discussion about the desirability of government intervention in automobile industry carbon lock-ins is the issue of ‘supporting infrastructure.’ Supporting infrastructure here covers a wide spectrum of facilities that helps the use of a particular technology. In the context of the automobile industry, this includes facilities such as refuelling stations, trained mechanics, university curriculum etc. Each of these facilities can be used by automobile manufacturers to their advantage, without them having to invest in the generation of these facilities. Yet, it is the inability to control the further use of the facility that dissuades them from investing in their generation.

Looking at the current state of infrastructure supporting the ICE, one may argue that despite this limitation the production of these supporting facilities has been adequate. Notwithstanding the force of this assertion, a question arises as to whether a similar degree of confidence can be reposed on the market if a new technology were to be introduced. The abundance of infrastructural facilities in the current environment is largely a result of the profitability of this infrastructure. If however a technological change were to be introduced into the market the profitability of investment in such new technology would be less than obvious. In a situation where other private actors are unsure of investing, the responsibility of investment falls upon the shoulders of the manufacturer who seeks to bring about this change. Given the public good dimension of such investment, the manufacturer will have a less than optimal incentive to invest.

A push in the right direction by the government in such a situation could help overcome this obstacle. The push could be either by way of the government investing, or by encouraging private actors to invest, in the generation of such facilities. Absent this, it may be long before the market find such an investment profitable.

#### IV. AN ASSESSMENT

It is clear from the above discussion that the carbon lock-in of the automobile industry presents a failure of market failure not remediable by existing market forces. Even to the extent that market forces can try to remedy it, there

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53 R. CORNES AND T. SANDLER, *THE THEORY OF EXTERNALITIES, PUBLIC GOODS AND CLUB GOODS* 240 (2d ed., 1996).

54 M.A. BROWN, *Market Failures and Barriers as a Basis for Clean Energy Policies*, 29(14) *ENERGY POLICY* 1197, 1202-1203 (2001).

exist significant risks. Firstly, an aspect as important as environmental pollution is being left to be handled by market forces which have traditionally proven quite inadequate; and secondly the conflicts of interests that the industry faces, and which may prevent them from putting their best foot forward in the direction of remedying the situation. On the other hand, economic theory suggests that the case of the carbon lock-in is a perfect recipe for government intervention. It arises as a result of a mix of circumstances – such as the public good dimension of essential supporting facilities that can help bring about this change, a lack of certainty as to future course of technological change etc., each of which the government could handle better than market forces.

The ultimate question that then arises is whether, in this theoretical background, the government must intervene. The answer to this question depends on a large number of variables. Since legislation is not strictly a logical exercise and is a process that is necessarily constrained by practical difficulties, a definitive suggestion of intervention cannot be made in the abstract. Therefore, it is useful to consider the theoretical discussion above in a concrete context.

### A. A Case Study

Automobiles have hitherto been too expensive to be able to reach the masses in India – a significant percentage of whom could not afford even low-end economy cars.<sup>55</sup> The lower-middle class– who constitute the largest segment of the population – have, given this limitation, been constrained to use either two-wheelers, or public means of transport.<sup>56</sup> The inherent risks and limitations of the two-wheeler, together with the deplorable state of public transport in India, has meant that the lower-middle class is a segment that could easily be tapped if the price barrier was breached.<sup>57</sup>

In this context, Tata Motors announced earlier last year the launch of their new car– the Tata Nano, into the Indian market. The car, proclaimed to be the most inexpensive car to reach mass production, is targeted at this class.<sup>58</sup> It is touted that with the introduction of the Tata Nano, the number of households who can afford a car will increase to 15 million – a 65 percent increase.<sup>59</sup>

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55 C. Lim et al., *Low-cost disruptive innovation by an Indian automobile manufacturer*, MMRC DISCUSSION PAPER SERIES (October 2009), available at [http://merc.e.u-tokyo.ac.jp/mmr/dp/pdf/MMRC280\\_2009.pdf](http://merc.e.u-tokyo.ac.jp/mmr/dp/pdf/MMRC280_2009.pdf) (last visited Feb 20, 2010).

56 A. Mukherjee and T. Sastry, *Recent Developments and Future Prospects in the Indian Automobile Industry* (2002), available at <http://hdl.handle.net/1721.1/1633> (last visited Feb 20, 2010).

57 *Id.*

58 Tata Motors Press Release, *The Tata Nano Arrives* (March 23, 2009), available at [http://www.tatamotors.com/our\\_world/press\\_releases.php?ID=431&action=Pull](http://www.tatamotors.com/our_world/press_releases.php?ID=431&action=Pull). See also *World's cheapest car is launched*, BBC NEWS ONLINE, Mar 23, 2009, available at <http://news.bbc.co.uk/1/hi/7957671.stm>.

59 *Tata Nano may expand market by 65%: CRISIL*, THE ECONOMIC TIMES ONLINE, Jan 12, 2008, available at <http://economictimes.indiatimes.com/news/news-by-industry/auto/automobiles/Tata-Nano-may-expand-market-by-65-CRISIL/articleshow/2694186.cms>.



While the significance and repercussions of this move are manifold, what is most relevant to the context of this essay is the implication of this development vis-à-vis pollution in India. The first set of cars entering the market have been combustion-engine driven. With petrol fuelled engines, they have been built to the most recent emission specifications and conform to the standards required of present day cars. It is claimed that the Tata Nano is one of the most fuel efficient petrol cars to be introduced into mass production.<sup>60</sup>

Normally, this set of facts would have been sufficient to impress even the most vehement of environmentalists. Upon consideration of the earlier sections of this essay, however, things do not look as appealing. The introduction of the Tata Nano has in some ways created a hitherto non-existent market – that of the lower-middle class car owners. Driven by the sheer number of people constituting this class, who are now subsumed within the category of car users, the reach of the automobile has increased manifold – and consequently the technology underlying the automobile. This increase in usage following the introduction of the Tata Nano represents a new wave of entrenchment of existing technology. The sudden increase in the number of cars that operate on existing technology, the consequent increase in demand for supporting industries to this technology, the increased relevance of familiarity with existing technology – all represent different aspects of this entrenchment. Given the magnitude of this entrenchment, the carbon lock-in will become only too firmly embedded. Any attempt thereafter to pull the industry out of this technology will have to be extremely distortionary.

Nevertheless, the veracity of such a conclusion may be questioned given recent developments in the automobile industry in India. Recognising the growing concerns about environmental pollution and the impact of the Tata Nano in heightening such a concern, Tata Motors expressed their intentions, quite early in the life of the Nano, to come out with an electric variant of the car.<sup>61</sup> They even forged a partnership with a Norwegian electric car specialist firm Miljøbil Grenland, to accelerate the launch of the electric variant.<sup>62</sup> Certain other companies have also expressed their interest in launching electric versions of low-cost automobiles targeted at a similar segment of the population as the Nano.<sup>63</sup> Given these developments, one could justifiably question whether the phenomenon of the carbon lock-in is indeed as serious as the theory in the previous sections projects it to be.

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60 *Supra* note 58.

61 *Tata Plans Electric Version of Nano*, THE TIMES OF INDIA, Aug 21, 2008, available at <http://timesofindia.indiatimes.com/articleshow/3386709.cms>.

62 *Id.*

63 *Supra* note 33.

To answer this question, one must consider the ability of the electric cars to compete with their ICE counterparts during this new wave of entrenchment. The discussions in the previous sections, equally applicable here, tend to suggest that the electric car is unlikely to be able to do so. Let us consider two illustrative aspects here to verify this proposition in the specific context of the Tata Nano.

### 1. After-sales services

The specific segment of the population which is being targeted by the Tata Nano is the lower-middle class for whom cost is one of the most important factors.<sup>64</sup> Costs include not only the initial expenditure of buying a new car but also the cost of operation, maintenance and repair. As has been witnessed over the past years, for each of these, company run servicing programs tend to be expensive. Consequently, for the cost-conscious, especially when the value of the automobile is low, the mechanic down the road tends to be the preferred option.<sup>65</sup>

A mechanic at the local garage, given the long-standing presence of the ICE engine, will be extremely familiar with the existing technology, and will consequently be able to provide the service necessary to such automobiles. Given this, the consumer is likely to feel quite confident of getting his servicing done through the mechanic at the local garage for his ICE engine driven automobile. On the other hand, a consumer with an electric car is likely to be much less comfortable. He will in turn have to depend on company-run servicing chains. Given that such servicing is likely to be expensive and because such service centres are as yet not quite as numerous as a consumer would desire, the electric variant is faced with a significant barrier. Consequently, on this count, the target consumers will be extremely unlikely to prefer the electric version.

### 2. Support facilities

An automobile requires certain basic infrastructure to be able to provide the services required of it – most significantly, an adequate number of refuelling stations. Inadequacy of such a facility could seriously undermine the viability of a technology which demands it.<sup>66</sup>

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64 S. Maxwell, *An expanded price/brand effect model - A demonstration of heterogeneity in global consumption*, 18(3) INTERNATIONAL MARKETING REVIEW 325 (2001).

65 KPMG, *Skill Gaps in Indian Automotive Service Sector*, BACKGROUND PAPER FOR CII CONFERENCE ON AUTOMOTIVE SERVICE, 6, AUTO SERV 2008, available at [http://www.in.kpmg.com/TL\\_Files/Pictures/SkillGaps\\_Auto08\\_low.pdf](http://www.in.kpmg.com/TL_Files/Pictures/SkillGaps_Auto08_low.pdf) (last visited Feb 20, 2010).

66 KPMG, *KPMG's India Automotive Study 2007: Domestic Growth and Global Aspirations*, available at <http://www.kpmg.fi/Binary.aspx?Section=174&Item=4340> (last visited Feb 20, 2010).

Given the long-standing presence of automobiles in India an excellent network of fuelling stations have emerged. Such facilities are equipped to supply petrol and/or diesel and in some instances LPG/CNG. The ICE engine thrives on this excellent network of support facilities. An electric car on the other hand, would have to depend on plug-points at the consumer's residence for such recharging. While this could potentially be sufficient to a certain segment of the consumer base, it poses a serious constraint on such consumers who do not have such facilities or such of those who need such facilities even outside of their homes. Consequently, an electric variant is unlikely to appeal to the sensibilities of a fair portion of the consumer base it targets.

On the whole, there appear to be a significant number of hurdles that restrict the electric car from competing on an equal footing with the new wave of inexpensive ICE driven automobiles. The concern that the earlier sections of the essay expressed therefore appear quite legitimate even in the specific context surrounding the introduction of the Tata Nano. This concern is only heightened by the magnitude of the problem the introduction of the Tata Nano range of cars is expected to usher.

As the previous sections of this essay highlight, the repercussions of this change are too onerous to be ignored. Given the inability of the market forces to provide a viable solution to the problem, it is imperative that the government steps in to correct this inefficiency in the market. The timing of such an intervention is also crucial. Given the complexities that the influx of cars are likely to lead to, it is necessary for the government to act quickly. It is imperative that the waves of new cars poised to enter the market are prevented from pushing existing technology too deep into the vicious polluting cycle. A delay in intervention will exponentially increase the difficulty of rectifying the problem at a later point in time. Additionally, apart from the fact that the government is in this instance best suited to provide a solution to the problem, the role a government is required to play in protecting the environment must embolden it to take all steps necessary to reduce automobile pollution. Even if only in the exercise of these paternalistic powers, in the face of an imminent threat of sustained pollution for years to come, the government must devise suitably tailored modes of intervention that can rectify the situation.

## V. CONCLUSION

The case of the carbon polluting technological lock-in in the automobile industry provides an excellent example of a market failure where the ability of market participants to correct inefficiencies, is severely constrained. Private interests, coordination problems, consumer uncertainty, lack of infrastructure, increased levels of risk etc., together provide sufficient economic justification

against change. Even the initiative of market pioneers could prove insufficient to get out of this vicious cycle given the innumerable risks that even such market leaders will not be able to handle. Unbridled by the limitations the market forces are constrained by, the government appears to be best able to respond to these shortcomings.

Traditionally popular instruments such as emission standards and pollution taxes which have hitherto operated on the understanding that – the problem of automobile pollution is merely a problem of an environmental externality – are thoroughly inadequate in dealing with the carbon lock-in which is inherently a more complicated arrangement. Emission standards and taxes work on a snapshot basis – they prescribe levels of acceptable pollution bearing in mind the existing levels of pollution and technology, while completely ignoring the long term effects of adhering to a particular technology. They at best galvanise the industries towards further improving their existing technology (which in effect further entrenches the technology) rather than pushing them in the direction of a transition in technology. For an intervention by the government towards remedying problems associated with the carbon lock-in, to be effective, it is necessary that the government fully understands the underlying problem and devises suitably targeted mechanisms.

An intervention which seeks to solve the problem of the carbon lock-in must not only be aimed at regulating the extent of pollution that automobiles produce in the short term, but must be such as to achieve the long term goal of working towards zero-emissions. Given the various levels at which the complexity of the carbon lock-in operate, any intervention must necessarily target all levels at which the inefficiency operates.

As the previous sections of this essay have stated, inefficiencies in the market can broadly be categorised as arising from: 1) problems of inertia; 2) technological limitations; 3) consumer indeterminacy; 4) inadequacy of infrastructure; 5) uncertainty of future development; and 6) lack of supporting facilities. Each of these concerns can be addressed by the government in many ways by encouraging investment (and if need be, investing itself) in supporting infrastructure (such as refuelling stations, service stations etc.), in training people in the use of greener technology, encouraging investment in and investing itself in research and development of greener technology, spreading awareness amongst the masses about the desirability of shifting towards greener technology, encouraging use of greener technology by providing suitable incentives etc.

The specific method the government adopts is not quite as crucial as is the basis for adopting a measure. So long as the measures are targeted at particular problems of the lock-in and are adopted with the aim of guiding the numerous interdependencies in the automobile industry towards greener

technology, there is some hope that a technological discontinuity will result. The timing of any such intervention however is crucial. The embedding of technology and its processes over time mean that early intervention is necessary. This is especially so when there is a possibility of further entrenchment of technology.

There are of course complications arising from implementing any such intervention, and the fairly over-arching discussion such as carried out in this essay does not consider all of them. It does, however, aim to identify certain key aspects which are cause for significant concern. Unless the government makes a serious effort to prevent the further entrenchment of polluting technology and takes proactive steps in working towards it in the near future, shifting away from such a technology may prove too difficult a task to achieve.

# INDEPENDENT DIRECTOR LAW IN INDIA: AN ECONOMIC AND BEHAVIORAL ANALYSIS

*Mandar Kagade\**

## I. INTRODUCTION

The institution of independent directors and the design of rules governing their independence have long been a subject of intense academic debate. The corporate governance fiasco earlier this year at *Satyam Computers Ltd.* in India has brought this issue into focus again. The Indian corporate governance system has borrowed the norm defining independence of directors from contemporary Anglo-American experiments in corporate law and governance.<sup>1</sup> I analyze this norm in the law and economics framework, drawing from the *rules versus standards* literature.<sup>2</sup> The *rules versus standards* debate is ubiquitous in law. Legal scholars have applied the dialectic to various areas of law, more particularly, antitrust,<sup>3</sup> international trade law<sup>4</sup> and private law.<sup>5</sup>

The law defining independence is *rules-based*; one that seeks to define *ex ante*, all the trappings of independence. Such *ex ante* definitions are perceived to foreclose all conflicts of interest that may affect the objectivity of outside directors and induce genuinely independent behaviour.<sup>6</sup> The present corporate governance law embodied in Clause 49 of the Listing Agreement of securities exchanges for example, defines the expression *independent directors* up front, detailing all such financial and familial links as would compromise the independence of an outside director.<sup>7</sup> The recent reform proposal – Companies Bill, 2009 too defines *independent directors* in terms of the prevalent rule-oriented language.<sup>8</sup>

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\* LL.M., University of Columbia Law School; B.L.S. LL.B., Government Law College, Mumbai University.

1 See Afra Afsharipour, *Corporate Governance Convergence: Lessons From The Indian Experience*, 29 Nw. J. INT'L & BUS. 335, 383 (2009) (observing that “the Sarbanes-Oxley Act and Clause 49 define independent director similarly”).

2 For a survey of rules-standards literature, see generally Pierre Schlag, *Rules And Standards*, 33 UCLA L. REV. 379 (1985); Cass Sunstein, *Problem With Rules*, 83 CAL. L. R. 953 (1995); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 43 DUKE. L. J. 557 (1992).

3 Daniel Crane, *Rules Versus Standards In Antitrust Adjudication*, 64 WASH. & LEE. L. REV. 49 (2007).

4 Joel Trachtman, *The Domain Of WTO Dispute Resolution*, 40 HARV. INT'L. J. 333 (1999).

5 Duncan Kennedy, *Form and Substance of Private Law Adjudication*, 89 HARV. L. R. 1685 (1976).

6 See Usha Rodriguez, *The Fetishization Of Independence*, 33 J. CORP. L. 447, 455 (observing that “behind all these rules lurks a belief that by closing off connections to the management, rulemakers can create the ideal board”).

7 See *infra* note 12.

8 See The Companies Bill 2009, S. 132(5). The Bill was initially tabled in October, 2008 in the House. However, owing to the lapse of then House on account of elections, it was re-tabled again on August 3, 2009 without any changes.

In this paper, I argue that when it comes to designing prescriptions defining *independent directors*, such *rules-based* solutions are inappropriate. I advocate that the law ought to keep the understanding of the expression *independent directors* malleable and heuristic. I argue that the law ought to define the aforementioned expression in terms of standards and that reform should be imposed through a proper legislation rather than through delegated devices like the Listing Agreement.

More generally, this paper nudges policymakers to think about the deterrence value of uncertainty to enforce genuine behaviour among independent directors and corporate insiders. I also invite attention to the benefits associated with (standards-induced) uncertainty in legal design which is overlooked even by the recently introduced reform proposal and often perceived to be a demerit.

The rest of the paper is as follows: Section II gives a brief introduction to the *rules versus standards* dialectic. Section III describes the present corporate governance regime in India including the norm defining the expression, *independent directors*. It reconstructs the present regime in the *rules-standards* discourse and articulates the problems associated with this approach. Section IV proposes the alternative legal form for the definition of independence. It argues that a *standard-like* definition is in consonance with economic analysis of independent director law and policy. Section V attempts a model *standard-like* definition of independence as a normative exercise. Section VI discusses other positives of having a *standard-like* form of the definition of independence. Section VII then discusses certain issues that a *standard-like* articulation of independence may entail; it counters these and other issues using insights from behavioral analysis of rules and standards. Section VIII concludes.

## II. RULES AND STANDARDS: AN INTRODUCTION<sup>9</sup>

Rules are sharp communicating devices. ‘No person shall be deprived of his liberty except according to procedure established by law’ clearly defines the limitation on State and the manner in which a person’s liberty may be taken away. The agents of the State, to whom the legal directive is addressed, have a clear *ex ante* idea about the limitation that is imposed on them. To the law enforcement agencies, ‘procedure established by law’ is a bright line solution; they have merely to apply the procedure given by law to each case where there is a cause for arresting a person. However, consider the following directive: ‘Excessive speeds shall be punished with severe fine.’ This directive is different from the earlier one in that for the law enforcement actors, the ‘severe fine’

9 This section borrows partly from Mandar Kagade, *Jus Cogens: A Rules-Standards Analysis*, 6 GLC LAW REVIEW (2007) 101, 103-4. See sources cited in *supra* note 2 for more general reading on the *rules versus standards* literature.



allows the discretion to make a casuist analysis of each case of speeding and then decide the quantum of penalty. Such open ended and heuristic directives are called standards.

The form of a directive as a rule or standard depends upon various factors – for instance, a legal system might want to deter actors from crossing the 100 mile threshold because it was found that speeds in excess of 100 miles are more likely to lead to accidents. A standard will be more likely to be used when the law makers do not know what particular speed is more likely to result in an accident. Thus the cost of gathering information is a key dimension on which the form of a legal directive is contingent.

There could be other reasons too. Sometimes institutions dictate the form of a legal directive; for example, constitutional norms dictate that criminal law give precise notice of the conduct that is criminalized. That explains detailed, even complex, drafting of the criminal laws. Similarly the unfairness associated with retrospective taxation would explain the need to make the tax law as precise as possible. First order rules of a legal system, like Constitutions for example, are, on the other hand, designed for longevity and that explains their design as standards as they are robust to obsolescence.

The difference between rules and standards is the amount of work required to be done in order to generate the content of the law before or after actors act.<sup>10</sup> Where the amount of work is less after the act, the directive is more likely to be a rule; when the work is more, the directive is more likely to be a standard. That being said, it is best to view the rules-standards universe as a continuum. Courts may over time develop exceptions to rules and they may morph into *de facto* standards. Similarly, the weight of precedent may *rulify* standards with the passage of time.

To summarize, rules have the following characteristics:

- They involve heavy *ex ante* information costs;
- They are cheaper to obey;
- They decide by offering a bright line solution in a sharp on/off manner.

Standards have the following characteristics:

- They involve *ex post* information costs;
- They are costlier to obey;
- They decide according to a balancing of competing considerations and facts.

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<sup>10</sup> Kaplow, *supra* note 2, at 559.

### III. THE DESCRIPTIVE CLAIM

Before we proceed further, I offer a brief narrative of the corporate governance regime in India.

The corporate governance regime in India, in its material respects, is governed by Clause 49 of the Listing Agreement.<sup>11</sup> The definition of independent directors is also found in clause 49.<sup>12</sup> The Listing Agreement is a sub-ordinate legislation enacted under the Securities Contract Regulation Act, 1956, that governs listed companies in India.<sup>13</sup> The Listing Agreement is enforced by the securities exchanges in India, as counter-party. Every public issuer undertakes to comply with the Listing Agreement. These also function as Self Regulatory Organizations and are generally structured as companies. The Securities & Exchange Board of India (SEBI), a body formed under the Securities & Exchange Board of India Act, 1992 is the principal securities regulator in the country, analogous to the Securities Exchange Commission in the US.<sup>14</sup> SEBI has power and duty under its statute to protect the interests of investors in securities and promote the development of and to regulate the securities market, as it thinks fit.<sup>15</sup> The securities exchanges and other securities market intermediaries are thus subject to the supervisory competence of SEBI.<sup>16</sup> SEBI therefore retains effective control over the Listing Agreement.

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11 Before the promulgation of Clause 49 as part of the Listing Agreement in 2000, corporate governance was almost non-existent in regulatory discourse of the country. See Afsharipour, *supra* note 1, at 355. See also Bernard Black and Vikramaditya Khanna, *Can Corporate Governance Increase Firms' Market Values: Evidence from India*, 4 (Univ. of Mich. Law Sch., Olin Working Paper No. 07-002, Oct. 2007), available at <http://ssrn.com/abstract=914440> (observing that before adoption of Clause 49, India was considered a laggard in corporate governance). Clause 49 ushered empowered audit committees, internal controls and compositional reforms on corporate boards. See Afsharipour *supra* note 1, at 374 (calling these reforms, "largest transformation of governance standards of Indian companies").

12 Clause 49 defines an independent director as a non-executive director who, *inter alia*, (a) apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its senior management or its holding company; (b) is not related to the promoters or management at the board level or at one level below the board; (c) has not been an executive of the company in the immediately preceding three financial years; (d) is not a partner or executive of the statutory audit firm or the internal audit firm that is associated with the company, and has not been a partner or executive of any such firm for the last three years. This will also apply to legal firms and consulting firms that have material association with the entity; (e) is not a supplier, service provider or customer of the company. This should include lessor-lessee type of relations also and (f) does not own 2 percent or more of voting shares. See SEBI circular SEBI/CFD/DIL/CG/1/2004/12/10 (Oct. 29, 2004), available at <http://www.sebi.gov.in/circulars/2004/cfdcir0104.pdf>. For discussion on Clause 49, see Afsharipour, *supra* note 1, at pp. 366-73 & nn.147-184.

13 See The Securities Contract (Regulation) Act, 1956.

14 See The Securities and Exchange Board of India Act, 1992.

15 *Id.* at 11.

16 For a detailed discussion on SEBI's role, see Afsharipour, *supra* note 1, at 356-358 & notes 88-107.

As we saw in the preceding paragraph, Clause 49 of the Listing Agreement defines *independent directors, ex ante*, in a manner as to exclude links, whether familial or financial, with the company, the management, the promoters and related parties.<sup>17</sup> This view assumes outsider status and disinterest as sufficient proxies for the independence of the director. It believes that by removing influences animated by financial interest and familial relations, true independence in the boardroom is achievable.<sup>18</sup> Animated by this desire, policymakers have strived to draw wider circles of exclusion trying to ensure that independent directors are chosen from a set of actors that is at arms length from the owner-managers. With each iteration, a fresh category of actors is excluded from being eligible to be appointed as independent directors.<sup>19</sup>

Proxies like absence of financial and familial interest are however, only a process or means to the goal of ensuring independent conduct by outside directors. More needs to be known before a director can be termed truly independent.<sup>20</sup> By equating mere outside status, characterized by absence of aforementioned ties, with the notion of genuine independence, the extant policy mistakes the process as the goal – that is to ensure genuinely independent conduct by the outside director-agent.<sup>21</sup>

#### A. An Agency Cost Explanation of Clause 49 and Its Structure

The regulator's choice of *ex ante* rules to define the expression, *independent directors*, in Clause 49 is a sign of shirking under the mask of eclecticism – I call it eclectic because as noted in Section I, the definition was drafted drawing upon elements of Anglo-Saxon corporate governance law. In

17 See *supra* note 12.

18 See Rodriguez, *supra* note 6, at 455 (observing similarly in the context of rules made under Sarbanes- Oxley Act and the NYSE/NASDAQ. As we saw, these bear a strong imprint on Clause 49. See Afsharipour, *supra* note 1, at 383).

19 Notice the amendment to Clause 49, effected from April 8, 2008 that made it mandatory to have half of the Board as independent if the non executive chairman of the Board was related to the promoter group or management. The earlier iteration mandated that only companies that had an executive director as the chair need have half of the Board independent. To avoid having half of the board as independent, companies now had to search for an “arm’s length” non executive chair; thus in the process adding another round of exclusion. See SEBI circular SEBI/CFD/ DIL/ CG/1/2008/08/04 (Apr. 9, 2008) inserting the proviso to 49(I)(A)(ii), available at [http://www.sebi.gov.in/Index.jsp?contentDisp=Section&sec\\_id=1](http://www.sebi.gov.in/Index.jsp?contentDisp=Section&sec_id=1).

20 These qualities include for example, the willingness to express dissent in a related-party transaction. It is a very good indicator of whether *relatedness* or affinity if any, is interfering with independent judgement. Indeed, it is difficult to define *independent directors* without involving a *standard-like* generality. See generally Victor Brudney, *The Independent Director — Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 598-99 (1982) (observing that the concept of independence does not carry a clear meaning for many of its proponents, making generality inevitable given that specificity is a function of *ex ante* information).

21 Some have called this tendency, *fetishization of independence*. See Rodriguez, *supra* note 6, at 451 (pointing out that requiring independence — defined as outsider status to the level of majority or supermajority, elevates a negative quality — lack of ties to management, to the status of positive virtue and thus fetishizes independence).

one sense, the *rule-bias* of the definition of *independent directors* in Clause 49 is owing to agency costs that regulators have imposed on their political principals – the lawmakers, and derivatively, the voters. *Ex ante* rules inform through boiler plate messages; they reduce costs of monitoring compliance because all the agents have to do is check boxes. Rules do away with deliberation altogether or to a substantial degree. Promulgation of rules is thus a beneficial choice when the regulator<sup>22</sup> is reluctant to incur monitoring costs. The fall out of all this is nominally independent directors who choose to rubber stamp the decisions of owner-managers and *Satyam*-like fiascos. This is because while rules are cheaply administrable (and impose negligible monitoring costs), rules are not robust to strategic action by actors.<sup>23</sup> *Satyam*<sup>24</sup> demonstrated that strategic actors, (like the promoters of *Satyam*) can easily circumvent these *ex ante* rules to appoint facially independent directors. Also, by promoting a check-box approach to regulation, rules *chill* regulatory incentives to detect strategic action.<sup>25</sup>

Further, as we saw above, corporate governance law in India, in its material respects, is governed by Clause 49 of the Listing Agreement – a delegated legislation effectively controlled by SEBI. The situation of corporate governance discourse in the regulator-controlled Listing Agreement lends credence to the agency cost explanation espoused here. By making Clause 49 – the metaphor for corporate governance in India, part of the Listing Agreement, SEBI retained the power to make changes in the corporate governance regime. At the same time, this measure considerably reduced any possibility of corporate governance being shaped through the objective medium of judiciary. Agency costs are imposed by empowered sectoral regulators like SEBI, if they are captured by dominant interest groups operating in that market. In any securities market, shareholders face an acute *collective action* problem,<sup>26</sup> and hence they are

22 The term is used here in a broader sense to include both regulators, properly so called and Self Regulatory Organizations like securities exchanges. Securities exchanges being companies themselves have perverse incentives to lightly monitor compliance as intense scrutiny might result in issuers choosing to list on another exchange. This will affect the revenues of these securities exchanges. Not surprisingly, enforcement is sub-optimal. See Afsharipour, *supra* note 1, at 388 (observing that compliance is weak and enforcement is lacking).

23 See Francesco Parisi and Vincy Fon, *On the Optimal Specificity of Legal Rules*, 18 (George Mason Univ. Sch. Of Law, Law & Econ. Research Paper No. 04-32, 2007), available at <http://ssrn.com/abstract=569401> (pointing out that greater specificity renders law more vulnerable to strategic action by individuals and firms).

24 See *infra* note 28 for the close connections that the promoters of *Satyam* had with the independent directors.

25 See, e.g., William Bratton, *Enron, Sarbanes-Oxley, And Accounting: Rules Versus Principles Versus Rents*, 24 (The George Washington Univ. Law Sch. Pub. Law & Legal Theory Working Paper No. 064, 2003), available at <http://ssrn.com/abstract=399120> (summarizing the problems commentators had with check-the-box system of GAAP rules in accounting as “auditors apply the rules mechanically, ignoring the substance of clients’ transactions”).

26 See generally MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* (1965).

unable to engage in concerted lobbying with the regulator. On the other hand, corporate insiders and securities intermediaries like securities exchanges have strong incentives to lobby the regulators for the type of law that suits them. The supply of regulation in corporate governance through the Listing Agreement reflects this theory of regulatory capture.<sup>27</sup> In the process, this policy imposes agency costs on the real beneficiaries of regulation – the outside investors. Other institutions like judiciary cater to diverse constituencies; the judges have security of tenure and post-retirement perquisites. Resultantly, judiciary is a more objective medium to articulate law. However, because the Listing Agreement is enforced by the securities exchanges as counter-party, the scope for judiciary to shape the corporate governance discourse has been minimal.

### *B. The Problem With Rules as Applied to Clause 49*

The Clause 49 understanding of the expression *independence* is under-inclusive because it does not include categories of persons that are related to the owner-managers through informal ties of friendship and familial affinity (who are nonetheless *not* related to the owner-managers within narrow meaning that the Companies Act gives the term, *related*).<sup>28</sup> It is inadequate because it

27 See Afsharipour, *supra* note 1, at 389 for evidence of how this capture leads to diluted enforcement (“within a few months of Clause 49’s effective date, SEBI had toned down its message” and quoting the then Chairperson, M. Damodaran stating “SEBI did not want an adversarial relationship with the listed companies”). This theory of capture is also evident on analysis of composition of Committees SEBI established, to propose a corporate governance framework. There was the Birla Committee and then the Narayan Murthy Committee. The present Clause 49 is a blend of the proposals of those two committees. Both the Committees almost exclusively comprised of representatives of the “issuer-regulator-self regulatory organizations” triad. See Report of the Kumar Mangalam Birla Committee on Corporate Governance (1999) Annexure 1, available at [http://www.sebi.gov.in/Index.jsp?contentDisp=Section&sec\\_id=3](http://www.sebi.gov.in/Index.jsp?contentDisp=Section&sec_id=3) (in a committee constituted to propose corporate governance reforms for the benefit of public retail shareholders, Mr. AK Narayanan of Tamil Nadu Investor Association was the sole voice representing them); See also Report of SEBI Committee On Corporate Governance Feb. 8, 2003, available at [http://www.sebi.gov.in/Index.jsp?contentDisp=Section&sec\\_id=3](http://www.sebi.gov.in/Index.jsp?contentDisp=Section&sec_id=3). The Murthy Committee had less than one-fifth of the total members representing investors. Out of a total of 22 members, Ms. Sucheta Dalal of The Financial Express, Mr. Manubhai Shah of the Consumer Education & Research Centre, Mr. Nitin Shingala of the Investor Grievances Forum & Mr. AK Narayanan of the Tamil Nadu Investor Association). On the theory of regulatory capture, see generally George Stigler, *The Theory of Economic Regulation*, 3 BELL J. OF ECON. & MANAGEMENT SCI. 3 (1971).

28 *Satyam* evidences the under-inclusivity of the definition of Independence in Clause 49. Vinod Dham, an independent director on the then Satyam Computers board, is a CEO of a venture-firm and a well-known figure in the computer technology sector. He was therefore clearly a repeat player with the owner-managers and came from the same epistemic community. The other independent director, M. Ram Mohan Rao was the Dean of Indian School of Business at Hyderabad, to which, later investigations revealed, Satyam CEO, Ramalinga Raju had made generous donations. Clearly therefore Mr. Rao was arguably  *beholden* to the owner-managers. See *SEBI Looking Into Satyam’s ISB Links*, 7th January, 2009, available at <http://ibnlive.in.com/news/exclusive-sebi-looking-into-satyams-isb-links/82093-7.html> (last visited September 24, 2009) (reporting that Satyam chairman Ramalinga Raju, who was on the executive board of Indian School Of Business has been making donations and contributions over time to the Business school and that SEBI was probing “in spirit” violation of corporate governance norms). They however were clearly independent within the meaning of Clause 49 showing its inadequacy in

fails to account for complex vectors like structural bias that may interfere with the objectivity of otherwise independent director.<sup>29</sup> Further, it fails to capture idiosyncratic variables like character, work ethic for example, that an independent director must possess to participate actively in supervising the management of firm.

Finally and perhaps most significantly, *rule-oriented* definition of independent directors results in a regime where firms truly dedicated to corporate governance cross-subsidize the agency-risks imposed by other firms who are merely compliance-driven. The present regime *ipso facto* precludes firms from recruiting independent directors from certain categories. Doing so, it inhibits promotion of deliberative shareholder democracy in corporations truly dedicated to corporate governance. This also potentially inhibits creation of shareholder value for these *good* firms. Firms dedicated to corporate governance might truly believe for example, that a related outsider, like a material supplier, has considerable firm-specific human capital (by virtue of the fact that he is a material supplier for a significant number of years for instance), and considerable incentives as counterparty to the issuer in being truly independent. It would therefore make good sense to have him on board to curb the risk-taking tendencies of the executive component of the board. In the rule-based regime however, he is *ipso facto* barred from being appointed as independent director. On the contrary, the under inclusivity of the framework gives ample room to free-rider owner-managers from *bad* firms to appoint nominally independent directors and subvert the purposes of corporate governance architecture by remaining compliant with the text of the law.

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accounting for soft ties and relations as well as structural bias that comes from being part of same epistemic community. Note that in similar circumstances, the Delaware Chancery Court found independence of outside directors on board of Oracle Corporation to have been compromised. See *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 920 (Del. Ch. 2003) (Delaware's contextual jurisprudence underscores the aptness of standard-oriented form for defining directorial independence that is the essence of this paper. Mangalam Srinivasan, a US based academician and TR Prasad, a retired civil servant officer were the other independent directors.) See TR Prasad, *Other Independent Directors Blame PwC*, THE ECONOMIC TIMES, 8th January, 2009, available at <http://economictimes.indiatimes.com/articleshow/3949689.cms> (last visited September 24, 2009) (identifying the independent directors and reporting their resignations). On the Satyam scam, see James Fontanella-Khan, *Timeline: The Satyam Scandal*, FINANCIAL TIMES, 7th January, 2009, available at [http://www.ft.com/cms/s/0/24261f70-dcab-11dd-a2a9-000077b07658.html?nlick\\_check=1](http://www.ft.com/cms/s/0/24261f70-dcab-11dd-a2a9-000077b07658.html?nlick_check=1) (last visited September 24, 2009). See generally on structural bias, Anthony Page, *Unconscious Bias and the Limits of Director Independence*, 2009 U. ILL. L. REV. 237 (2009) (arguing that Directors may have preferences even though they may not be consciously aware of them and that regardless of their good faith, unconscious cognitive forces will prevent directors' decisions from being unaffected by their preferences). Page points out that Delaware Courts have acknowledged the existence of structural bias. *Id.* at pp. 246 & nn. 57-61.

29 Structural bias is likely to promote group-think in the Boardroom. Group-think chills dispassionate deliberative discourse in the boardroom. Governance mechanisms should therefore aim for negating its influence.



#### IV. WHY INDEPENDENCE IS BEST DEFINED AS A STANDARD

Of course the argument that there are problems associated with the present rule-based regime does not *ipso facto* justify the inference that standards are better in defining independence. Accordingly, this section will argue why defining independence as standard is in consonance with economic analysis of independent director law and policy.

As legal economists like Louis Kaplow tell us, economic analysis of *rules versus standards* reveals that where disputes with homogenous fact matrices arise frequently, it is economically efficient to structure the form of legal directive as a rule. Thus a legal directive designed to punish speeding on a busy road is best structured as a rule as instances of application of the legal directive over it are likely to be more frequent. Promulgating the directive as rule will be cost-effective in such situations as the *ex ante* promulgation costs can easily be amortized over the number of disputes that arise frequently. On the other hand, when a wide variety of facts and combination of facts are relevant to the legal pronouncement, *ex ante* promulgation costs are inefficient as there may not be sufficient number of disputes *ex post* to amortize the costs of such *ex ante* promulgation. Therefore, in such cases, it is efficient to leave the facts to be determined on a case by case basis *ex post* as and when the disputes arise. In other words, the legal directive is best designed as a standard in such situations.<sup>30</sup>

Dispassionate objectivism, a value at the core of independence analysis, can be compromised by so many facts and factors beyond the reductionist constructs of the human being that it is very likely that the reason why an outside director is interested/non-independent in one case is different than why some other director appears disinterested/non-independent in other case.<sup>31</sup> Some outsiders are beholden to the owner-managers because the latter chose them; others are affiliated to charities that CEOs donate to and there are still others that merely have similar cultural anchors. Behavioral analyses also reveal that individuals may be influenced by variety of heuristics and biases beyond self

<sup>30</sup> See Kaplow, *supra* note 2, at 564.

<sup>31</sup> See, e.g., *In Re Oracle Corp. Derivative Litig.* 824 A.2d 917 (Del. Ch. 2003) in which Vice-Chancellor Strine examined the diverse links between the defendant Larry Ellison and the independent directors on the committee formed to determine the prosecution of derivative suit against Ellison, both of whom were tenured academics at the Stanford University. Strine examined Ellison's charity to SIEPR, the Stanford promoted think-tank, of which they were senior fellows, the personal links that Ellison had with one of the independent directors, the fact that one of the co-accused with Ellison had been a supervisor to one of the independent directors during his graduate work at Stanford and the *Rhodes-like* endowment that Ellison was contemplating for Stanford University at that time to be relevant factors in determining whether independence of the directors on the committee was compromised. Strine further also alluded to the social ties between the independent directors on the committee and the defendants and said they might play a role in the court's analysis implying he may even countenance structural bias as an issue



interest and rational choice.<sup>32</sup> These biases, (especially norm compliance), are more likely to be material when the entrepreneurial class comprises of closely-knit social groups, as is the case in India. In so far as directorial behavior is characterized by diverse preferences beyond the (*homo economicus*) default rule, my normative claim is consistent with the *Kaplowean* thesis.

### A. Locating the Standard-like Definition

At this point, it is also material to consider the location of the *standard-like* definition. This reform should be imposed through primary legislation rather than through delegated devices like the Listing Agreement. This is necessary in the light of regulatory capture concerns articulated earlier. Legislatures supply law to a diverse, wider set of consumers. Moreover, lawmakers are drawn from a diverse set of sectors/professions, unlike regulators, who are likely to have only (financial) sector-specific skill sets.<sup>33</sup> Finally, lawmaking at the legislature has the benefit of open, oftentimes lengthy, deliberation. To borrow from Brandeis J. in a related context,<sup>34</sup> this *sunlight* is likely to deter lawmakers from supplying private goods under the garb of public goods. An additional hedge is bicameralism at the parliamentary level, a Bill is thus read three times in Parliament before it moves to the President's desk for her assent. In contrast, delegated lawmaking can be discrete – in fact, so discrete that even practitioners find it troublesome to keep track of new promulgations.<sup>35</sup> Delegated lawmaking thus occurs in an atmosphere that is particularly conducive to capture/bargains. All these factors suggest that legislatures are relatively less likely to be captured by repeat players in the capital markets and hence provision in the legislation is likely to be a better alternative to regulating corporate governance.

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relevant to determination of independence. In other cases, for e.g. *Beam ex rel Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961, 979 (Del. Ch. 2003), the court noted that some professional or personal friendships, can exceed family loyalty and may raise a reasonable doubt about independence. CEO's brother-in-law (*Harbor Financial Partners v. Huizenga*, 751 A.2d 879, 889 (Del. Ch. 1999)) grandfather-grandchild, (*Mizel v. Conelly*, No. CIV.A. 16638, 1999 550369, at 4 (Del. Ch. Aug. 2, 1999)) tutor to the ward of the interested executive, (*In Re Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 359 (Del. Ch. 1998)) are other relationships that have been claimed to prejudice independence.

32 See Russell Korobkin, *Behavioral Analysis And The Legal Form: Rules Versus Standards Revisited*, 79 OR. L. REV. 23, 44 (2000).

33 Because they have more specific skill sets, regulators are more likely to find post-tenure employment in the same sector. This post-employment prospect among regulatory personnel may have perverse effects incentivizing regulatory capture *ex ante*.

34 Describing the purpose of publicity in 1913, he said: *Sunlight is the best disinfectant*, implying that the obligation to disclose all material information to the public will deter fraud in the capital markets. See, LOUIS BRANDEIS, *OTHER PEOPLE'S MONEY — WHAT PUBLICITY CAN DO* (1914), available at <http://www.law.louisville.edu/library/collections/brandeis/node/196>.

35 A case in point is the maze of press notes issued by the Udyog Bhavan in the context of Foreign Exchange Management Act, 1999 that has often confounded practitioners, including yours truly.

### V. REDEFINING INDEPENDENCE AS A STANDARD

Academic discourse advocating principles-based regulation of independence has *inter alia* suggested learning from the contextual law of Delaware and other states.<sup>36</sup> Unlike the rule-based approach of Clause 49, Delaware for example, takes a more nuanced, contextual approach towards the conception of directorial independence. There is no *ex ante* definition of *independent directors/independence* under Delaware law. Rather the Delaware judiciary examines whether a putative independent director was genuinely independent in a particular transaction, *ex post* in light of all the existing relevant facts.<sup>37</sup> I agree with that discourse and build on it in this part. Taking cue from these suggestions, I construct a model definition of independence in this segment and define the expression *independence* in terms of standards rather than rules. More specifically, I argue in favor of re-defining *independence* in terms of the Cadbury Commission Report.<sup>38</sup>

Before we proceed, a brief introduction to the Cadbury Commission is in order. In 1991, the Financial Reporting Council, the London Stock Exchange and the Association of Chartered Certified Accountants – the British chartered accountancy body – formed the *Committee on the Financial Aspects of Corporate Governance*. Chaired by Sir Adrian Cadbury, the Committee considered board composition and responsibilities, the role and position of audit committees, as well as other issues relating to financial reporting and accountability. The Committee published a report commonly known as the Cadbury Report.<sup>39</sup> In the process, the Cadbury Report also articulated a definition of the expression, *independence* in the context of outside directors: *Apart from their directors' fees and shareholding, they should be independent of management and free from business or any relationship which could materially interfere with the exercise of their independent judgement.*

Seen through the *rules-standards* prism, the definition of *independence* articulated by the Cadbury Report is *standard-like*. The Cadbury report therefore provides a good model for the definition designed as standards.<sup>40</sup> Notice that the definition imposes significant *scier- costs* on the actors *ex ante*; the contours of what *independence of management* means is left open for the actors to determine. Similarly the expression, *any relationship which could*

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36 See Rodriguez, *supra* note 6.

37 *Id.* at 464-66.

38 REPORT OF THE COMMITTEE ON FINANCIAL ASPECTS OF CORPORATE GOVERNANCE (1992), available at <http://www.ecgi.org/codes/documents/cadbury.pdf> [hereinafter Cadbury Report].

39 Afsharipour, *supra* note 1, at 379.

40 Cadbury Report, *supra* note 38, at para 4.12 (recommending that majority of non-executive directors should be independent of the company and then articulating the meaning of the expression, independence).

*materially interfere with the exercise of independent judgement* includes within itself ties that arise because of close friendships or the like, while at the same time allowing the issuer to adduce reasons why it thinks that a *prima facie* non-independent director is nonetheless independent, because the relationship is not such as could materially interfere with the exercise of her independent judgement. Since, the Cadbury report was one of the first attempts to codify the definition of expression *independent directors*, it made sense to extract the *value of vagueness*<sup>41</sup> by dispersing the costs of promulgation rather than incurring significant information costs upfront.<sup>42</sup> The latter limb, *any other relationship* is again left open ended and construed *ejusdem generis* to the more particular form of words used earlier, covers persons with familial links that are not otherwise related to the management of the Company and persons with links to the Company, its subsidiary or its promoters. Thus, the Cadbury Report articulation is a goal-oriented definition rather than process-oriented definition. It excludes persons having any relationships including pecuniary relationships from being independent directors if the impact of that nexus is such as would interfere with the independence of judgement. A *standard-like* articulation will allow the courts to scrutinize and punish imposition of agency costs by nominally independent directors, *ex post*.

Also, uncertainty can be valuable from a social perspective. Gillian Hadfield illustrates this point by giving an example of community of shepherds:<sup>43</sup> A group of shepherds is contemplating migration to new grazing lands. Suppose there are two routes. The shepherds know that wolves will kill all the passing sheep on one of these routes but do not know on which route. So, they send a scout to observe the wolves and predict the safer group. The scout observes and predicts that one route has 70% chance of having wolves on it while the second route has a 30% chance, when the group passes. If the scout communicates his signal in a deliberately ambiguous way, some sheep will stray and take the wrong route. Their non-arrival can generate a sufficiently strong signal as to the safe route and the community can learn from it.

In a similar way, at the regulator level, a *standard-like* definition would give a chance to witness a range of behavior by the issuers in appointment of independent directors. Like the shepherds' herd in Hadfield's example, since some sheep (read: issuers) might stray and appoint directors that are found to be nominally independent *ex post* by courts, studying the nature of affiliation

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41 See Hadfield, *Weighing The Value Of Vagueness: An Economic Perspective On Precision In The Law*, 82 CAL. L. REV. 541, 546 (using the expression, value of vagueness).

42 Notice that legislation in most contexts follows a similar pattern, from standards to rules. For example, the earliest *applicable law* was *justice, good conscience and morality* and indeed even after the advent of the *Benthamite* revolution, Judges continued to fill the lacunae by deciding cases on those broad principles.

43 Hadfield, *supra* note 41, at 548.

that led the courts to hold them non-independent, will, with the passage of time, give the regulator sufficient information to collect a list of proxies that may act as signaling devices.

## VI. POSITIVE EXTERNALITIES

### A. *The Directors' & Officers' Liability Insurance Market*

The low information-costs associated with the presently prevalent *rule-based* prescription coupled with the little or no risk of *ex post* personal liability of the Directors<sup>44</sup> has had a considerable chilling effect on the market for Directors' & Officers' (D&O) liability insurance. At present, securities law in India does not require listed firms to purchase a D&O liability cover for its directors and the risk premium is as low as 0.5% of the total insurance cover.<sup>45</sup> A *standard-like* conception of independence will generate a robust and long-term D&O liability insurance market for independent directors. At the directorial level, the probability of *ex post* liability brings with it, the concomitant risk of losses in reputation markets.<sup>46</sup> Risk-averse outside directors will therefore demand that issuers purchase D&O insurance as a condition for serving on their boards.

Empirical studies focused on how liability insurers transmit and transform the content of corporate and securities law suggest that insurers seek to price D&O policies according to the risk posed by the prospective insured and that they focus on corporate governance in assessing risk.<sup>47</sup> They find that insurers weigh in deep governance factors like character, loyalty, executive compensation rules, inorganic growth plans through mergers and acquisitions and gather risk-assessment data through devices like "underwriters' meetings" that makes their assessment factor in data not covered by formal proxies like financial and familial

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44 This may be traced to the collective action problem, in turn caused by the diversified holdings of institutional investors like Mutual Funds. The ready liquidity in the securities exchanges provides the ease of exit that has a chilling effect on the incentive to monitor proactively by seeking judicial recourse. Ironically enough, it is the Mutual Fund (Regulations), 1996 that mandate a diversified portfolio for mutual funds for prudential concerns. This mandate however is at counter purposes to the aim of promoting corporate governance, at least in so far as it may be achieved through institutional shareholder activism.

45 Aman Dhall, *SEBI May Make D&O Liability Must For Listed Cos.*, THE ECONOMIC TIMES (Mumbai), April 19, 2009, available at <http://economictimes.indiatimes.com/News/News-By-Company/Corporate-Trends/SEBI-may-make-DO-liability-insurance-must-for-listed-cos/articleshow/4419041.cms>.

46 The new Companies Bill, 2009 proposes to have a class action mechanism. The Class action law increases the risk of *ex post* personal liability for independent directors. See section 216 of The Companies Bill 2009, available at [http://www.mca.gov.in/Ministry/actsbills/pdf/Companies\\_Bill\\_2009\\_24Aug\\_2009.pdf](http://www.mca.gov.in/Ministry/actsbills/pdf/Companies_Bill_2009_24Aug_2009.pdf).

47 Baker & Griffith, *Predicting Corporate Governance Risk: Evidence From the Directors' & Officers' Liability Insurance Market*, 74 U. CHI. L. REV. 487 (2006).

ties with the owner-managers.<sup>48</sup> The significance of this interaction is that the insurance intermediary will have, in its possession, certain *soft* variables that may generate agency costs, which will factor in the premium payable by the issuer. (*Inter alia*, these may include factors like structural bias, character, *beholdenness* towards the owner-managers, motive behind assuming independent directorial post and commitment to the cause). If the premium and other details of the D&O liability insurance that they purchase for the independent directors are *communicated* to the stakeholders in the securities market, it will improve capital market efficiency through the signaling effect provided by these details.<sup>49</sup> This disclosure will signal capital and corporate control markets and subject issuers with high agency costs to capital market discipline.

After the regulator mandates that all issuers ought to disclose the premium payable on the D&O liability insurance they have bought and other details about the same, the securities exchanges may set up specific ceilings for premium payable based on the industry of the issuer concerned and subject the issuers that breach that ceiling to penalties including mandatory delisting etc.<sup>50</sup>

### B. Deliberative Lawmaking Process

As we saw in Section IA, rules govern through boiler-plate messages. They therefore inhibit the *social construction* of the law. Rules are likelier therefore to suffer from democratic deficit as (being rigid), there is not much possibility of reading into them *ex post*, the voices of insular minority stakeholders that are left out *ex ante*. Standards, on the contrary, correct the democratic deficit, by allowing courts to read into the law *ex post*. Also, when independence is defined as a standard, boards, their attorneys, the securities regulator, courts, institutional shareholders, retail shareholders, media, investor-protection non-profits, all will deliberate upon construction of the phrases used in the context of facts that arise from time to time and communicate that understanding. Over time, the judiciary will clarify the contours of proxies that define true independence. This declaration by the judiciary will potentially internalize all these voices that make up the social construction of the expression. Although this mode of lawmaking is *noisy*, it has the twofold virtue of being much more

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48 *Id.* at 511, 513.

49 Sean Griffith, *Uncovering A Gatekeeper: Why The SEC Should Mandate Disclosure Of Details Concerning Directors' And Officers' Liability Insurance Policies*, 154 U. PA. L. REV. 1147, 1207.

50 Indeed when Clause 49 was included in the listing agreement, the then SEBI Chairman M. Damodaran articulated regulator's plans to enforce compliance with Clause 49 through the sanction of delisting. However, the regulator later diluted its stand in part, because of the "problems that delisting might subject the investors to." See Afsharipour, *supra* note 1, at 389. Under the present Delisting Guidelines, delisting is not *ipso facto* and mandatory. The securities exchanges retain discretion to decide on delisting. See SEBI (Delisting of Securities Guidelines)-2003, clause 15.1, clause 15.2 & Schedule III, available at <http://www.sebi.gov.in/guide/guide2003.pdf>.

democratically enriched and ensuring true independence, albeit in an incremental, iterative process. Further, as we saw in Section III, *rule-like* drafting might itself be the result of regulatory capture and agency costs imposed by the regulator. *Standard-like* drafting ensures that no vested constituency hijacks the lawmaking process because norms are articulated *ex post* by the judiciary—an institution that is relatively less subject to capture.

## VII. A REBUTTAL OF SOME IMPORTANT COUNTER-ARGUMENTS

A possible counter-argument to the claim that the expression *independence* ought to be defined as standards is that an uncertain definition will create incentives for out of court settlement by the respective parties.<sup>51</sup> If this happens, socially optimum number of precedents may not be created by courts/tribunals so as to clarify the true scope and purport of the expression, independence, and the law will remain in flux for too long a time to be socially beneficial. However, behavioral analysis of legal forms has revealed that standards promote the self serving bias. Self-serving bias will incentivize self serving constructions of ambiguous fact matrices. Thus standards may be said to catalyze litigations as the shareholders will construe the open ended definition of independence to suit their own constructions.<sup>52</sup> It is unlikely therefore that the chilling effect will occur. One qualification to this statement may be in order: The self serving bias may promote a lot of suits/proceedings to be filed by shareholders; but once the parties subject the entitlement (the entitlement here will be the claim to the damages that the plaintiff/petitioner believes she has a right to, for fiduciary breach by the independent director for non-independent conduct) to judicial forces beyond their control, the petitioner may feel less endowed about the entitlement depending upon how the litigation process unfolds. The feeling of being less endowed after the proceeding/suit is filed may catalyze a settlement while the proceeding/suit is pending. This may generate a liquid and efficient market in entitlements; but the same will come at a social cost in that less number of precedents may be created. Such settlements after the commencement of litigation can however be easily controlled by the law by

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51 See Jason Scott Johnson, *Bargaining Under Rules Versus Standards*, 11 J. L. ECON. & ORG. 256, 257 (1995) (stating that the credible taking threat created by *ex post* balancing test can induce an equilibrium involving immediate agreement, using the landfill-resident illustration); See also Ian Ayres & Eric Talley, *Solomonic Bargaining: Dividing A Legal Entitlement to Facilitate Coasean Trade*, 104 YALE L. J. 1027 (1995) (arguing that a standard will create incentives for the parties to reveal private information and hence an agreement may be more readily reached under the shadow of standards).

52 See Korobkin, *supra* note 32, at 46-47 (Discussing self-serving bias and inferring that standards will lead to more litigation). While it is true that Korobkin also posits that standards promote efficient trades, he also qualifies his assertion controlling it for the effect of self-serving bias conceding that self-serving bias will replicate the endowment effect of a rule-like regime making attainment of equilibrium difficult even in a standard-like setting. See *id.* at 51-53. Note that self-serving bias is also a function of the manner in which litigation unfolds. As the litigation progresses, self-serving bias is likely to be progressively depressed.



proscribing the settlement of fiduciary breach claim against the directors or making the settlement of such claims subject to the discretion of the court/tribunal. That will chill the market for entitlements and ensure socially optimum number of precedents is generated. In any event, as pointed out in Section VIA, the uncertainty induced by a *standard-like*, open ended definition will catalyze the D&O liability insurance market that will provide vital signals to the capital markets.

Firms where agency risk (*inter alia*, this may be because of the interested status of the independent directors on board) is high will have their securities traded at depressed prices and may even have their management taken over, in some cases. Now the possibility of the underwriter inferring the extent of agency risk incorrectly is extremely limited. The underwriter has seen first hand, attributes of the CEO hiring a given independent director, the attributes of the corporation, its links with the independent director to be appointed and the independent director herself. Most importantly, the D&O liability insurer has strong incentives to scrutinize all the proxies that may be held to interfere with the judgment *ex post*. This is because if courts/tribunal eventually hold that the directors were interested or otherwise had their independence compromised, it is the D&O liability insurer who will foot the bill. So, the underwriter will know if the outside directors are only apparently independent persons. It is unlikely therefore that the signal that D&O liability insurers communicate to the capital markets will be flawed. The D&O liability market will hedge against sub-optimal *precedent-creation* that could be one negative fall out of a *standard-like* directive defining independent directors. A positive determination by courts on merits therefore, while certainly desirable, is not the only way of disciplining errant boards with *box-tick* independence.

But invocation of self-serving bias leads us to another issue: if standards promote self-serving bias, the *standard-like* definition of *independent directors* should affect actions of the board, *ex ante*, at the time of appointing outside directors and lead them into believing that their nominees are *de facto* independent. Will this give rise to (implicit) opportunism by insiders *ex ante*? It is unlikely however that this will happen. The *ex post* threat of class actions and capital market discipline as also risk-averse outside directors, taken together, would have a *de-biasing* effect on self-serving perceptions.

Another counterargument against open ended standard definitions is that such definitions are likely to create supply-side concerns in the independent director market. It is said that uncertainty will induce extreme risk-averse conduct (over-deterrence) with the result that firms will only look to recruit *arms-length* directors and shun directors that have even a semblance of ties with the management and the issuer. This will make independent directors, a scarce(r) resource and raise the cost of hiring independent directors. This argument misses



the fact that these concerns equally arise in the context of *rule-like* definition of independence.<sup>53</sup> Each iteration adds a fresh category of persons to the excluded list. Such *ipso facto* and blanket exclusion should in fact invoke more supply-side concerns than ones associated with open-ended definition. In rule-oriented framework, firms who genuinely believe in the independence of a related outside director have no opportunity to justify their choice before objective fora like courts. A *standard-like* definition, on the other hand, allows a wide autonomy to the corporation in appointing its independent directors. Far from creating supply-side concerns in the independent director market, a *standard-like* definition of independence eases those concerns for the *good* firms who genuinely believe in independence of their related outsiders (and who will therefore justify their belief before D&O underwriters, shareholders and the courts). It is true that boards will be much more wary while appointing directors and may incur costs by investing in legal advice and buying D&O insurance to retain talented personnel with them. However, it is unlikely that these premiums will be substantial for genuine issuers and will hardly add to their cost. So, conceding that uncertainty will add to the cost of issuers, these costs will only be substantial for firms having high agency-risk; and that of course is entirely justifiable.

Finally, it may be argued that a *standard-like* definition of independence will add to the cost of *learning the law*, for issuers. Indeed, economic analysis reveals that standards are costlier to comply than rules.<sup>54</sup> However that is not always the case. As behavioral analysts have shown, standards that require adjudicators to judge citizens' actions on the basis of whether those actions comply with community norms might require even less effort for citizens than would be rules.<sup>55</sup> The institution of independent directors and the object it seeks to achieve has decided fairness underpinnings – a norm which actors may easily understand. In so far as fairness is easily assimilated concept, the argument that a *standard-like* construction of the definition will be costlier to comply than a rule-based definition requires further investigation. Secondly, the present Clause 49 is a complex rule in the rules-standards binary not a pure one.<sup>56</sup> A complex rule, because of the severity of factors involved, is a standard masquerading as a rule.<sup>57</sup> The increase in cost of compliance in a regime where

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53 See Somasekhar Sundaresan, *Independent Directors Do Not Grow On Trees*, BUSINESS STANDARD, Mar. 22, 2007, available at <http://www.business-standard.com/india/news/independent-directors-do-not-growtrees/278528> (arguing that it was time to address supply side for independent directors and criticizing amendments to Clause 49 that creates these concerns).

54 See Kaplow, *supra* note 2, at 569.

55 Korobkin, *supra* note 32, at 35.

56 The difference between a complex rule and a simple (pure) rule is that while the latter is a relative scalar, the outcome whereof depends only upon one factor, the complex rule is a relative vector where the outcome depends upon a variety of factors.

57 Notice the references to *standard-like* expressions like *material* in some sub clauses of Clause 49, *supra* note 12.

independence is defined as a pure standard (as for example is the case with the model I propose in this paper), would be marginal, if at all.

### VIII. CONCLUSION

This paper argues that a rule-oriented definition of *independent directors* is under-inclusive and suffers from democratic deficit. Worse, as it disqualifies desirable persons from being appointed as directors, it could be destructive of shareholder value. It argues, placing reliance on the economic analysis of independent director and policy, that standards are the more appropriate legal form for defining independence. This paper proposes a *standard-like* definition of independence. It demonstrates that regulatory capture has diluted both the supply and enforcement of corporate governance law at the regulator-level, and argues that the aforementioned reform ought to be introduced through primary legislation. It proposes that this structural reform will catalyze the D&O liability insurance market and unlock a hitherto dormant gatekeeper in the form of the D&O liability insurer. It seeks to demonstrate that none of the arguments against having an indeterminate *standard-like* definition for independence are strong enough not to adopt a regime of pure standards defining independence.

Law and economics scholars have for long, applied their tools to appreciate and propose solutions to vexed issues in corporate governance and practice. The debate surrounding directorial independence is one such issue. The economics of standards-induced uncertainty may well be the Holy Grail that solves the directorial independence conundrum, particularly the strategic action problem that leads to insiders appointing their cronies as independent directors.

In fact, if policymakers introduce changes in the incentive structure in the legal services market that align the interests of lawyers and petitioner-shareholders, *ex ante* standards in substantive law and *ex post* risk of class actions will make this model even more effective.

Finally, though the focus of this essay is India, the argument that it makes against rule-oriented definitions of independence and for *standard-like* definition is applicable more generally. Indeed, the paper is a response to and in furtherance of the insight inviting attention to Delaware's contextual jurisprudence of directorial independence and comparing it with (*federalized*) rule-oriented norms implemented in the US and extolling the merits of the former approach.<sup>58</sup> The argument made in favor of *standard-like* definitional reform in the paper holds true especially in the United States, which has (regrettably) witnessed a movement towards rule-oriented norm-making in corporate law and governance.

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58 See Rodriguez, *supra* note 6.

## ESSAY

# REFUSE TO CHOOSE: THE ROLE OF METHODOLOGICAL PLURALISM IN THINKING ABOUT LAW AND ECONOMICS IN INDIA

*Bikku K. Kuruvila\**

*“I...have ropes around my neck, I have them to this day, pulling me this way and that, East and West, the nooses tightening, commanding, choose, choose. I buck, I snort, I whinny, I rear, I kick. Ropes, I do not choose between you. Lassoos, lariats, I choose neither of you, and both. Do you hear? I refuse to choose.”<sup>1</sup>*

## I. INTRODUCTION

The inaugural issue of an Indian journal on law and economics offers productive opportunities to reflect on the discipline, open new lines of inquiry and frame terms of discussion moving forward. Opening moments offer important chances to understand critical paradigms assess intellectual needs and suggest new ways of understanding the world.

What, then, is law and economics? In simple terms, the field is understood as the economic analysis of law. Writing in 1975, Richard Posner defined the field as:

the application of the theories and empirical methods of economics to the central institutions of the legal system, including the common law doctrines of negligence, contract, and property; the theory and practice of punishment; civil, criminal and administrative procedure; the theory of legislation and of rulemaking; and law enforcement and judicial administration.<sup>2</sup>

Henry Manne, Dean Emeritus of George Mason University School of Law and another founding father of the discipline, adds that core tools would include such standard apparatuses as demand elasticity, economic cost concepts (including opportunity cost), production functions, property rights (the economic, not the traditional legal concept – that is, the objective characteristics of “ownership”), transactions costs, the nature and formation of market prices, competition and monopoly, theory of the firm (old and new varieties), public-choice theory, and the rudiments of quantitative methods, including statistics, finance and accounting.<sup>3</sup>

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\* Senior Consultant, National Institute of Public Finance and Policy.

1 SALMAN RUSHDIE, *EAST, WEST: STORIES* 173 (1995).

2 Richard A. POSNER, *The Economic Approach to Law*, 53 *TEX. L. REV.* 757 (1975).

3 Henry G. Manne, *The Judiciary and Free Markets*, 21 *HARV. J.L. & PUB. POL'Y* 11 (1997).

What, then, is Indian law and economics? While the level of development of the country's economy and reach of the state have been, and are, debated at length, aside from practitioner publications on issues of commercial law, Indian legal scholarship appears to be intermittently developed and dependent upon the efforts of talented individual scholars; notwithstanding studies of law and the economy or the application of economic methods to Indian law.<sup>4</sup> Individual pieces exist assessing various commercial regimes,<sup>5</sup> though these efforts do not seem to form a part of a broader body of scholarship. Furthermore, the emergence of such scholarship does not seem likely in the absence of an institutional basis or incentive structure to suggest that such literature would develop.<sup>6</sup>

In a negative and normative sense, what Indian law and economics should not be, is also clear. Without elaborating at length, an authentically Indian approach to law and economics seems no more desirable or possible than an authentically Indian chemistry or physics. That a law and economics scholarship grounded in Indian institutional, social, economic, historical, and political realities would have distinct concerns and flavors appears similarly unremarkable. To say, for example, that law and economics studies of the SEBI Act of 1992 would provide different findings than similar studies of the U.S. Securities and Exchange Act of 1934 is, on an obvious level, banal and does not further our understanding of legal institutions in any great depth.<sup>7</sup>

As I will elaborate in subsequent sections, law and economics has developed distinct "ways of thinking" (to quote Richard Posner) that are by definition interdisciplinary and intellectually productive. Law and economics

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4 See generally, BIBEK DEBROY, *IN THE DOCK—ABSURDITIES OF INDIAN LAW* (2000) (One of many books by noted economist and scholar on Indian law); Website of Upendra Baxi, [www.upendrabaxi.net](http://www.upendrabaxi.net) (listing the papers of this eminent human rights lawyer).

5 See Haitian Lu, Hong Huang & Swati Deva, *Unraveling the Puzzle of Differing Rates of FDI & FVCI in India & China*, 4 *ASIAN JOURNAL OF COMPARATIVE LAW* (2009); John Armour & Priya Lele, *Law, Finance & Politics: The Case of India* (ECGI Working Paper Series in Law, Working Paper No. 107, 2008); Raffiq Dossani & Martin Kenney, *Creating an Environment: Developing Venture Capital in India* (BRIE Working Paper No. 143, June 6, 2002); Afra Afsharipour, *Corporate Governance Convergence: Lessons from the Indian Experience* (UC Davis Legal Studies Research Paper Series, No. 81, June, 2009).

6 Reasons for the relative lack of institutional development of Indian legal or Indian financial legal scholarship could lie in the relative privileging of other fields such as economics post-Independence to the development, only in recent decades, of national law schools with the ability to produce high grade law graduates on a more systematic basis as well as the rise in social status of the legal profession, though these conjectures are quite speculative and require further investigation. See, Indian Corporate Law Blog, <http://indiacorplaw.blogspot.com/> (With varying contributors, offering timely discussions of the rulings of key tribunals). Hopefully, the initial publication of the Indian Journal of Law and Economics signals a greater interest in and trend towards deeper and more diverse legal writing in the country going forward.

7 Though a more thorough comparative study of the legal regimes created by these two acts, the ways that they might shape and be shaped by social, commercial forces, could no doubt be of great interest to those interested in the Indian subcontinent.

has also inspired many applications of the field methods and core premises to new areas of inquiry.<sup>8</sup> Yet, to fix the boundaries of the field (in India or elsewhere) would come at significant intellectual cost. Our understanding of “what counts” in the field should be dynamic. As I explain in more detail below, in extending law and economics to the Indian context, scholars and practitioners should not lose sight of the productive possibilities of reading different disciplines together. Through the very act of juxtaposing multiple bodies of knowledge, scholars foreground and question fundamental assumptions about any given body of knowledge. In doing so, legal theorists can tease out, frame, and realize a deeper sense of context and understanding of the workings of legal institutions and processes as well as social and commercial forces in the subcontinent.

I argue, on a very general level, that those interested in law and economics, in the Indian context, should explore a broad variety of fields to understand the complex interactions of law, legal processes and institutions, and socio-economic relations. In particular, I emphasize the role of history as a useful example of disciplinary endeavors that would supplement, broaden, and enrich our understanding of these interactions. Fields from behavioral finance to legal and political science scholarship about institutional design would also add to inquiries about legal processes, institutions, and society. I also use case studies involving issues of regulatory design and Indian financial law to illustrate the intuitive, though perhaps under-theorized and less-appreciated value of these approaches. While this paper does not attempt a comprehensive inventory of the extensive number of fields that could be brought to bear on studies of law and economics and India, the act of reading together key themes and trends can suggest informative ways of looking at the law, its institutions, doctrines, texts, and practices, in the subcontinent (and beyond). Rushdie’s whimsical quote is a paean to cultural ‘hybridity’ and the many influences on a traveler, though the line, as with much of Rushdie’s work, references somewhat older, broader, and more complex debates in the social sciences about interdisciplinary work and the production of knowledge.<sup>9</sup> For purposes of this discussion, somewhat aside from the original reference to East and West, Rushdie’s injunction can be seen as a serious warning against remaining within the disciplinary confines of any mode of study. Applied to methods and an understanding of the law, Rushdie’s words are instructive; refuse to choose.

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8 Posner, *supra* note 3, at 779-782. Perhaps surprisingly, Posner offers a somewhat qualitative or less mechanistic definition of the field as a way of thinking and a “knack for looking at things a certain way.”

9 See HOMI K. BHABHA, *THE LOCATION OF CULTURE* (2004); *COSMOPOLITANISM* (Carol A. Breckenridge, Sheldon Pollock, Homi K. Bhabha & Dipesh Chakrabarty eds., 2002); SALMAN RUSHDIE, *SATANIC VERSES* (2008) (arguably referencing academic debates in history, sociology, anthropology, philosophy, linguistics and literature in the late 1980s and 1990s about the social construction of identities, cultural hybridity and revisionist approaches to history).

## II. LAW AND ECONOMICS: WHAT IS IT? WHAT HAS IT INSPIRED?

Attempts to develop law and economics in India must of necessity engage with existing versions of the field. Extensively, though not exclusively, developed in the U.S., law and economics offers a developed body of knowledge to guide initial forays of the discipline in a new regional context, that is, the Indian one. Despite being formed in the context of different legal systems with different histories, cultural assumptions, and political processes, law and economics offers developed analytical tools to start the analysis of legal institutions in India. Given the paucity and lack of systematic development of legal scholarship in the country, critical dialogue with extant variants offers important starting points and tools to define what law and economics could mean in India. Hopefully, deep studies of law and economics in Indian contexts can enrich it as well as general legal studies beyond India.

### *A. Method*

Law and economics can be understood through methodology. Richard Posner divides the field into two broad forms. One, an older and more literal understanding of law and economics, would simply apply principles of economics to explicitly economic areas of regulation; antitrust, trade, corporations and labor law, taxation, securities regulation and corporate finance.<sup>10</sup> These involve regulations grounded in conventional principles of economics. The role of economics in ordering such regulation is perhaps straightforward and uncontroversial. Second, as suggested above, is the economic analysis of law writ large, the extension of economic analysis to a range of non-market behavior: from doctrines of negligence and legislation to criminal law and legal procedure, social discrimination, gender relations and even charity and love.<sup>11</sup> Economic approaches to law assume that those involved in the legal system act as rational maximizers of their preferences,<sup>12</sup> while the doctrines, procedures and institutions of the legal system would be organized or assessed in the light of promoting economic efficiency and the efficient allocation of resources.<sup>13</sup> Economic analysis is helpful in designing reforms to legal rules, processes, and institutions,<sup>14</sup> just as quantitative studies of legal systems in presenting these institutions in broader,

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10 Posner, *supra* note 3, at 757-59, 779.

11 *Id.* at 759, 761-63.

12 *Id.* at 761.

13 *Id.* at 763-64. Posner writes that the “rules assigning property rights and determining liability, the procedures for resolving legal disputes, the constraints imposed on law enforcers, methods of computing damages and determining the availability of injunctive relief — these and other important elements of the legal system can best be understood as attempts, though rarely acknowledged as such, to promote an efficient allocation of resources.”

14 *Id.* at 764-65.

more systematic contexts allow productive assessments of their functioning.<sup>15</sup>

### *B. Analysis*

What insights do law and economics frameworks direct us towards? Invoking Posner, Anthony Ogus reminds us that law and economics provides important positive or interpretive, not simply normative, observations about the world.<sup>16</sup> Ogus argues that the purchase of law and economics on legal scholarship, notwithstanding controversy over the theoretical basis and methodological dimensions of the field,<sup>17</sup> can be understood in the sense that the field “is seen as making a major contribution to the traditional central task for legal scholarship, promoting coherence and systematic orderliness in the law.”<sup>18</sup>

First, Ogus writes that efficiency interpretations – interpretations of the law based in economic analyses of allocative efficiency – can “provide a firmer foundation and less ambiguity than notions of morality or corrective justice, which are often asserted to be the basis of... legal rules.”<sup>19</sup> For example, law and economics scholars can be found arguing that the morality of breach of contracts can be ascertained, for legal purposes, in the context of incomplete agreements, by reference to whether the cost of performance for a seller of services exceeds the value of such performance to the buyer.<sup>20</sup> To return to Ogus, the tendency of courts to impose liability for omissions on those involved in a pre-tort relationship with a victim, such as employers in the case of workplace accidents, can be understood through arguments that employers “assume responsibility for positive steps to secure the health and safety of employees, the cost (in part, at least) being offset against wages and other benefits provided.”<sup>21</sup> Here, “(t)he law performs the useful economic function of imposing the solution which parties themselves would rationally have reached if they had

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15 *Id.* Posner asserts that statistical study can contribute much to our knowledge of legal systems and that economists are perhaps best trained in these methods. In 2010, thirty five years after the writing of this article, the use of rigorous quantitative analysis in disciplines from political science, education and even literature is, perhaps, unremarkable. See, e.g., Franco Moretti, *Graphs, Maps, Trees: Abstract Models for Literary History 1*, 24 *NEW LEFT REVIEW* 67 (2003).

16 Anthony Ogus, *What Legal Scholars can learn from Law and Economics*, 79 *CHL.-KENT L. REV.* 383, 383 (2004).

17 See *infra*, notes 45-56 and accompanying text.

18 Ogus, *supra* note 17, at 395.

19 *Id.*

20 Steven Shavell, *Why Breach of Contract May Not Be Immoral Given the Incompleteness of Contracts*, 107 *MICH. L. REV.* 1569, 1580-81 (2009) (suggesting different definitions of morality and arguing that given incompletely specified agreements, a “buyer is made whole if she receives expectation damages, so she should not be discouraged from contracting under a regime with breach and payment of these damages,” and that “different criteria may be employed for choosing among definitions of morality: consistency with the moral beliefs found in the population; derivation from favored underlying principles; and the advancement of the welfare of contracting parties,” where, according to welfare criteria, “breach and payment of expectation damages raise the well-being of both sellers and buyers.”

21 Ogus, *supra* note 17, at 396-99.



been able to make an appropriate contract.”<sup>22</sup>

In a related sense, law and economics also serves scholarship by providing a means to classify and structure the law.<sup>23</sup> For example, as a straightforward and positive analysis, economic studies of law offers ways of determining judicial productivity through measures of court delay, estimates of the cost of eliminating it, changes in numbers of judges and budgets, and assessments of the costs of different kinds of proceedings and major procedural reforms.<sup>24</sup> Law and economics lenses offer insight into issues such as the costs of discrimination against a particular social group and examine the extent to which enforcement of implied warranties in tort law is a costly means of securing the physical welfare of consumers.<sup>25</sup> Tax scholars debating issues of progressivity and redistribution in taxation might argue that these concepts cannot be understood apart from social spending or equated simplistically with graduated, as opposed to flat, taxes.<sup>26</sup> Or, the same scholars might make a disparate array of assessments of the efficiencies and social costs of different levels of taxation and styles of enforcement.<sup>27</sup>

### C. Program

Law and economics has a normative dimension. Bracketing the role of analysis for the moment, law and economics can come with a program. Henry Manne argues straightforwardly that “only capitalism and free markets can deliver on the promise of material goods that has come to be expected throughout the world,”<sup>28</sup> and that the substantive protection of property rights and freedom of contract necessary for a free market economy can be achieved through judges applying the methods of law and economics.<sup>29</sup> Judges should “still be

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22 Ogus, *supra* note 17, at 396-99. Ogus argues that, “(i)n general, it is cheaper for someone already engaged in an activity to take steps to constrain risks arising from it than for a passive agent to respond to a risk created by another. This is because the active agent has already selected that activity which presumptively generates for herself the greatest utility: the added cost of taking care in that activity might be relatively small.”

23 Ogus, *supra* note 17, at 399-401.

24 Posner, *supra* note 3, at 769; Manne, *supra* note 4, at 35.

25 Posner, *supra* note 3, at 770; GARY BECKER, *THE ECONOMICS OF DISCRIMINATION* (1971); Gary Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968);

26 Louis Kaplow, *Taxation and Redistribution: Some Clarifications*, 60 TAX L. REV. 57 (2008) (noting that the most redistributive tax, a 100 percent tax with proceeds rebated pro rata to the population, is a flat tax, or that depending on exemption levels, poor people might be taxed less under flat taxes than graduated income taxes).

27 See also Posner, *supra* note 3, at 770 (suggesting that law and economics studies of tax might make comparisons of the social cost of income tax evasion with examinations of revenue loss, discuss what might be an optimum system of tax penalties or whether the marginal product of various forms of tax enforcement activities, such as audits, exceed the marginal cost).

28 Manne, *supra* note 4, at 11. (speaking at a symposium panel of the (U.S.) Federalist Society published by the Harvard Journal of Law and Public Policy titled “What is the ‘Law’ in Law and Economics”).

29 Manne, *supra* note 4, at 31. Manne states that “(f)ortunately, however, the part of the common law tradition that is more important for a free-market economy — namely, the substantive

influenced to decide a wide variety of cases in a manner consistent with the philosophy of a free-market economy,”<sup>30</sup> and “would believe that they are not there to regulate individuals’ behavior in accordance with the judge’s own preferences, but rather to enforce the free choices, private contracts, and reasonable expectations of the parties.”<sup>31</sup> The rule of law – or equal application of the law to all people under the same set of relevant circumstances – would be the form of dispute resolution best suited to a free market’s needs and “should be known or knowable in advance and not made up after the fact.”<sup>32</sup> The following of precedent, at least in common law systems, and the right to appeal, ensure consistency and lower transactions costs,<sup>33</sup> while ensuring “that a legal system operates consistently with the requirements of a free market.”<sup>34</sup> The question of who would watch the watchers has no easy answer, but governments should be kept as small and simple as possible.<sup>35</sup>

#### D. Avatars

Law and economics has a number of offspring and other disciplinary relations, for example, public choice, mechanism choice, and new institutional economics. Public choice scholarship is an extensive field. Within finance, public choice studies look at the political economy of subjects such as the delisting process and insider trading, banking deregulation, the politicization of corporate governance, lawyer self-regulation, externalities and legal opinions in structured finance, stock-transfer restrictions and issue choice in trading venues, federalism, broker-dealer law and subprime mortgages, and the application of economic reasoning to case law.<sup>36</sup>

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protection of property rights and freedom of contract — can be achieved judicially in other ways. Judges could simply establish, through case decisions, a set of rules of law consistent with the efficient functioning of a market economy.”

30 Manne, *supra* note 4, at 32.

31 Manne, *supra* note 4, at 33.

32 Manne, *supra* note 4, at 12-13. Manne uses the term dispute resolution as the application of law to, or resolution of legal disagreements (through arbitration, litigation or regulation, for example) over changes in rules, taxation, individual acts of crime, public regulation and private contracts

33 Manne, *supra* note 4, at 16-17.

34 Manne, *supra* note 4, at 17.

35 Manne, *supra* note 4, at 14-15.

36 See, e.g., the work of one public choice scholar, prominent Yale Law School professor Jonathan Macey; Jonathan Macey, *Helping Law Catch Up to Markets: Applying Broker Dealer Law to Subprime Mortgages*, 34 J. CORP. L. 789 (2009); Jonathan Macey, *Down and Out in the Stock Market: The Law and Economics of the Delisting Process*, 51 J.L. & ECON. 683 (2008); Jonathan Macey, *A Close Read of an Excellent Commentary on Dodge v. Ford*, 3 VA. L. & BUS. REV. 177 (2008); Jonathan Macey, *Getting the Word Out About Fraud: A Theoretical Analysis of Whistleblowing and Insider Trading*, 105 MICH. L. REV. 1899 (2007); Jonathan Macey, *Too Many Notes and Not Enough Votes: Lucian Bebchuk and Emperor Joseph II Kvetch about Contested Director Elections and Mozart’s Seraglio*, 93 VA. L. REV. 759 (2007); Jonathan Macey, *The Politicization of American Corporate Governance*, 1 VA. L. & BUS. REV. 10 (2006); Jonathan Macey, *Commercial Banking and Democracy: The Illusive Quest for Deregulation*, 23 YALE J. ON REG. 1 (2006); Jonathan Macey, *Occupation Code 541110: Lawyers, Self-Regulation, and the Idea of a Profession*, 74 FORDHAM L. REV. 1079 (2005).

Keeping in mind the law of administrative agencies, the source of most Indian regulation of finance, there is a significant literature on mechanism choice. Focusing particularly on regulation, mechanism choice could be seen as involving the issues of designing optimal instruments to achieve social objectives given externalities, transaction costs, free riding, or incomplete information.<sup>37</sup> This literature reviews the demand for administrative agency law as well as the use and efficacy of conduct rules, quantity/property rules, price/liability rules, information disclosure, government ownership, and private ordering.<sup>38</sup> Mechanism choice literature also examines more complex models that broaden the demand side of such law to include advocacy groups and political players, pays attention to the supply side of legislation by looking at the role of legislators and regulators in policy and examines phenomena such as framing effects and mass numbing – responding intensely to the plight of a single individual but remaining unmoved by the plight of thousands or millions. This literature can also look at situations such as crises responses, the role of voting rules, and republican moments where mass movements move “normal” politics to achieve transformative political change.<sup>39</sup>

Law and economics is also self-correcting, reflects internal tensions and debates, and both informs and is informed by related developments in economics.<sup>40</sup> New Institutional Economics (“NIE”) can be understood perhaps as the economic analysis of organizational design, where organizational design is thought of as including a wider set of transactions, namely institutions, organizations, and contracts, and where legal enforcement is assumed to be impeded or impossible.<sup>41</sup> Stated in inter-disciplinary terms, NIE can be thought of as: a set of analytical tools or concepts from a variety of disciplines in the social sciences, business and law....NIE addresses two overarching issues: what are the determinants of institutions — the formal and informal rules shaping social, economic and political behaviour? And what impact do institutions have on economic performance?<sup>42</sup>

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37 See Jonathan B. Wiener & Barak D. Richman, *Mechanism Choice*, in PUBLIC CHOICE AND PUBLIC LAW (Daniel A. Farber & Anne Joseph O’Connell, eds., forthcoming 2010), available at <http://ssrn.com/abstract=1408163> (providing a wide-ranging review of the scope of public choice literature in the context of public law and attempts to think of institutional design as a means of correcting market failures.); Sandeep Baliga & Eric Maskin, *Mechanism Design for the Environment*, in HANDBOOK OF ENVIRONMENTAL ECONOMICS 305-324 (Karl-Goran Maler & Jeffrey R. Vincent eds., 2003).

38 *Id.*

39 *Id.*

40 Ejan Mackaay, *History of Law and Economics*, in ENCYCLOPEDIA OF LAW AND ECONOMICS 92 (Boudewijn Bouckaert & Garrit De Geest eds., 2000) (stating that “practitioners of law and economics no longer sing in a single voice.”).

41 Rudolph Richter, *The Role of Law in the New Institutional Economics*, 26 WASH. U.J.L. & POL’Y 13, 14-15 (2008).

42 L.J. ALSTON, THE NEW PALGRAVE DICTIONARY OF ECONOMICS (Steven N. Durlauf & Lawrence E. Blume eds., 2008), available at [http://www.dictionaryofeconomics.com/article?id=pde2008\\_N000170](http://www.dictionaryofeconomics.com/article?id=pde2008_N000170).

NIE analyses are associated with the works of Ronald Coase, Douglass North, Oliver Williamson, Claude Menard, Avner Grief and Harold Demsetz. NIE studies can be seen as an elaboration of earlier versions of neoclassical microeconomics and assumes bounded rationality, imperfect information and uncertainty, and positive transaction costs.<sup>43</sup> Applied to the law, NIE analytics investigate issues such as informal procedures and non-market organizations that efficient organizational structures are dependent on, contracting costs, contractual problems such as renegotiations under duress and incompletely specified agreements.<sup>44</sup>

### *E. Critiques*

Law and economics has been critiqued on many fronts; for the fields assumptions and discursive parameters, for implicit understandings of the role and functioning of law on its own terms, and politics. Starting with assumptions and how law and economics frames debates, scholars like Anthony Ogus, argue that “the law reflects values and goals other than allocative efficiency,”<sup>45</sup> and that while interpreting the legal entitlements in the light of allocative efficiency can provide the law with firmer foundations, such assessments do so by sacrificing moral concerns, or at least morality as commonly understood.<sup>46</sup> Gregory Alexander, for example, argues that the law must balance a plurality of values in these inherently complex conflicts and that no algorithm is available *ex ante* by which we can reduce all these goods and ills into a singular scalar metric which can then be straightforwardly applied in future conflicts of this kind.<sup>47</sup>

In particular, law and economics scholarship, especially the first generation of this work, has been critiqued for assumptions of rational choice and market efficiency embedded in these paradigms. While these debates have not been fully settled, some scholars find that traditional rational choice models offer the best point of departure, even if departures must be made, while others find that in these cases, empirical evidence demands a more comprehensive reevaluation

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43 Richter, *supra* note 41, at 27. The traditional picture of neoclassical microeconomics, of course, suggests a model assuming individual rationality, perfect information and zero transaction costs. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 18-21 (6th ed. 2003) (defending assumptions of perfect rationality).

44 Richter, *supra* note 41, at 33-36. (discussing the seminal work in New Institutional Economics of Oliver Williamson in developing his “transaction cost approach” and other scholars).

45 Ogus, *supra* note 16, at 383.

46 *Id.* at 396; Though, see Shavell, *supra* note 20, at 1581.

47 Gregory S. Alexander, *The Social-Obligation Norm in American Property Law*, 94 CORNELL L. REV. 745, 805 (2009); See also Mark V. Tushnet, *Law, Science, and Law and Economics*, 21 HARV. J.L. & PUB. POL’Y 47, 49 (1997) (arguing that “(i)f as I think, neither law and economics nor law and literature, nor anything else, offers privileged access to general ways of understanding the law, it is hard for me to see any ground on which to rest the claim that one or another way of arriving at understanding is generically preferable”).

of the basic postulates of rationality and market rationality.<sup>48</sup> Lynn Stout, for example, argues that efficient market theory in finance can be critiqued for presumptions of homogeneous investor expectations, effective arbitrage, and investor rationality. In turn, he states that an expanding body of work on asset pricing investigates heterogeneous expectations of investors, that theoretical and empirical scholarship demonstrates how and why arbitrage may move certain types of publicly available information into price more slowly and incompletely than earlier writings suggested, and that the burgeoning literature in behavioral finance provides indications of what happens to prices when market participants do not all share rational expectations.<sup>49</sup> Indeed, the premise of this article is that the study of law and economics in India should be supplemented by, and involve, a re-examination of, those avenues of inquiry that are foreclosed by traditional applications of the methods of the field.

Second, law and economics can also be critiqued for its approach to and understanding of the autonomy of law. With regards to the role and function or autonomy of law, law and economics as a discipline appears to have an essentially unidirectional mandate: to bring to bear the tools of economic analysis to the law. As discussed earlier, this endeavor is tremendously productive on its own terms precisely by ordering debates of the law with clear frameworks for thinking about the costs of decision and error. Law and economics scholars also concede that any interpretive theory is of necessity simplifying and that law and economics scholarship should be assessed for its predictive power.<sup>50</sup> Lawyers, however, shirk the unique contributions that we are best positioned to make, by refusing to theorize legal texts, doctrines, discussions, institutions, and processes on their own terms; terms that are not fully reducible to economic terms. As suggested by University of Chicago and Harvard Law School scholar, Cass Sunstein, law operates in the realm where people may agree on particulars while disagreeing on principles, where people occupying certain institutional roles are required to look at certain considerations and not others.<sup>51</sup> To use one example, individuals

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48 Douglas G. Baird, Richard A. Epstein & Cass R. Sunstein, *Symposium on the Law and Economics of Consumer Choice*, 73 U. CHI. L. REV. 1 (2006).

49 Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635 (2003) [hereinafter Stout, *The Mechanisms of Market Inefficiency*]; See also Lynn A. Stout, *The Investor Confidence Game*, 68 BROOK. L. REV. 407 (2002). (Examining rational expectations in the context of retail investor behavior and highlighting the importance of understanding how investor confidence may be cultivated as well as destroyed).

50 Posner, *supra* note 3, at 774 (arguing that “a scientific theory necessarily abstracts from the welter of experience that it is trying to explain, and is therefore necessarily “unrealistic” when compared directly to actual conditions,” but that such theory is still useful if it correctly predicts the behavior of a wide variety of phenomena in the real world, and that “lack of realism does not invalidate the theory; it is, indeed the essential precondition of a theory.” Indeed, “a theory cannot be overturned by pointing out its defects or limitations but only by proposing a more inclusive, more powerful, and above all more useful theory”).

51 Sunstein, *supra* note 4, at 89-94 (arguing provocatively that the key to social stability in a pluralistic society lies in the phenomenon of incompletely theorized agreements).

may agree on the need for enforcement of contracts while disagreeing on first principles about the role of the state. Or, to use another, a judge tasked with interpreting the intended meaning of the Foreign Exchange Management Act, may, unsurprisingly, issue rulings for textual, interpretive or doctrinal reasons, or for reasons related to beliefs about the role of the judiciary and respect for precedent, not for reasons having anything to do with allocative efficiency. In situations like this, to fail to understand the principles or concerns behind such practices on their own terms, or to reduce such actions to purely economic terms, whatever the interpretive or normative value of such analyses, misses an opportunity to theorize the interplay between legal values, institutions and processes and broader social, economic or other forces. In these murky areas, those familiar with the law can shed valuable light.

Third, the programmatic agenda of law and economics scholarship has been heatedly discussed, though I argue, at least for the purposes of this paper, that charged discussions about the politics of law and economics would distract attention from the methodological and interpretive points that I would like to make. As discussed above, the politics of at least the first generation of law and economics scholarship seems clear.<sup>52</sup> The statements of Henry Manne regarding capitalism and free markets, property rights, freedom of contract, the appropriate interpretive posture for judges deciding cases, precedent, equal application of the law, and the role of government hardly need elaborating. In turn, law and economics has been critiqued for having a conservative bias and for the links between the field and right-wing American social movements.<sup>53</sup> Still, the position that ideology, worldviews, political and institutional positions, and historical context are an irreducible part of argument does not lead to the conclusion that such argument can be reduced to polemic.<sup>54</sup> Additionally, for example, to highlight the efficiency implications of a particular set of rulings as an interpretive matter does not necessarily lead to the conclusion that efficiency must be adopted as an important or paramount value.<sup>55</sup> Finally, Richard Posner argues that “the motivations and personal opinions of researchers ought to be irrelevant to the appraisal of their work, as should be the political implications, if any, of that work,” and that “(t)he validity of research is independent of the motives behind

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52 See, *supra* section II.C.

53 See Mark Tushnet, *The Rise of the Conservative Legal Movement: The Battle for Control of The Law*, 87 TEX. L. REV. 447 (2008). (Discussing the active support of the John M. Olin Foundation for law and economics as a means of promoting American conservative causes ranging from faculty wars at Harvard Law School to scaling back the regulatory state).

54 STANLEY FISH, *THERE'S NO SUCH THING AS FREE SPEECH: AND IT'S A GOOD THING, TOO* (1994) (seen light of this article, arguing that the act of offering analysis makes no sense absent an existing, and for the time being, unquestioned ideological vision); Posner, *supra* note 3, at 775-76 (arguing that research that provides support for social democratic positions—liberal in American terms—is not equally identified and criticized on the same grounds).

55 *Id.*



it or the uses to which it might be put.”<sup>56</sup> While the notion that the motivations and implications of scholarship have some relationship to positions taken seems intuitively straightforward, and perhaps interpretively unavoidable, to reduce scholarship to politics also, is, no doubt, equally a mistake.

### III. LAW AND ECONOMICS: WHAT CAN IT BE?

What would law and economics look like in India? How might the points of reference discussed above inform law and economics studies in the country or subcontinent? I argue that those interested in law and economics in India should study a broad variety of fields to understand the complex interactions of law, legal processes and institutions, and social, economic relations. I hold that while law and economics frameworks, as constituted, offer productive analyses of a broad range of subjects, those interested in law and economics should pay attention to the values, processes and ways of thinking that are necessarily foreclosed<sup>57</sup> by the economic analysis of law. In particular, I emphasize the role of history as a useful example of disciplinary endeavors that would open out, add to and enrich our understandings of these interactions though I do not limit my argument to just saying that lawyers should read more history. As I elaborate below, certainly fields such as behavioral finance and legal and political science scholarship about institutional design do add to our collective understanding of legal institutions, processes and society.<sup>58</sup> I offer three case studies and paradigms. The first case study is of a popular government program, which demonstrates the ways that conventional law and economics types of analyses offer productive guidance to scholars, policy makers, and the interested public. Second, a quick discussion of behavioral finance paradigms, suggests engaging ways that scholarship organized around different theoretical premises can enrich

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<sup>56</sup> *Id.*

<sup>57</sup> Posner, *supra* note 3, at 774 (arguing that “an economic theory of law is certain *not* to (*emphasis added*) capture the full complexity, richness and confusion of the phenomena — criminal activity or whatever — that it seeks to illuminate. That lack of realism does not invalidate the theory; it is, indeed, the essential precondition of a theory”); Tushnet, *supra* note 47.

<sup>58</sup> The examples discussed here are not intended to provide an exhaustive list of the fields that could be brought to bear to study the law and economics as I would understand these processes, institutions and forms of study. There are, of course, other fields whose objects of study dovetail and shed light on law, economics and India such as law and development or empirical legal studies. Law and development, for example, has roots extending back to World War II and offers fascinating and conceptually provocative discussions of the role of legal systems and economic development. See David A. Skeel, Jr., *Governance in the Ruins*, 122 HARV. L. REV. 696 (2008); Katharina Pistor, *Who Tolls the Bells for Firms? Tales from Transition Economies*, 46 COLUM. J. TRANSNAT'L L. 612 (2008). Some scholars argue straightforwardly that strong economic development is a consequence of having the right laws and governance structures in place. See Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997); Raphael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998). Others are critical of the notion that “good law + good enforcement = good economic outcomes,” and describe law as not



understandings of the law and socio-economic relations. Finally, I use assessments of heated contemporary debates about India and globalization on a macro-theoretical level and regulatory design on a more confined intellectual level to illustrate the value of historical scholarship (as well as literature on regulatory design) to illustrate the value of methodological pluralism in supplementing the value-addition of today's law and economics.

### *A. Law and Economics in Indian Contexts*

What insights could law and economics methodologies, as currently understood, produce in India? Ogus suggests that the field can suggest productive comparative insights, particularly examinations of differences in national legal treatment of identical factual situations.<sup>59</sup> Ogus argues that law and economics can enrich this type of comparative study by assessing any differences in outcomes as well as understanding why different legal systems might reach the same or similar outcomes.

Also, in a straightforward sense, the methods of law and economics can simply be applied to Indian law, institutions, and legal processes. In March, 2008, the UPA government announced a massive program of farm loan waivers to assist small and marginal farmers.<sup>60</sup> The program was touted nationally as a momentous policy decision benefiting struggling farmers. Under the terms of the program, Rs.60,000 crore or about US \$15 billion in debts owed by

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politically neutral and better understood as part of a "highly iterative process of action and strategic reaction and that local, regional or national contexts matter in assessing these institutions. To this view, understanding the inevitable complexity of law on its own terms would offer a more nuanced and rich picture of the role of legal institutions in development. Curtis J. Milhaupt & Katharina Pistor, *Law and Capitalism: What Corporate Crises Reveal About Legal Systems and Economic Development around the World* 5-6 (2008); Daniel Berkowitz, Katharina Pistor & Jean-Francois Richard, *The Transplant Effect*, 51 AM. J. COMP. L. 163 (2003) (referencing different generations of law and development scholarship and assessing the difficulties of translating laws from one national context to another). This literature can trail off into discussions about definitional matters or issues such as the activities of legal service providers. Nonetheless, the strands of the law and development literature above offer productive attempts to think about legal systems, national traditions and social welfare, particularly development. John Ohnesorge, "Beijing Consensus" Anyone?" 104 Nw. U. L. REV. 257, 257 (2010) (Contributing to a symposium debating "(t)he future of law and development"). See also Ashwini Agrawal, *The Blue Sky Laws and Corporate Policy*, The Harvard Law School Forum on Corporate Governance and Financial Legislation (Dec. 9, 2009), available at <http://blogs.law.harvard.edu/corpgov> (an example of empirical legal studies work using regression estimates to analyze the effectiveness of investor protection laws).

59 Ogus, *supra* note 16, at 393. (discussing, for example, the situation of a reader who, as a consequence of following negligent advice regarding investments given in a newspaper, sustained financial losses, but would not be able to recover damages under either English law (because there is duty of care in relation to negligent misrepresentations extending beyond "special relationships") or French law (where there is no equivalent principle, but the reader would probably be denied compensation on the different ground that there is an insufficiently strong causal link between the negligence and the loss).

60 See *Massive farm loans waiver*, THE HINDU, March 1, 2008, available at <http://www.thehindu.com/2008/03/01/stories/2008030155460100.htm>.

approximately 40 million farmers overdue as of a cut-off date of December 31, 2007 would be waived completely. Yet, Vijay Mahajan of BASIX, a microfinance institution,<sup>61</sup> argues that according to the National Sample Survey, over half or 51.4 percent of the farmer households in the country did not access credit at all, whether from institutional or non-institutional sources.<sup>62</sup> Moreover, only 27 percent of total farm households had any loans from formal sources, while 73 percent did not. Eighty percent of those categorized as 'marginal farmers' did not have any borrowing whatsoever from formal sources. So, only the upper quartile of farmers would benefit from this program. Furthermore, by the terms of the program, only bank loans overdue as of the specified cutoff date would be eligible for loan waiver relief. So, to Mahajan, writing in 2008, "a big grape farmer in Nasik who had a bumper crop but was politically aware, so did not repay his loan, will get a waiver of Rs. 1 lakh while a poor rainfed farmer in Vidarbha who has sold his less than normal yield cotton crop to the state monopoly cotton federation, at a lower than market price, will be deemed to have repaid his Rs. 15,000 loan from the proceeds that he has yet to receive."<sup>63</sup> Mahajan also notes that there is no fig leaf to this pro big farmer waiver, as seen in pronouncements that not only crop loans but also term loans for tractors, poultry farms and more would be covered by the waiver or that there would be a 10 percent bonus payment to all farmers selling their produce through regulated market yards, once again, large farmers. Mahajan concludes by writing that:

[t]he same Rs. 60,000 crore could have been used to drought-proof 60 million hectare of dryland at Rs. 10,000 per hectare, which would permanently secure the livelihoods of at least 3 crore of our poorer farmers in rainfed areas. Dozens of successful examples exist, of the rehabilitation of natural watersheds and traditional water storage structures by NGOs and government agencies. Part of the funds could also be used to rehabilitate the dilapidated canal irrigation systems, conditional on the states switching to participatory irrigation management... Even if one were to accept that the loan waiver was aimed at gaining electoral advantage, it could have been done much more equitably and would have fetched more votes.<sup>64</sup>

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61 See BASIX, <http://www.basixindia.com> (last visited Feb. 23, 2010). (Operating in Andhra Pradesh, Karnataka, Orissa, Jharkhand, Maharashtra, Madhya Pradesh, Tamil Nadu, Rajasthan, Bihar, Chattisgarh, West Bengal, Delhi, Uttarakhand, Sikkim, Meghalaya and Assam, including over 22,400 villages).

62 Posting of Vijay Mahajan to *ajayshahblog*, Waiver of Mass Debt (WMD), available at <http://ajayshahblog.blogspot.com/search/label/redistribution> (last visited Feb. 17, 2010). (Laying out the subsequent analysis of the farm loan waiver program).

63 *Id.*

64 *Id.*

### *B. Behavioral Finance*

Behavioral law and economics uses cognitive psychology to develop better understandings of decisions and choice.<sup>65</sup> In finance, this work can examine matters such as asset pricing when investors have heterogeneous expectations, how and why arbitrage may move certain types of publicly available information into price more slowly and incompletely, and the uneven signaling effects of prices when all market participants do not share rational expectations.<sup>66</sup> If public choice advocates suggest that administrative agency functioning is best explained by rent-seeking behavior, scholars using cognitive psychology frameworks for assessing administrative agencies observe that criteria such as the use of heuristics, framing and expert overconfidence or myopia can provide equally rich understandings of agency failure. Concepts such as expertise, seeing a given situation repeatedly and the human ability to categorize offer useful schema to guide a regulatory body's decision-making.<sup>67</sup> US public choice literature is deeply skeptical of the ability of legislatures to further general welfare, finding them obsessed with furthering geographic, parochial interests and finding them to often fall prey to rent-seeking interest groups.<sup>68</sup> Judiciaries are cast as independent from regional and interest group pressures, while agencies are held to be largely responsible to the executive branch and whose decisions are worthy of deference. Cognitive legal literature would suggest that judicial tools, often limited to interpretive techniques or invalidating a particular statute, are crude tools for stopping bad policy. Agencies could pander to legislatures from whom they seek funding, or if autonomous, be unaccountable. While legislatures, with their committee structures, yet requirements for passage of legislation by the votes of the full generalist body, offer the institutional set-up for developing expertise while avoiding regulatory capture.<sup>69</sup> As will be discussed in more detail below, delegation of authority over, for example, foreign exchange law, to the independent central bank could lead to policy decisions for which the bank is formally unaccountable, though subjecting these regulatory decisions to the political process does not necessarily

65 Cass R. Sunstein, *Behavioural Analysis of Law*, 64 U. CHI. L. REV. 1175 (1997).

66 Stout, *The Mechanisms of Market Inefficiency*, *supra* note 50.

67 Jeffrey J. Rachlinski & Cynthia R. Farina, *Cognitive Psychology and Optimal Government Design*, 87 CORNELL L. REV. 549, 558-60 (2002) (Offering alternative paradigms to assess administrative agency decision-making, suggesting, for example, that expertise produces a useful set of schema to guide decisionmaking, but like all schema, limit a decisionmaker's ability to think differently about a problem and to recognize the limitations inherent in that schema); Jeffrey J. Rachlinski, *Rulemaking Versus Adjudication: A Psychological Perspective*, 32 FLA. ST. U. L. REV. 529, 546 & 549 (2005) (Arguing, for example, that an agency developing policy through adjudication will often see an issue repeatedly, and in different contexts, before it makes a decision. Also analogizing to the value that human expertise in administrative agencies would offer by pointing out that experts on artificial intelligence have been unable to simulate the human power to identify structure and patterns).

68 *Id.* at 583.

69 *Id.*

offer grounds for optimism that policy decisions would be made in an engaged matter.<sup>70</sup> Different insights highlighted by varied disciplinary endeavors will no doubt have to come together to provide a composite picture of the problems studied by law and economics in India.

### C. *History, Law and Economics*

If the central thesis of this article is to foreground the productive possibilities of juxtaposing different disciplines while suggesting broader approaches to law and economics, what visions does history have to offer? History, including economic history, allows discussions on grand questions about important policy problems facing societies today, questions about the very organization of society, prosperity, distribution, inequality, and sustainability.<sup>71</sup> In turn, law is a rich palimpsest of fascinating moments in Indian history. To use the examples of financial law, history, particularly economic history, offers compelling narratives explaining the structure of Indian financial regulation and offers important perspectives on contemporary questions of law and policy.

One example involves heated contemporary debates about India and globalization on a macro-theoretical level and issues of regulatory design on a more discrete scholarly level. In the context of Indian finance, heated debates continue about issues such as the role of the financial sector and the extent of India's integration into world markets.<sup>72</sup> These issues, in turn, can also revolve around more particular questions of institutional or regulatory design.

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<sup>70</sup> See *infra* note 80 and accompanying text.

<sup>71</sup> While the story of Nehruvian socialism, Indira Gandhi-era bank nationalizations and/or India's "license-paper raj" shading into trade and partial financial liberalization in the 1980s and 1990s is part of the subconscious of Indians above a certain age, if not many or most under, these narratives offer rich, plausible explanations of the style of regulation characterizing the Indian economy, including the financial sector, the role of the public sector and the legal role of the central bank, not to mention questions of growth, equality and the role of planning versus markets. See ARVIND PANAGIRIYA, *INDIA: THE EMERGING GIANT* 26 (2008) (periodizing this story slightly differently and arguing that "despite interventionist domestic policies, India had a relatively liberal trade and investment regime in the 1950s"); THE OXFORD COMPANION TO ECONOMICS IN INDIA (Kaushik Basu ed., 2007); T. N. SRINIVASAN & SURESH TENDULKAR, *REINTEGRATING INDIA WITH THE WORLD ECONOMY* (Peterson Institute ed., 2003); THE POLITICAL ECONOMY OF DEVELOPMENT IN INDIA: EXPANDED EDITION WITH AN EPILOGUE ON THE POLITICAL ECONOMY OF REFORM IN INDIA (Oxford University Press, USA ed., 1999); 2 THE CAMBRIDGE ECONOMIC HISTORY OF INDIA 2 THE CAMBRIDGE ECONOMIC HISTORY OF INDIA c-1751... c.1970 (Dharma Kumar & Meghnad Desai eds., 1983); IMAGINING INDIA: IDEAS FOR THE NEW CENTURY (Penguin Books ed., 2008).

<sup>72</sup> Avinash Persaud, *Let's Tobin Now*, FINANCIAL EXPRESS, Sept. 2, 2009, available at <http://www.financialexpress.com/news/lets-tobin-now/510396> (arguing for the feasibility and desirability of a financial transactions tax to contain volatility); with, Ila Patnaik, *Tobin Tax is only for textbooks*, FINANCIAL EXPRESS, Nov. 21, 2009, available at <http://www.financialexpress.com/news/column-tobin-tax-is-only-for-textbooks/544249> (arguing that for India currently, foreign investment is a way of containing rupee appreciation and bringing in funds into a credit-constrained economy); COMMITTEE ON FINANCIAL SECTOR REFORMS, *supra* note 36, at 34-48 (arguing that capital account liberalization can be a way of promoting financial development). Taken together, both articles reflect passionate positions on the role of the financial sector in the global economy.

Specifically, the role of India's central bank is highly contested with some arguing that the Reserve Bank of India's (RBI) cautious approach to global financial integration protected India during the current global financial crisis;<sup>73</sup> while others argue that "there is no evidence to support the claim that an Indian style license-permit raj, coupled with Indian-style capital controls, was needed to avoid a financial crisis in 2008".<sup>74</sup> Looking at questions of institutional design, these claims are given meaning by the regulatory authority given to the RBI to manage foreign exchange transactions and capital flows.<sup>75</sup> That central banks should enjoy autonomy with regards to the conduct of monetary policy is, of course, a widely and consensually held position, although the extent of central banks mandates with regards to broader issues such as financial stability is vigorously debated.<sup>76</sup>

Looking to history, early twentieth century commentary on the creation of the central bank, including statements from figures such as John Maynard Keynes and Sir Basil Blackett, the colonial Finance Minister of India from 1923 onwards about the creation of the RBI, emphasize the role of central bank independence from political influence as a check on nationalist attempts to concentrate power in the hands of the legislature.<sup>77</sup> Talking specifically about India, Keynes states that "banking business must be outside the regular government machine, ignorant of 'proper channels,' and free of the official hierarchy where action cannot be taken until reference has been made to a higher authority."<sup>78</sup> Regulatory actions by administrative agencies are typically seen as policy decisions subject to the political process and the specific textual

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73 See Y. V. REDDY, *INDIA AND THE GLOBAL FINANCIAL CRISIS* 275-85 (2009) (By the Governor of the RBI until the latter part of 2008, expressing skepticism about the benefits of liberalizing capital flows); Pranab Bardhan, *Notes on the Political Economy of India's Torturous Transition*, 44 *ECON. POLIT. WKLY.* 31 (2009), (stating that relatively cautious financial regulation and state control over banks may have insulated the Indian economy somewhat from the recent global financial crisis).

74 Ila Patnaik, *No one like us*, *INDIAN EXPRESS*, Aug. 31, 2009, available at <http://www.indianexpress.com/news/no-one-like-us/509056/0>. (Arguing that countries and regions with rather different macroeconomic and micro-prudential frameworks like Canada, Mexico, Latin America and South Korea did just fine in avoiding a financial crisis in 2008 and that a country like South Korea is an open capital account country and more open than it was prior to the Asian Crisis of 1997).

75 Foreign Exchange Management Act, 1999, No. 42 of 1999 § 6 (stating that the "Reserve Bank may... specify (a) any class or classes of capital account transactions which are permissible; (b) the limit up to which foreign exchange shall be admissible for such transactions," and further granting the RBI the authority to prohibit, restrict or regulate specific forms of financial transactions such as those involving debt, equity, currency and property).

76 See COMMITTEE ON FINANCIAL SECTOR REFORMS, *A HUNDRED SMALL STEPS* 5, 12-14 (2009) (arguing that the RBI, as one of many institutions responsible for financial sector regulation, should have a single objective, inflation-targeting, and should avoid excessive regulatory micromanagement).

77 See A.J. Saunders, *The Indian Reserve Bank and Sir Basil Blackett's Work in India*, 38 *THE ECONOMIC JOURNAL* 405, 408-409 (1928); G. Findlay Shirras, *The Reserve Bank of India*, 44 *THE ECONOMIC JOURNAL* 258, 260-264 (1934).

78 G. Findlay Shirras, *A Central Bank for India*, 38 *THE ECONOMIC JOURNAL* 573, 574-586 (1928).

grants of legal authority in appropriate statutes or constitutional clauses.<sup>79</sup> The roles and positions of the central figures in current Indian financial policy debates are different, though this historical record, combined with the statutory authority granted to the central bank over foreign exchange transactions in the Foreign Exchange Management Act, suggests a continuity and context for RBI independence as a matter of institutional culture and policy.<sup>80</sup>

#### IV. CONCLUSIONS

The inaugural issue of an Indian journal on law and economics offers productive opportunities to reflect on the discipline, open new lines of inquiry and frame terms of discussion going forward. Opening moments offer important chances to understand critical paradigms, assess intellectual needs, and suggest new ways of seeing. I have argued in this paper that to freeze the boundaries of the field (in India or elsewhere) would come at significant intellectual cost. While law and economics frameworks offer productive analyses of a broad range of subjects, those interested in law and economics should also pay attention to the values, processes, and ways of thinking that are necessarily foreclosed by the economic analysis of law. Scholars and practitioners should not lose sight of the productive possibilities of reading different disciplines together, of emphasizing and scrutinizing closely the fundamental assumptions of any body

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79 See Steven G. Calabresi & Saikrishna B. Prakash, *The President's Power to Execute the Laws*, 104 YALE L.J. 541 (1994); and, Frank H. Easterbrook, *Unitary Executive Interpretation: A Comment*, 15 CARDOZO L. REV. 313, 318-19 (1993); with Lawrence Lessig & Cass R. Sunstein, *The President and the Administration*, 94 COLUM. L. REV. 1, 93-106 (1994) and Cynthia R. Farina, *The Consent of the Governed: Against Simple Rules for a Complex World*, 72 CHI.-KENT L. REV. 987 (1997) (elaborating a heated debate in the 1990s, though a debate of earlier provenance and one that still continues today, over issues of the extent of executive branch authority over the U.S. administrative state, ultimately grounded in constitutional and textual or interpretive concerns over separation of powers).

80 In any case, it is not clear that separating regulatory functions from monetary authority, or subjecting the former to the political process would have the results desired by proponents of a limited role for the RBI. See Bibek Debroy, *A lethargic 100 days for UPA II*, THE FINANCIAL EXPRESS, Aug. 31, 2009, available at <http://www.financialexpress.com/news/column-a-lethargic-100-days-for-upa-ii/509003/0#> (finding that the second UPA governments first 100 days in office has been marked by inaction on a wide variety of issues from issues with the proposed unique identity card and the revamping of the National Rural Employment Guarantee Act to the National Food Security Act, higher education matters, land acquisition, rehabilitation and resettlement, and judicial not to mention financial sector reforms); See also *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-45 (1984) (reflecting settled constitutional doctrine in the US known as the Chevron doctrine requiring courts to defer to an agency's interpretation of a statute unless Congress has directly determined the issue under consideration); See also Manne, *supra* note 4, at 23-24 (holding that there was considerable debate during the 1930's about the extent to which courts could override administrative agencies' interpretation of the authority granted by the US Congress, though this battle was almost completely won in the US Supreme Court by advocates of administrative discretion). Obviously, precedents from American regulation need not translate into similar outcomes in Indian contexts, though the example is certainly a possibility, and instructive. Regulatory authority over foreign exchange matters granted to an administrative agency hived off from the RBI may lead to no different policy decisions.

of knowledge, and of realizing a deeper sense of context and the interrelationship between legal processes, doctrines, conventions, institutions and social, economic forces in the country and the subcontinent. The history and the studies of institutional design and behavioral finance, not to mention conventional economic analyses of law, are collectively the examples of scholarship that offer nuance and predictive power to studies of India, law and economy. Rushdie's injunction applied to methods and an understanding of the law is more than whimsical; refuse to choose.



# THE ROLE OF ECONOMICS IN CARTEL DETECTION THROUGH LENIENCY PROGRAMMES

*Tissya Mandal\**

## I. INTRODUCTION

*People, who combine together, to keep up prices, do not shout it from the housetops. They keep it quiet. They make their own arrangements in the cellar where no one can see. They will not put anything into writing nor even into words. A nod or wink will do.*<sup>1</sup>

Competition law broadly relates to efforts at promoting competition through the means of legislature. “Competition” in competition law, however, is a misnomer, since competition law deals not so much with competition as the lack thereof.

The most serious form of anti-competitive agreement is cartel formation.<sup>2</sup> Cartels diminish social welfare, create inefficiency in resource allocation, and transfer wealth from consumers to the participants in the cartel by modifying output and/or prices.<sup>3</sup> Engaging in cartel activities to avoid the rigors of competition can result in the creation of artificial, economically inefficient and unstable industry structures, lower productivity gains or fewer technological improvements and sustained higher prices.<sup>4</sup> A law and economics approach can be undertaken to comprehend the circumstances under which leniency policy can be successfully used as a tool in preventing the formation of anticompetitive agreements by competition authorities. Leniency policies can be approached from the point of view of the prisoner’s dilemma. A “prison official” intending to take advantage of the prisoner’s dilemma from a law and economics perspective should structure

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\* IV Year, B.A., LL.B. (Hons.), West Bengal National University of Juridical Sciences, Kolkata.

1 Lord Denning in Registrar of Restrictive Trading Agreements v. W. H. Smith & Son Ltd., [1969] 3 All E.R. 1065 (H.L.).

2 Different definitions of the term cartel have been provided by different Competition Authorities. Some of them are discussed here under:

“Cartels mean express or tacit conventions, promises or agreements among firms to fix price and limit volume of production and sales, and selection of trading partners. They are classified in terms of the object of restriction into price cartels, volume cartels, market allocation cartels, and bid riggings.” (See *What Practices are Subject to Control by the Antimonopoly Act?*, JAPAN FAIR TRADE COMMISSION, available at [http://www2.jftc.go.jp/e\\_page/aboutjftc/role/q-3.htm](http://www2.jftc.go.jp/e_page/aboutjftc/role/q-3.htm)). “Cartel definition: Arrangement(s) between competing firms designed to limit or eliminate competition between them, with the objective of increasing prices and profits of the participating companies and without producing any objective countervailing benefits.” (See GLOSSARY OF TERMS USED IN EU COMPETITION POLICY, available at [http://europa.eu.int/comm/competition/publications/glossary\\_en.pdf](http://europa.eu.int/comm/competition/publications/glossary_en.pdf)).

3 EUROPEAN COMMISSION, XXXIIND REPORT ON COMPETITION POLICY 2002, available at [http://ec.europa.eu/competition/publications/annual\\_report/2002/en.pdf](http://ec.europa.eu/competition/publications/annual_report/2002/en.pdf), at p. 28.

4 VINOD DHALL, COMPETITION LAW TODAY - CONCEPTS, ISSUES AND LAW IN PRACTICE 14 (2007).

incentives in such a way as to make confessing a dominant strategy for each prisoner. Anti-cartelist policies would do well to learn from this experience when letting a person “turn approver” in anti-cartelist crackdowns. The idea is to induce each one of the offenders to provide sufficient evidence to convict the others, while possessing the knowledge that the other offenders have the same incentives.<sup>5</sup>

The ideal leniency policy offers companies involved in a cartel – which self-report and hand over evidence – either total immunity from fines or a reduction of fines which the Competition Commission would have otherwise imposed on them. It also benefits the Commission, allowing it not only to pierce the cloak of secrecy in which cartels operate but also to obtain insider evidence of the cartel infringement. The leniency policy also has a deterrent effect on cartel formation, also destabilizing the operation of existing cartels, as it sows the seeds of distrust and suspicion among cartel members.<sup>6</sup>

In India, cartels have been formed in various sectors such as cement, steel, tyres, trucking, family planning devices, etc. India is also believed to be a victim of overseas cartel in soda ash, bulk vitamins, petrol, etc. These tend to raise the price of products or reduce the choice of consumers. Business houses are affected most by cartels as the cost of procuring inputs is increased or choice is restricted pushing the houses to become uncompetitive, unviable, or simply satisfied with lesser profits.<sup>7</sup> The 1998 OECD Recommendation proclaimed that cartels are “the most egregious violations of competition law”.<sup>8</sup> Developing countries are worse affected than their developed counterparts due to a mixture of the absence of a competition regime and an inadequate capacity to detect, discover, and prosecute domestic and overseas cartels.<sup>9</sup>

## II. THE ECONOMIC RATIONALE BEHIND CARTEL FORMATION

Cartel formation depends mainly on structural conditions characteristic of oligopolistic markets. It is indubitable that the principal motives for undertakings to collude and form trusts are profit maximization, uncertainty-reduction, and

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5 Hans W. Friederiszick & Frank P. Maier-Rigaud, *The Role of Economics in Cartel Detection in Europe*, in *THE MORE ECONOMIC APPROACH TO EUROPEAN COMPETITION LAW* (Dieter Schmidtchen, Max Albert & Stefan Voigt, eds. 2007), available at [http://www.esmt.org/fm/312/Role\\_of\\_Economics\\_in\\_Cartel\\_Detection\\_in\\_Europe.pdf](http://www.esmt.org/fm/312/Role_of_Economics_in_Cartel_Detection_in_Europe.pdf), at 13.

6 Leniency is a key tool in detecting and deterring cartels in New Zealand. The Commerce Commission of New Zealand released its updated Cartel Leniency Policy on 1 March 2010. This assists the Commission to be better able to detect and break up cartels operating in New Zealand, providing benefits for consumers, businesses, markets, and the economy. It also fosters the deterrence of new cartels.

7 G. R. Bhatia, *Combating Cartel in Markets- Issues and Challenges*, EXECUTIVE CHARTERED SECRETARY, 654-657 (July 2006).

8 OECD REPORTS, *FIGHTING HARD CORE CARTELS: HARM, EFFECTIVE SANCTIONS AND LENIENCY PROGRAMMES* 12 (2002).

9 Bhatia, *supra* note 7.

lessening the pressure of competition as well as the risk of potential entry in the business by new players.<sup>10</sup>

Oligopolistic firms regularly face a dilemma, which consists of a trade-off between two alternatives: to opt for collusion that consents to joint profit maximization, or to opt for competition, rising the own net income and market share to detriment of adversaries. Oligopolistic firms should, therefore, estimate and compare the expected financial results of following or breaking the cartel's rules. If the firm decides to infringe a cartel arrangement by decreasing prices and increasing production levels, it should consider two inversely proportional effects: 1) the quantity effect<sup>11</sup>, since expanding production raises total revenues (being an oligopoly, unlike perfect competition, marginal revenue to the firm exceeds the marginal cost); and 2) the price effect, since increasing production raises the number of sold product units, but simultaneously decreases the price of the last marginal unit sold as well as all other units sold before. If the quantity effect prevails over the price effect, the firm will benefit from cheating the cartel by facing a situation of decreasing price and increasing production; on the other hand, if the quantity effect is dominated by the price effect, the firm will not benefit from violating the bargain. Which one of the two effects will prevail depends substantially on competitors' reaction.

### III. ECONOMIC ANALYSIS OF LENIENCY POLICY

In principle, various economic approaches are available to detect cartels. Following the structure-conduct-performance paradigm, a *structural* approach could seek to identify the characteristics that make an industry prone to collusion; a *conduct* approach could look at behavioural patterns that are more likely to be associated with collusion than with competition; and a *performance* approach could, for example, look for supra-competitive profitability.<sup>12</sup> However, all of these methods are costly to adopt in a routine way to detect collusion. Cartels cannot by nature depend on binding, legally enforceable contracts; they must therefore rely on some form of self-enforcement. This can make cartels fragile and induce cartel participants to come forward and report the cartels' activities. Leniency policies have until now been globally successful in fighting cartels through each of the policies' four stages: 1) prosecution, making conviction and penalization stricter and more frequent; 2) detection, making discovery more probable; 3) desistance, making cartels less stable, seeding mistrust and suspicion among cartel partners; and 4) deterrence, making cartels less profitable.<sup>13</sup>

10 DHALL, *supra* note 4.

11 The change in total revenue caused by quantity is called the quantity effect.

12 Paul A. Grout, *Structural Approaches to Cartel Detection*, EUROPEAN UNIVERSITY INSTITUTE ROBERT SCHUMAN CENTRE FOR ADVANCED STUDIES, available at <http://www.eui.eu/RSCAS/Research/Competition/2006%28pdf%29/200610-COMPed-Grout.pdf>, at 2.

13 Danilo Samà, *Competition Law, Cartel Enforcement & Leniency Program*, available at <http://econpapers.repec.org/paper/pramprapa/14104.htm>, at 12.

We know that the success of a cartel depends mainly on the level of “trust”<sup>14</sup> existing among the cartel members. Leniency programmes, because they provide formal incentives to the cartel’s members for cheating on each other, can exploit this fact to reduce the duration of cartels. Each cartel member-firm now faces a prisoner’s dilemma-like situation, since it must contemplate whether or not to apply for leniency. Its choices are two: 1) not to report, in the hope that other members will choose the same; and 2) to report, if it believes that it is imminent that another partner-firm will also report. By giving cartel members a reward for confessing, leniency programmes disseminate distrust within the cartel. This makes the cartel’s bond weaker, and increases the possibility of members withdrawing. The challenge for antitrust authorities is to induce cartel members to stop waiting and start the “race to confess”.<sup>15</sup>

#### IV. SUBSTANTIVE DIFFERENCE FROM THE PRISONER’S DILEMMA

Leniency policies on cartel firms, however, do not exactly fit into the typical chart of the prisoner’s dilemma. In most cartel investigations, the prosecutor lacks necessary evidence. A chart of the strategies available to members can be drawn, analogous to that of the prisoners’ dilemma:

		PLAYER 2	PLAYER 2
		<i>Confesses</i>	<i>Does Not Confess</i>
PLAYER 1	<i>Confesses</i>	(-10, -10)	(0, -20)
PLAYER 1	<i>Does Not Confess</i>	(-20, 0)	(0,0)

There is, as such, no strictly dominant strategy - a dominant strategy is the name given to the strategy that gives a better pay off, regardless of the strategy chosen by the other player - but it is still ascertainable that if there is any risk of one player’s partner confessing, then the first player should confess first. As both players are indifferent between their possible strategy when their partner is playing ‘not confess’, this means that the strategy ‘confess’ is a weak dominant strategy.

14 The expression “trust”, coined by the Anglo-Saxon tradition, embodies in a very efficacious manner the concept of anti-competitive cartel since it alludes to the relationship of mutual confidence and reliance that must be necessarily instituted among the adherents to the market sharing, production limitation, or, more straightforwardly, price increase agreement. See DHALL, *supra* note 5, at 42.

15 Richard Moberly, *Protecting Whistleblowers By Contract*, 79 COLO. L. REV. 975, 1043 (2008), at 980.

Although ‘confess’ is a weak dominant strategy for both players, which makes the pair of strategies [confess, confess] a Nash Equilibrium, there is still a second equation in the game: [not confess, not confess]. This means that in the absence of any leak of information, cooperation between the two parties may actually get both to play ‘not confess’ and guarantee a better pay-off to each.

Rarely, however, are things as simple as this: cartel members usually lack certainty about incriminating information not being disseminated since that could be obtained not only from the other members’ cheating on the cartel but also as a result of complaints coming from competitors or consumers, and investigations launched by competition authorities. The setting is complicated also by the fact that cartels are formed and maintained only as long as there is sufficient level of trust among its members. This particular setting makes the equilibrium no longer static, but rather subject to changes over time.

#### V. TASK OF THE COMPETITION AUTHORITY

All of this makes the role of the competition authority critical: it can create distrust and construct a more favourable prisoner’s dilemma, i.e. one in which confession appears as the dominant strategy. In order to do this, it will often revert to the use of evidence concerning relatively minor crimes (which are often ancillary to a price-fixing<sup>16</sup> scheme) as leverage to spur confession from one of the cartelists. Not always, however, will such evidence be available. Moreover, authorities are frequently called to make a strategic choice in the matter: even in case they do have substantial evidence to convict, they might be able to inflict bigger sanctions by waiting a bit longer so as to collect more information. Since the authorities do not normally have the occasion to meet personally with cartel members to foster confessions, the situation results in a much more complicated form than the basic prisoner’s dilemma: they have to take utmost care in sending signals to the cartelists, in order to get them to play the same ‘game’ that they are playing: a strategic game theory.<sup>17</sup>

Moreover, it is not only the first whistle-blowing party that can get away with paying no fines, but also subsequent parties who can cooperate to get decreased penalties. To encourage confessions adequate protection must be provided to whistleblowers. At the commencement of the interrogation the authority should make it clear to the whistleblower that that the interview is

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16 Price fixing is an agreement among competitors to raise, fix, or otherwise maintain the price at which their goods or services are sold. It is not necessary that the competitors agree to charge exactly the same price, or that every competitor in a given industry join the conspiracy. Price fixing can take many forms, and any agreement that restricts price competition violates the law.

17 Nicolo Zingales, *European and American Leniency Programmes: Two Models towards Convergence?*, (2008) 5(1) COMP. L. REV. 8.

confidential. A new enactment on the lines of the Whistleblower Protection Act of 1989<sup>18</sup> of the US could be drafted to protect the identity of the whistleblowers and their security.

There is direct link between the success of the leniency/ whistle blowing culture and the position that the Competition Commission of India adopts in the future. High fines and active enforcement, such as that displayed by the European Commission, are more likely to increase leniency applications. It is unlikely that leniency would have been such a viable and attractive option for cartelists in the EU had the European Commission not adopted an aggressive fining policy. For example, in 2007 in the *Chloroprene Rubber* cartel, the leniency applicant avoided a fine of Euros 200 million whereas a foreign company involved in the same cartel received a fine of Euros 47 million.<sup>19</sup> In the same year, in the *Gas Insulated Switchgear* cartel, a European leniency applicant avoided a fine of Euros 200 million whereas four Japanese participants were together fined Euros 264 million.

#### VI. SCOPE OF LENIENCY IN INDIA

The key advantage for India is that the competition law in other jurisdictions is very well developed, and as such there will be plenty of precedents and guidance to assist with the development of an Indian competition regime. The Competition Commission will be able to effectively combat domestic as well as cross border cartels through adopting a combination of various methods. These include deciding upon an explicit definition of 'cartel', the power to impose deterrent penalty linked with profits or turnover on each member, explicit provisions to exercise jurisdiction in respect of overseas acts having adverse effects on competition in India, other provisions to enter into cooperation agreement with contemporary overseas competition agencies, efforts to build a strong domestic competition culture, coordination with government departments and sector-specific regulators, and stressing the need for strong sanctions in view of the irredeemable harms caused.

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18 The Whistleblower Protection Act of 1989 is a United States federal law that protects federal whistleblowers, or persons who work for the government who report agency misconduct. A federal agency violates the Whistleblower Protection Act if it takes or fails to take (or threatens to take) a personal action with respect to any employee or applicant because of any disclosure of information by the employee or applicant that he or she reasonably believes evidences a violation of a law, rule or regulation; gross mismanagement; gross waste of funds; an abuse of authority; or a substantial and specific danger to public health or safety. *See Whistleblower Protection Act Information*, U.S. SECURITIES AND EXCHANGE COMMISSION, available at <http://www.sec.gov/eeoinfo/whistleblowers.htm>.

19 Jaishree J. Vyavaharkar, *Blowing the Whistle on Cartels in India and beyond*, 1 COMPETITION LAW REPORTS 272, 273 (2008)

## VII. CONCLUSION

There is a universal interest in the use and development of leniency programs as a means of detecting and cracking international cartel activity. The message has been clear that leniency programs can provide antitrust enforcers with an unprecedented tool for detecting and investigating cartel activity. The formula for a successful anti-cartel enforcement program should include equal share of stiff potential penalties, high detection rates, and transparent enforcement policies. This will prevent most groups from ever engaging in cartel activity. However, when cartels are formed, we have found that the amnesty Program, with its lure of leniency in exchange for self reporting and full cooperation, is the most effective investigative tool for cracking cartel activity.



# A STUDY OF THE AVIATION SECTOR IN INDIA: AN ANALYSIS OF THE EMPLOYMENT CONTRACTS OF AIRHOSTESSES IN LIGHT OF *SHEELA JOSHI V. UNION OF INDIA*

Vrinda Bhandari\*

## I. INTRODUCTION

Employment contracts, attributing rights and responsibilities between the parties to the bargain, are contracts of service in varied sectors such as construction, finance, business etc. Although, they have been subject to strict legal/contractual scrutiny, the emerging area of Law and Economics has endeavored to analyze their economic basis, with regard to termination clauses or covenants to compete. In such a sphere, aviation contracts, specifically termination clauses of airhostesses, present an interesting case study insofar as they reflect the competing ideals of economic efficiency and social justice. This can be evidenced by the Delhi High Court decision in *Sheela Joshi v. Indian Airlines Ltd.*<sup>1</sup> wherein the termination of overweight airhostesses was upheld in light of the competitive and cosmetic nature of the airline industry.

This note critically examines the employment terms of airhostesses pertaining to their strict appearance requirements to evaluate their economic efficiency, in light of *Sheela Joshi*, without considering their social and moral probity. Part II of this note lays down the current practice and legal rule, tracing the transformation of the court's approach *qua* airhostesses as "victims" of appearance-based discrimination and the change evidenced in *Sheela Joshi*. Part III undertakes an economic analysis of the airline's decision to value appearance and purportedly customer preference over experience.

## II. THE CURRENT PRACTICE AND LEGAL RULE: BACKGROUND OF THE *SHEELA JOSHI* JUDGMENT

The liberalization of the Indian aviation industry saw the emergence of new players in direct competition with the government-run airlines. To escape the organizational and managerial inefficiencies which had beset the national carriers, these private airlines streamlined their operations and spruced up their image<sup>2</sup> by employing attractive airhostesses, ordering designer staff uniforms

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\* III Year, B.A., LL.B, (Hons.), National Law School of India University, Bangalore.

1 2000 (54) D.R.J. 276 (Del.). The High Court here held that an airhostess can be dismissed from employment for being 'fat' since it was an industry which paid attention to cosmetic factors and in the time of increased competition, the government airlines can fire for such reasons. The appeal is currently awaiting decision in the Supreme Court.

2 Shashi Sharma, *Aviation Industry in India: Challenges for the Low Cost Carriers*, available at [http://works.bepress.com/cgi/viewcontent.cgi? article=1000 &context=shashi\\_sharma](http://works.bepress.com/cgi/viewcontent.cgi? article=1000 &context=shashi_sharma) (last visited 20th February, 2010).

and improving in-flight entertainment. Consequently, the average profile of an airhostess metamorphosed, with the national carriers struggling to keep pace.<sup>3</sup>

Our courts have usually stereotyped women in our “*tradition-bound, non-expressive society*”<sup>4</sup> by endeavoring to help them “*settle down in a respectable family*.”<sup>5</sup> This distinctly Indian, semi-paternalistic judicial perspective<sup>6</sup> could also be evidenced in the aviation industry, *vide Air India v. Nargesh Meerza*.<sup>7</sup> The Supreme Court here struck down the service rules fixing a lower retirement age for airhostesses as gender-discriminatory and *ultra vires* the Constitutional notion of equality. Fazal Ali J., censured the attempts of an “*open insult to the institution of our sacred womanhood*” when it was sought to be argued that appearance, glamour and weight were important parameters to be considered for an airhostess.<sup>8</sup> He decried this purported objectification of women which suggested that “*younger and attractive*” women were better placed to “*entertain and look after*” passengers since such a pre-supposition ran contrary to the grain of Indian society.<sup>9</sup>

Against this background, the Delhi High Court passed a landmark decision in *Sheela Joshi* upholding the airhostesses’ termination<sup>10</sup> for being overweight.<sup>11</sup> This was contested on two grounds: for being unreasonable, unfair and without the sanction of law *and* for affronting their ‘dignity, honour and womanhood’.

The High Court rejected the first ground by referring to Clause 9(II)(b) of their contract which created a mutually acceptable and legally binding

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3 With the introduction of Kingfisher Airlines, with their designer uniforms, model airhostesses and the idea of luxury travel, both Air India and Indian Airlines were forced to adapt by giving a new look to their cabin crew, in line with “contemporary fashion..” See Correspondent, *United Colours of Air India Crew*, REDIFF NEWS, June 11, 2007, available at <http://www.rediff.com/money/2007/jun/11ai.htm> (last visited 16th February, 2010)

4 *Bharwada Bhoginbhai Hirijibhai v. State of Gujarat*, A.I.R. 1983 S.C. 753.

5 For instance in rape cases, courts have noted that the prevailing mores in Indian society would not facilitate a lie by the prosecutrix in a rape case since it would adversely affect her chances of getting married. See *Sunil Kahar v. State of Bihar*, 1992 CRI. L. J. 3647 (Pat.); *Jito v. State of Himachal Pradesh*, 1990 Cri. L. J. 1434 (H.P.).

6 *State of Madhya Pradesh v. Babulal*, 2008 (1) S.C.C. 234.

7 A.I.R. 1981 S.C. 1829.

8 *Id.*

9 *Id.* Fazal Ali J. stated that such an approach appears “*to be in bad taste and is proof positive of denigration of the role of women and a demonstration of male chauvinism and verily involves nay discloses an element of unfavourable bias against the fair sex which is palpably unreasonable and smacks of pure official arbitrariness.*”

10 The airhostesses were told that they would be treated on leave if there was any leave to their credit and that if there was none it would be deemed to be “leave without pay.” They challenged this on the ground that although the airline had always insisted on weight regulation and checks, they had never strictly enforced them. Then they had suddenly, in a series of circulars, reduced the grace in the quantity of excess weight and in May 2006 finally withdrew even the 3 k.g. grace amount.

11 *Sheela Joshi v. Indian Airlines Ltd.*, 2000 (54) D.R.J. 276 (Del.).

obligation.<sup>12</sup> It permitted Indian Airlines to terminate services for crossing the specified weight limit. Even the grant of earlier concessions did not vest a *legal right* with the plaintiffs, since they had knowingly consented to the employment terms.<sup>13</sup>

On the second and more contentious ground, Sharma J. ruled in favour of the respondents by linking the job profile of an airhostess with the competitive nature of the industry.<sup>14</sup> Even safety concerns necessitate a limit, insofar as being overweight often affects the agility and reflexes required in emergency situations.<sup>15</sup> This, thus entitled airlines to expect employees to maintain a specified waistline, and was in no “*way unfair, unreasonable and insulting to their womanhood.*”<sup>16</sup> The premise of the judgment is best stated as, “*In this era of cut-throat competition no airlines can afford to remain lax in any department whatsoever, be it the personality of its crew members, their physical fitness in all respects or the air worthiness of the aircraft or in relation to other facilities such as catering etc.*”<sup>17</sup>

It is interesting to note that although the judgment was appealed against, the Supreme Court did not adjudicate upon the merits since eleven petitioners had rejoined duty after losing weight.<sup>18</sup> This change in judicial opinion is reflected in the words of the court in *Air India Cabin Crew Association v. Yeshawinee Merchant*<sup>19</sup> where it noted that “*Air India is a travel industry. Pleasing appearance, manners and physical fitness are required for members of the crew of both sexes.*”

These judgments are in consonance with the latest trend of airlines paying greater attention to physical condition and personal appearance as an indicator of personality.<sup>20</sup> Consequently, during a recent recruitment drive by Air India, while excusing candidates with acne or ungainly teeth, Personnel Manager Meenaxi Dua explained, “*There should be no scars, acne, or any major*

12 Clause 9(II)(b): During the training period and on appointment as Airhostesses, your services are liable to be terminated under the following circumstances... If you do not maintain weight within the prescribed limits.

13 *Supra* note 11.

14 *Id.*, “*And let us not forget that in this era of cut throat competition no Airlines can afford to remain lax in any department whatsoever, be it the personality of its crew members, their physical fitness in all respects or the air worthiness of the air craft or in relation to other facilities such as catering etc.*”

15 *Id.*, “*the aircrafts fly at a very high altitude. Quite often emergency situations arise because of air turbulence or on account of aircraft developing snag. The Cabin Crew including the Airhostess are expected to handle the situation deftly, with alacrity and presence of mind. All this will be possible only if the Cabin Crew possesses the highest order of physical and mental fitness*”

16 *Id.*

17 *Id.*

18 Sheela Joshi v. Indian Airlines, A.I.R. 2010 S.C. 302.

19 A.I.R. 2004 S.C. 187.

20 S. Majumdar, *India grounds “fat” airhostess*, BBC NEWS, June 6, 2008, available at [http://news.bbc.co.uk/2/hi/south\\_asia/3502493.stm](http://news.bbc.co.uk/2/hi/south_asia/3502493.stm).

*marks on the face... looks matter in this line of work, and therefore we are giving it a lot of importance*”.<sup>21</sup> These cosmetic changes have a direct bearing on the image and hence success of air carriers, which explains the description of Kingfisher’s airhostesses as “flying models.”<sup>22</sup>

This note will thus seek to analyze whether the decision in *Sheela Joshi* was premised on economically sound principles or was a knee-jerk judicial reaction pandering to the concerns of the national carriers facing stiff competition.

### III. ECONOMIC ANALYSIS OF THE LAW

The analysis of *Sheela Joshi* is based on whether it is economically efficient to value appearance over experience in an attempt to maximize profit and customer satisfaction. This is not a “justice” analysis, rather a determination of whether the airlines are *actually* assessing consumer preferences correctly and consequently, whether their decision to focus on personal appearance even at the cost of quality/experience, is in line with their purely commercial motives. This necessitates a three pronged argument analyzing whether there is any connection between consumer/passenger tastes and the appearance of flight attendants; *second*, whether the employment contract achieves this implicit purpose; and *third*, to determine whether an “at will” or “just cause” system of employment is more efficient.

The neo-classical economic model is premised on the desirability of aggregating personal preferences expressed in the market place by focusing on the determination of prices, outputs and income distributions in the markets through supply and demand, in their quest to achieve equilibrium.<sup>23</sup> Thus the primary consideration for airlines would be to maximize customer/passenger preferences by engaging in taste-based discrimination. This, however, begets the question whether customers/passengers are influenced by the appearance of airhostesses.

#### A. Are Passengers Influenced by Appearance?

Employers (airlines) will continue recruiting till the time they *believe* the value of the worker’s production (judged by passenger satisfaction at the quality of service) is greater than the cost of the worker working.<sup>24</sup> Without conclusive empirical data, one can only rely on the *perception* of airlines evidenced by

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21 Monica Chadha, *No acne allowed for airhostesses*, BBC NEWS, February 19, 2004, available at <http://news.bbc.co.uk/2/hi/3502493.stm>.

22 Careers with Kingfisher Airlines, available at [http://www.flykingfisher.com/exp\\_crew.asp?id=112](http://www.flykingfisher.com/exp_crew.asp?id=112). (last visited February 16, 2010).

23 R. POSNER, ECONOMIC ANALYSIS OF LAW 615 (3d ed., 1986).

24 John J. Donohue III, *Is Title VII Efficient?*, 134 U. PA. L. REV. 1411, 1412 (1986).

their qualification criteria<sup>25</sup> which seem to view attractive airhostesses as great potential for profit.

Thus, for instance, Clause 9 of the contract signed by trainee airhostesses and Indian Airlines provides for the termination of services in case the airhostess: (I) gets married before a specified time period; (II) does not maintain weight within the prescribed limits.<sup>26</sup> Kingfisher Airlines, in an endeavor to have a fleet of “model” airhostesses, has launched an all India “Flying Models” Contest and has organized monthly “Kingfisher Flying Face of the Month” contests.<sup>27</sup> Jet Airways also advertises for young and “attractive” unmarried airhostesses, aged between 18 and 27 years. A youth magazine covering the pressures of the industry interviewed airhostesses across airlines, revealing the high premium placed on appearance and attractiveness,<sup>28</sup> wherein airlines employed grooming instructors to keep a check on their makeup and airhostesses were grounded for getting even a single pimple on their face.<sup>29</sup> These incidents highlight the value placed by airlines on physical appearance rather than the competence or training of airhostesses.

### *B. The Correlation Between Passenger Preferences and the Revenue Generated*

The establishment of a clear link between consumer/passenger preferences and physical appearances does not necessarily guarantee profits to a commercial airliner. Economically, satisfaction is defined as a function of perceived quality and “disconfirmation”, which is the extent to which the perceived quality fails to match the pre-purchase expectations.<sup>30</sup> This is similar to the business concept of “Hygiene Factors”, which *sui generis* do not afford satisfaction but are necessary to avoid dissatisfaction, since they have a greater negative impact on satisfaction and repurchase intentions.<sup>31</sup> Repurchase intentions

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25 Since most contracts which airlines sign with their airhostesses and in-flight crew are not available in the public domain, reliance has been placed on news paper archives and other external sources of information.

26 Sheela Joshi v. Indian Airlines, 2000 (54) D.R.J. 276 (Del.). It was Clause 9(II)(b) which was the subject of litigation since the airhostesses were grounded for being over weight.

27 *Kingfisher Air to Have Models as Airhostesses*, THE HINDU, July 28, 2004, available at <http://www.thehindubusinessline.com/bline/2004/07/29/stories/2004072902510600.htm>.

28 *Main Udna Chahiti Thi*, JAM MAGAZINE, available at [http://www.jamag.com/coverstory/cover\\_story\\_10.htm](http://www.jamag.com/coverstory/cover_story_10.htm) (last visited February 22, 2010).

29 In fact, sometimes airhostesses were grounded or warned for wearing the incorrect shade of lipstick or eye liner. They are told how to wear their hair, how to bleach their face etc. Some have even gone to the extent of getting surgery done. This is the best evidence one can provide as to how airlines link appearance to customer satisfaction. *Id.*

30 Eugene W. Anderson & Mary W. Sullivan, *The Antecedents and Consequences of Customer Satisfaction for Firms*, 12(2) MARKETING SCIENCE 125, 128 (1993).

31 An example of hygiene factors would be clean tablecloths at restaurants. Though a customer would not frequent a restaurant based on the sole reason of it having clean tablecloths, a disjunct between the expectations and the actual quality of the tablecloth would result in lower repurchase

have been found to be more inelastic for firms providing higher satisfaction<sup>32</sup> which incentivizes airlines to create a “long-run reputation effect” of maximizing customer satisfaction which would insulate them from varied industrial and price fluctuations.<sup>33</sup>

Many economists believe that in the long run taste-based discrimination will eventually peter out in light of increased competition.<sup>34</sup> Using race as an example, Becker argues that eventually a factory owner will employ a black worker who gives him a higher per capita productivity at the same wage rate as opposed to a white employee, and his success would impel others to follow suit.<sup>35</sup>

This argument is however premised on the assumption that there is an *aversion qua* certain groups even though all the workers are *equally productive*.<sup>36</sup> Therefore, this analysis will not apply to the aviation sector, since the discrimination is not on account of the personal preferences of the employer, but on the personal preferences of the passenger. Instead of firms aiming for profit maximization by eventually employing the most productive worker, airlines achieve wealth maximization by maximizing consumer satisfaction by pandering to their preferences which necessitates appearance discrimination.

These considerations raise important questions regarding statistical methods of discrimination wherein airlines use group characteristics as a cost-efficient method of predicting individual worker attributes.<sup>37</sup> The preferences of most customers here are attributed to all customers and thus, credence is given to *general* rather than specific passenger preference which might harm the airhostesses. For instance, even though some customers might value prompt and efficient service over the appearance, it is impossible to actually determine each preference and employers have to engage in statistical discrimination. However, efficiency *qua* airlines is maximized if the gains from imposing appearance requirements outweigh the loss to the airhostesses who might be grounded.<sup>38</sup>

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intentions of the consumers, which in this case, would imply not visiting the restaurant again. F. HERZBERG ET AL., *THE MOTIVATION TO WORK* 23 (12th ed., 2009).

32 See *supra* note 31, at 141.

33 *Id.*

34 S.J. Schwab, *Employment Discrimination*, 572, 576 (Cornell University School of Law, Working Paper No. 5530, 1999), available at <http://encyclo.findlaw.com/5530book.pdf> (last visited February 20, 2010)

35 GARY S. BECKER, *THE ECONOMICS OF DISCRIMINATION* 15 (2d ed., 1971).

36 *Id.* at 14-18, 39-54.

37 *Supra* note 36, at 576.

38 Michael Sattinger, *Statistical Discrimination with Employment Criteria*, 39(1) INT'L ECON. REV. 205, 222 (1998).

### C. Whether an “at will” or “just cause” Termination Clause is More Efficient?

Having established the need for differential appearance-based contracts, especially from the perspective of the employer, I will endeavor to analyze the covenants in the employment contract, highlighting the termination clauses. This entails a comparison between the “at will” and “just cause” standard of employment.

Unlike other product or technology-specific industries where students are taught general “know-how,” and not industry-specific information, at the university level, airhostesses are trained at aviation academies, where they take courses ranging from personal grooming and fitness to an introduction to the air-travel industry.<sup>39</sup> Thus, the relational or specific human capital investment, i.e. on-the-job training is lesser for airlines than other product-specific industries where each firm needs tailor-made training programs to help employees adjust. Thus, it is easier for airlines to fire employees,<sup>40</sup> placing the emphasis on a more “at will” style of employment (seeing that it would be between the two extremes).<sup>41</sup>

The fears of opportunistic employers is however reduced in “at will” contracts because of the theory of repeated games wherein the employer, recruiting periodically, would be adversely affected by an “opportunistic” reputation while selecting future candidates whilst simultaneously increasing transaction costs of interviewing and monitoring the progress of new candidates.<sup>42</sup> The relationship between the airline and the airhostess would end most efficiently, *only* when the total gains to both parties accruing from the relationship (quality of services for the employer and the job security and satisfaction to the employee) would fall short of the total gain from termination<sup>43</sup> (the possibility of hiring a more attractive and crowd-appeasing employee for the airline and the future job prospects for the airhostess).

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39 There are various aviation academies such as Frankfinn Institute of Airhostess Training which offer one year courses teaching aviation, hospitality and travel management. See [http://www.frankfinn.com/courses/btec\\_hnc\\_in\\_aviation\\_hospitality\\_and\\_travel\\_managt.php](http://www.frankfinn.com/courses/btec_hnc_in_aviation_hospitality_and_travel_managt.php) (last visited February 21, 2010)

40 Gary S. Becker, *Investment in Human Capital: A Theoretical Analysis*, 70(5) J. POL. ECON. 9, 25 (1962).

41 “At will” employment rules allows employer to sever their employment relationship for a good reason, a bad reason or no reason at all. A “just cause” standard, on the other hand, rests on the inequality of bargaining power between the parties and hence the reasons for termination decisions should be defensible. See Ed Nosal, *Optimal At-Will Labour Contracts*, 68 (270) *ECONOMICA* 187, 188 (2001).

42 Stewart J. Schwab, *Life-Cycle Justice: Accommodating Just Cause and Employment at Will*, 92(1) *MICH. L. REV.* 8, 25 (1993).

43 Sherwin Rosen, *Commentary: In Defense of the Contract of Will*, 51(4) *U. CHI. L. REV.* 983, 984 (1984).



This thus ensures an implicit self-enforcing contract, inasmuch as the airline would not abuse its position as an at-will employer since an unreasonable termination would mean increased reputation and transaction costs, while airhostesses would perform to certain set standards, for *fear* of termination in the knowledge of her relatively short cabin crew career span.<sup>44</sup>

In fact, Schwab points out that the danger of employer opportunism is greatest for late-career workers, and noticeable in cases of some beginning-career employees, specifically those who have moved to take a job or quit another job,<sup>45</sup> which would include newly recruited airhostesses. This is because the employees, i.e. airhostesses, commit to an irretrievable, and hence greater investment to the relationship, in terms of educational and re-allocation costs, as opposed to airline employers.<sup>46</sup> Furthermore, they would find integration into the job market relatively difficult, in lieu of the tendency to prefer recruiting a younger woman.<sup>47</sup>

Conversely, the tendency to slack increases manifold during mid-career, since employees often become complacent and over-comfortable in their work place, which is when “just cause” employment becomes inefficient, a predicament common to the public sector, wherein productivity is often sub served to job security.<sup>48</sup>

To solve this problem, Schwab posits an interesting solution, in line with American case law which seeks to offer contract protections at the beginning and end of the career cycle which employ an “at will” stand for the mid-career employees.<sup>49</sup> This solution would possibly provide the adequate safety net to the airhostesses whilst safeguarding the interests of the airlines.

#### IV. CONCLUSION

This paper sought to analyze whether the ruling of the Delhi High Court in the *Sheela Joshi*<sup>50</sup> case prioritizing appearance/taste based discrimination over employee performance in cases of termination was economically efficient.<sup>51</sup> This was contextualized by outlining the competitive nature of the industry post liberalization.

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44 Jet Airways, for instance, prefers its cabin crew to be aged between 18-27 years.

45 *Supra* note 44, at 11.

46 *Supra* note 44, at 39.

47 Each airline would have its own crop of experienced and new airhostesses. Thus, if they have to recruit, they would prefer younger airhostesses, since their life span being so short, they would want to catch them young and unblemished. As age increases, chances of weight loss and wrinkles etc. also increase.

48 *Supra* note 44, at 39.

49 *Supra* note 44, at 11.

50 *Sheela Joshi v. Indian Airlines*, 2000 (54) D.R.J. 276 (Del.).

51 This question is based on the assumption that even if arguments relating to the impact of weight on the performance of the flight attendants were not considered, would airlines be justified in imposing weight restrictions?

Discrimination in economic life, according to Robert Cooter, usually entails “*sorting people according to traits rather than productivity*”<sup>52</sup> and it is when this discrimination is targeted against a certain group without any egalitarian or reasonable basis that it is “invidious”.<sup>53</sup> An economic analysis of law requires the clear establishment between consumer/passenger preferences *and* the airhostesses’ appearance. Subsequently, using an economic definition of satisfaction, a link was drawn between definite preferences and the repurchase intentions, which would eventually have a bearing on the revenue generated and profit maximized of the particular airline.

After having provided a theoretical rationale justifying the prevalence of appearance- based discrimination as a means of improving economic efficiency of the firm (airline) with respect to the consumer (passenger) to achieve equilibrium in a neo-classical framework, comparative literature and case law on employment contracts were examined. These sought to find a *via media* of applying both the “at-will” and “just cause” standard to balance employer opportunism with lethargic and complacent employees.

Thus, the ruling in *Sheela Joshi v. Indian Airlines*,<sup>54</sup> is economically sound, insofar as it provides for a more efficient position in society for the air line which has capitalized on consumer preferences to maximize profit; for the passenger whose satisfaction (and hence utility derived from each air trip will increase) and for the flight attendants, whose personal appearance would improve their chances of further employment and improve the movement of labour and hence integration of the labour market.

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52 Robert D. Cooter, *Market Affirmative Action*, 31 SAN DIEGO L. REV. 133, 137 (1994).

53 *Supra* note 35, at 573.

54 2000 (54) D.R.J. 276 (Del.).

## REVIEW

### THE AMBIVALENT LIFE OF *DEAD AID*

Priya S. Gupta\*

*Dead Aid: Why Aid is Not Working and How There is a Better Way for Africa.* By Dambisa Moyo. New York: Farrar, Straus & Giroux. 2009. pp. 208. Cloth, \$24.00.

#### I. INTRODUCTION

As of May 2010, a Google search for “*Dead Aid* ‘Moyo’” yielded over 300,000 results. The Dambisa Moyo page on Facebook has over 8,500 fans. Academics, policymakers, journalists, and even *Elle Magazine*<sup>1</sup> all have something to say about the book, about her. Why? What is it about this book that has touched a chord, or in many cases, a nerve, with so many people? Perhaps it is her message: Western countries should completely *turn off* the tap of foreign aid to Africa (yes, all African countries are aggregated by their continent) and Africa should use financial alternatives to achieve development instead. Perhaps it is Moyo herself: highly educated, professionally experienced, African, female, and a zealous advocate for her cause. This review attempts to address this question and offer an argument defending the importance of this book despite its substantive flaws.

Dambisa Moyo’s diverse qualifications and work experience place her in an ideal position to offer credible insight into foreign aid. She has a Ph.D. in Economics from Oxford, and a Master’s Degree from Harvard. She has worked for the World Bank and Goldman Sachs. Indeed, her expertise with financial instruments is obvious, and demonstrated by her seemingly effortless explanations of complex financial instruments for a diverse audience of readers.

Previous commentators have focused on the ideal combination of Moyo’s resumé and Zambian upbringing.<sup>2</sup> She is a unique success story from a country

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\* Assistant Professor, Jindal Global Law School (JGLS); Assistant Director, Centre for Women, Law, and Social Change, Sonipat, NCR of Delhi, India.

The author would like to thank Emily Bosch, of the OECD, for her insights and discussions regarding aid and economic growth.

1 *Les Femmes de la Semaine*, ELLE, Oct. 2, 2009, available at <http://www.elle.fr/elle/Societe/Les-femmes-de-la-semaine/Les-femmes-de-la-semaine-02-10-2009/Dambisa-Moyo/%28gid%29/987364>.

2 See, e.g., Jagdish Bhagwati, *Banned Aid: Why International Assistance Does Not Alleviate Poverty*, FOREIGN AFFAIRS, Jan./Feb. 2010, at 120 (referring to Dambisa Moyo as “a young Zambian-born economist with impeccable credentials”); Paul Collier, *Dead Aid by Dambisa Moyo: Time to Turn off the Aid Tap?*, THE INDEPENDENT, Jan. 30, 2009, available at <http://www.independent.co.uk/arts-entertainment/books/reviews/dead-aid-by-dambisa-moyo-1519875.html> referring to Moyo as “an African woman, articulate, smart, glamorous, delivering a message of brazen political incorrectness”).

which “continues to flounder in a seemingly never-ending cycle of corruption, disease, poverty, and aid-dependency” (p. xv). With this book, a new voice has been heard in a dialogue primarily dominated by Western males in academia or the public sector. This voice is female, has a Zambian accent, and speaks from years of experience in investment banking.<sup>3</sup> This review primarily addresses her insights as the last of these perspectives, as a banker. Even so, the significance of her contribution as an African female cannot be ignored, especially when one looks at the tenor of the incredible response she has received, a phenomenon addressed briefly in the third part of this review.

This review begins by laying out Moyo’s arguments against aid and recommendations for alternatives, as well as my own reservations regarding the book, in Part I. Part II addresses the incredible response which *Dead Aid* has received and evaluates a few common criticisms of other reviewers. In Part III, I offer an argument for the importance of *Dead Aid* on two grounds: the form and content of the book itself, and the response it has engendered. In short, I argue that Moyo’s book is accessible, timely, and fills a gap in current popular development literature in the West by offering specific recommendations regarding financial alternatives. Moreover, the overwhelming response to it, both positive and negative, has served her mission of catalyzing a dialogue of alternatives to aid.

## II. PART I: MOYO’S ARGUMENT

Moyo’s primary thesis is unequivocal and unapologetic. She argues that aid is not merely ineffective; it is the *cause* of poverty and underdevelopment in Africa (p. 47). Therefore, countries in Africa and Western donors should cut off aid completely in the next five years, and use a variety of financial instruments (including foreign direct investment (FDI), securities offerings, microfinance, and remittances) and international trade to achieve their development goals.

The first half of the book is focused on current development and foreign aid policy and how it has failed. Moyo gives a concise introduction to the concept of aid, defending her aggregation of all government-to-government and multilateral organization-to-government aid transfers as “foreign aid” and of all African countries as “Africa” for the purpose of the book’s arguments and prescriptions (*Preface* and Chapter 1). She explicitly does not include direct aid transfers to non-governmental recipients from charities or non-governmental organizations (NGOs) (p. 7).

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3 See, e.g., *Voice of Disenchantment*, THE ECONOMIST, Mar. 12, 2009 (“[T]he intellectual arguments about aid are still conducted largely within a small circle of Western white men. So it is good to welcome a new voice to the debate, and a black African woman too”); and Bhagwati, *supra* note 2, at 120 (stating that aid “debates have largely been the province of Western intellectuals and economists” and that with *Dead Aid*, “the African silence has been broken”).

Once she has defined the parameters of “aid” and “Africa,” she then provides “A Brief History of Aid” from the end of the Second World War (Chapter 2). Along the way, she highlights a few reasons why these aid efforts have failed, including lending to un-creditworthy governments and central banks, lending to countries with poor records of good governance, and shifting focuses in aid policy – from poverty to development to governance to “glamour aid”. While she covers an impressive amount of history in a mere eighteen pages, she glosses over many significant nuances of the complex political economic history of aid. I will explore one of these in particular, governance, before returning to the rest of her argument.

Early in the book, Moyo introduces a thread of an argument regarding good governance, which she picks up again later in the book. According to Moyo, while “governance remains at the heart of aid today,” it is an “open question” whether this aid strategy has had any long-term effects (p. 23). Despite Africans having had “train[ing] in ethics and good governance at Western universities,” and despite “radical reforms aimed at improving transparency and efficiency,” it is “debatable whether these initiatives have had any real bite in countries which still opt to be dependent on aid” (p. 23). So, if aid efforts have been unable to establish practices of good governance, how are such practices to come about? Later in the book, Moyo offers her answer:

But where private capital trumps aid every time is on the question of governance. You can steal aid every day of the week, whereas with private capital you only get one shot. If you steal the cash proceeds of an international bond issue, you most certainly will not be able to get more cash this way. The capital markets may be forgiving, but not as forgiving as to be fooled by the same culprit twice. And without cash to assuage the restlessness of an army, no despot can stand (p. 142).

The oversimplified solution she offers above is not an oversight – she goes on to say:

In a world of bad governance the cost of doing business is much higher.. since the risk premium associated with the unpredictable behavior of a bad government always looms large. As long as issues of bad governance linger overhead (guaranteed to be the case in a world of aid-dependency), the cost of investing in Africa will always be exorbitantly high. *Yet in a world of good governance, which will naturally emerge in the absence of the glut of aid*, the cost (risk) of doing business in Africa will be lower (p. 143, emphasis added).

Moyo's treatment of the issue of good governance is unfortunately symptomatic of various aspects of her discussion of economic development policy – she glosses over issues too quickly and provides oversimplified reductions of the cause and effect of aid policies. These flaws are significant shortcomings of the book. Unfortunately, they come early in the book, and relate to the substantive areas of development theory covered extensively by previous scholars and reviewers.

After the historical overlay and the introduction of the governance argument explored above, Moyo explores why “Aid is Not Working,” offering her own reasons as well as those of various development economists (Chapter 3). Again, while the breadth of her treatment is an accomplishment, she falls prey to oversimplification and confounding of correlations and causations. More problematic, however, is her sound bite-esque assertion regarding aid. Moyo goes beyond what most development economists assert regarding the failure of aid. In no uncertain terms, she condemns aid as the malignant cause of Africa's problems: “Were aid simply innocuous – just not doing what it claimed it would do – this book would not have been written. The problem is that aid is not benign – it's malignant. No longer part of the potential solution, it's part of the problem – in fact aid *is* the problem” (p. 47, emphasis in original).

Unfortunately for this book, her support for this assertion is not wholly convincing, as illuminated by several examples. Firstly, in support of this argument, she attacks conditionalities attached to World Bank and IMF loans without stating clearly the reasons for her objections. Early in the book, she makes a vague argument criticizing them on account of their market-based approach (pp. 20-22), but then later criticizes the fact that these (market-based) policies were not enforced (p. 39). Many other economists have argued that the trade liberalization and privatization conditions of the Washington Consensus were not healthy policies for the least developed economies of the world.<sup>4</sup> However, her attack on them attempts to have it both ways – not only is the content of these policies part of the reason Africa is underdeveloped, but their lack of enforcement as well.

Another problematic aspect of this part of the book is her lack of citations for studies and papers to which she refers. When she concludes her attack on conditionalities, she refers to a “World Bank study” which “found that as much as 85 per cent of aid flows were used for purposes other than that for which they were initially intended” (p. 39). In the absence of a citation, we are left to wonder when this study took place, which geography and projects it encompassed, and whether or not the purposes towards which the aid flows

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4 See, e.g., WILLIAM EASTERLY, *THE WHITE MAN'S BURDEN* (2003).

were redirected were useful ones or not. A similar missing citation is (not) found regarding the IMF, when she tells us that “[t]he evidence against aid is so strong and so compelling that even the IMF . . . has warned aid supporters about placing more hope in aid as an instrument of development than it is capable of delivering . . . [and] also cautioned governments, donors and campaigners to be more modest in their claims that increased aid will solve Africa’s problems” (p. 47).

Additionally, she undermines her main thesis condemning aid with its own oversimplification. She highlights the seeming paradox of a small scale mosquito net producer who is put out of business by aid efforts providing free nets in order to demonstrate aid’s ineffectiveness in the long term (by decreasing local production) even when it appears successful in the short term (in providing free nets) (pp. 44-45). This example in particular illustrates how her thesis could have used some nuance. Several paragraphs after the mosquito net example, she offhandedly mentions food aid which purchases from local producers, as the right kind of thinking (p. 45). In doing so, she (implicitly) supports an argument in favor of aid itself – just the right kind of aid. Indeed, a nuanced thesis would have incorporated this kind of thinking, perhaps arguing that this constructive kind of aid could be worked into a model which provided immediate mosquito nets to prevent the spread of malaria while supporting local production for long term supplies. In her argument, however, this “macro-micro paradox” of the mosquito net producer is used simply as an example of why aid just does not work.

Her next chapter attempts to further the anti-aid argument by explaining how aid is “The Silent Killer of Growth” (Chapter 4). Perhaps if she had convinced us in previous sections that aid was completely ineffective, we might have been able to make this cognitive leap off the foreign aid cliff with her. Instead, her argument sounds incendiary, to the point of “caricature.”<sup>5</sup> This overstatement is unfortunate in that it partially distracts readers from several important insights she offers, such as how free aid money reduces government accountability to their constituents because governments are left less dependent on tax revenues (p. 58). This is a compelling point – if corrupt leaders can get away with opacity and poor rule of law with little financial consequence, they probably have little incentive to improve. However, insights such as these do not save this chapter, or this half of the book. This chapter, the last one before she explores the capital alternatives, was her chance to tie together her argument and evidence and offer a final convincing blow to aid. Instead, at the close of this part of the book, it remains unclear how evidence supports doing away with

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5 I agree with the Economist on this point. THE ECONOMIST, *supra* note 2 (“[Moyo] overstates her case, almost to the point of caricature”).



aid entirely, rather than just redirecting its flow to its effective outlets.

After the tumult and anticlimax of the first half of the book, the second part of the book lays out what she refers to as the *Dead Aid* prescriptions. Here is where Moyo shines, and her experience and her analysis serve her arguments well. She provides easily understood explanations of several international and domestic market based solutions to encourage growth: international and domestic bond offerings, cooperation with China to gain more foreign direct investment (FDI), lowering of barriers to trade, and regulatory reform to facilitate remittances and microfinance (p. 77-140).<sup>6</sup> She defends these solutions thoroughly: for example, spending almost ten pages discussing the viability of bonds from emerging markets despite common misconceptions (pp. 77-86). She provides practical details surrounding the solutions, such as advice to get a credit rating (p. 78), and to have the bonds guaranteed by the World Bank (p. 95). And, she provides examples of success stories, including that of her own country of Zambia (p. 89). Despite the current financial downturn, these capital solutions are worth considering, especially in a time when donor governments are tightening their belts in efforts abroad.

### III. PART II: THE RESPONSE

The response to Moyo's book has been incredible. She has been interviewed in countless newspapers and magazines, and on numerous news programs. *O, The Oprah Magazine* named her on their "First Ever Power List."<sup>7</sup> *Elle Magazine* named her on their "Les Femmes de la Semaine" (Top Ten Women of the Week) in October 2009.<sup>8</sup> And, *Time* named her as one of their "100 Most Influential People in the World" in 2009.<sup>9</sup> She has been on the BBC, CNN, and even *The Colbert Report*. She has made rounds of the UN, the Organization for Economic Cooperation and Development (OECD), and the Council of Foreign Relations, to name a few of the organizations who have wanted to hear more from her. The President of Rwanda, Paul Kagame, invited her to his country to discuss the *Dead Aid* prescriptions in the Rwandan context.<sup>10</sup>

6 Moyo also fails to distinguish the market-based approach of the Washington Consensus from the market-based solutions offered in *Dead Aid*. While I believe that her approach does avoid some of the shortcomings of the Washington Consensus (for example, by advocating for particular kinds of capital liberalization, FDI, and south-south trade relations), an explicit discussion of the differing content and rationale of the two market-based approaches would have been helpful.

7 *O's First Ever Power List*, O, THE OPRAH MAGAZINE, Aug. 11, 2009, available at <http://www.oprah.com/world/Os-First-Ever-Power-List/10>.

8 *Les Femmes de la Semaine*, ELLE, Oct. 2, 2009, available at <http://www.elle.fr/elle/Societe/Les-femmes-de-la-semaine/Les-femmes-de-la-semaine-02-10-2009/Dambisa-Moyo/%28gid%29/987364>.

9 *The 2009 TIME 100: The World's Most Influential People*, TIME, Apr. 20, 2009, available at [http://www.time.com/time/specials/packages/article/0,28\\_804,1894410\\_1893209\\_1893459,00.html](http://www.time.com/time/specials/packages/article/0,28_804,1894410_1893209_1893459,00.html).

10 Readers are cautioned against generalizing Kagame's reception as indicative of the response of all of Africa, or even of Rwanda.

And, at the same time, many development scholars have been less than thrilled with the book. Her own mentor, Paul Collier, wrote a review in *The Independent* in which he stated that “I doubt that many of Africa’s problems can be attributed to aid. It is, in my view, something of a sideshow.”<sup>11</sup> Adekeye Adebajo, the executive director of the Centre for Conflict Resolution in Cape Town, reviewed *Dead Aid* in *Business Day*, and called it “one of the most dangerously influential books in recent times.”<sup>12</sup> And, shortly after the book was released, she engaged in a back and forth column war on rather personal terms in *The Huffington Post* with Jeffrey Sachs, who is a leading expert on aid, Special Advisor to the UN Secretary General, and former professor of hers.<sup>13</sup>

These skeptics, as well as others, often raise the following three criticisms: *Dead Aid* fails to distinguish between effective aid and ineffective aid (and therefore the prescription to end all aid is too extreme); Moyo’s figures are questionable, and her argument is not an important contribution to the aid dialogue; and, she oversimplifies and overstates her case.

#### A. *Dead Aid Fails to Distinguish between Effective Aid and Ineffective Aid*

Shortly after *Dead Aid* was released, Jeffrey Sachs had the following to say in the *Huffington Post*:

Moyo, Easterly, and others lump all kinds of programs - the good and the bad - into one big undifferentiated mass . . . Here are some of the most effective kinds of aid efforts: support for peasant farmers to help them grow more food, childhood vaccines, malaria control with bed nets and medicines, de-worming, mid-day school meals, training and salaries for community health workers, all-weather roads, electricity supplies, safe drinking water, treadle pumps for small-scale irrigation, directly observed therapy for tuberculosis, antiretroviral medicines for AIDS sufferers, clean low-cost cook stoves to prevent respiratory disease of young children.<sup>14</sup>

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11 Collier, *supra* note 2.

12 Adekeye Adebajo, *Economist’s Self-Flagellating Aid Tract Does Continent No Favours*, *BUSINESS DAY*, Dec. 18, 2009, available at <http://allafrica.com/stories/200912180143.html>.

13 Jeffrey Sachs, *Aid Ironies*, *THE HUFFINGTON POST*, May 29, 2009, available at [http://www.huffingtonpost.com/jeffrey-sachs/aid-ironies\\_b\\_207181.html](http://www.huffingtonpost.com/jeffrey-sachs/aid-ironies_b_207181.html); Dambisa Moyo, *Aid Ironies: A Response to Jeffrey Sachs*, *THE HUFFINGTON POST*, May 26, 2009, available at [http://www.huffingtonpost.com/dambisa-moyo/aid-ironies-a-response-to\\_b\\_207772.html](http://www.huffingtonpost.com/dambisa-moyo/aid-ironies-a-response-to_b_207772.html); Jeffrey Sachs, *Moyo’s Confused Attack on Aid for Africa*, *THE HUFFINGTON POST*, May 27, 2009, available at [http://www.huffingtonpost.com/jeffrey-sachs/moyos-confused-attack-on\\_b\\_208222.html](http://www.huffingtonpost.com/jeffrey-sachs/moyos-confused-attack-on_b_208222.html).

14 Sachs, *Aid Ironies*, *supra* note 13.

Moyo responded unequivocally:

The aid interventions that Mr. Sachs lauds as evidence of success are merely band aid solutions that do nothing to lift Africa out of the mire - leaving the continent alive but half drowning, still unable to climb out on its own. . . Yes an aid-funded scholarship will send a girl to school, but we ought not to delude ourselves that such largesse will make her country grow at the requisite growth rates to meaningfully put a dent in poverty.<sup>15</sup>

Moyo did not go on to say that her prescriptions would at least preserve the ‘band-aids’ while working towards longer term solutions. Though I agree with her critics that the band-aids are important, it is unclear why the short term aid efforts, especially ones in food and medicines, and the market-based capital solutions have been polarized into mutual exclusivity by this dialogue.

*B. Her Figures are Questionable and Her Argument is not an Important Contribution*<sup>16</sup>

Moyo should have provided citations for more of her evidence, and many reviewers have raised questions surrounding the bleakness of the picture she paints regarding aid’s effects. Her critics probably raise valid points regarding her numbers.<sup>17</sup> However, I think those who stop there are missing much of the point. While we can debate to what extent Africa is underdeveloped, most people do not dispute that it is. There is very little value in engaging in a numbers war. Instead, if readers focus on how she is using development economics and figures regarding poverty – not as hard facts, but as a backdrop for why financial alternatives should be pursued, perhaps her contribution to the dialogue will be heard.

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<sup>15</sup> Moyo, *supra* note 13.

<sup>16</sup> See, e.g., THE ECONOMIST, *supra* note 3 (criticizing *Dead Aid* for not “mov[ing] the debate along much” and stating that Moyo’s “arguments are scarcely original” and that “[t]here is almost nobody left, even in the aid lobby, who seriously thinks that bilateral (government-to-government) aid is the sole answer to world poverty, as she suggests”).

<sup>17</sup> In Jeffrey Sachs’ second column in *The Huffington Post* regarding *Dead Aid*, he engages in the following analysis regarding Moyo’s figures:

She makes the following statement: ‘No surprise, then, that Africa is on the whole worse off today than it was 40 years ago. For example in the 1970’s less than 10 percent of Africa’s population lived in dire poverty — today over 70 percent of sub-Saharan Africa lives on less than US\$2 a day.’ Let’s parse that statement for a moment. World Bank researchers Shaohua Chen and Martin Ravallion prepare the benchmark under-\$2-a-day historical headcount data going back to 1981. According to their figures, headcount poverty under \$2 a day was 74 percent of the population in sub-Saharan Africa in 1981 and 73 percent in 2005. Other prominent estimates that go back to 1950 or 1970 also contradict Moyo’s statement, by showing high and persistent poverty. All of the macroeconomic time series by Maddison, Summers and Heston, and others tell the same story: the majority of Africa’s population started out impoverished at the time of national independence in the 1960s and 1970s, and a majority remains impoverished till today. Sachs, *Moyo’s Confused Attack on Aid for Africa*, *supra* note 13.

It is easy to criticize her development theory, her poverty numbers, and her oversimplified criticism of aid. If the book ended at Chapter 4, merely leaving us hanging off the foreign aid cliff without the safety net of chapters 6-10, many of her critics might have had a solid argument. However, Moyo's real substantive contribution is not in the first half of the book, it is in the recommendations she gives in the second half. If her readers disagree with her development and aid analysis, so be it. Plenty of other scholars have disagreed on appropriate policies regarding development, aid, and growth. Personally, I don't agree with the extreme suggestion that aid should be turned off completely, especially when certain financial endeavors, such as microfinance, may depend on aid in their early stages. However, it is much harder to dispute that countries should attempt to use the array of financial options laid out in the second half – the half which most of her reviewers seem to have missed. Sure, every option might not work for every country in the current financial environment, but she offers sufficient alternatives that lend to the credibility of the book and which deserve attention.

Moyo acknowledges she is not the only person to have pointed out aid's ineffectiveness. She acknowledges that even her parents thought she was writing a fairly obvious thesis.<sup>18</sup> But, even if it (the first half of the book) has all been said before, is that any reason for someone to refrain from saying it? It has been said before, but nothing, or not much, has changed. In that case, it is even more important that someone say it again, and then act on it. She is doing exactly that. She is using the book as a tool for advocacy and for reaching those who make decisions about aid. If she hadn't written the book, and yet still campaigned for a reduction of aid and the use of capital solutions, I doubt attacks on her or the book's prescriptions would have been as vicious (because they would have lacked fodder from the first half of the book), but I also doubt she would have garnered the kind of attention and support she has received.

### *C. The Entire Book is Oversimplified and Overstated*<sup>19</sup>

While I have addressed my agreement with this criticism in the first part of this review, I would like to note two points. First, though her oversimplified analysis is problematic on some occasions, perhaps it is also the very thing that appealed to a wide audience and led to her great following. Her easy message and her simple arguments make her easy to quote and easy to remember. Her pithy paragraphs are not going to be applied in World Bank or IMF reports to explain exactly why programs have worked or have not worked. However,

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18 Interview by William Easterly, New York University, with Dambisa Moyo, New York, N.Y. (Mar. 26, 2009).

19 See, e.g., *THE ECONOMIST*, *supra* note 3; Bhagwati, *supra* note 2 (“[Moyo] verges on deliberate provocation when she proposes terminating all aid within five years”).

they have been picked up by popular press, and appreciated by people like Kofi Annan<sup>20</sup> and Paul Kagame<sup>21</sup>, and have led to her own presence in those closed doors where aid or its alternatives are formulated – so perhaps she will accomplish nuanced policy goals in the end.

The overstatement of her case works in her favor as an advocate as well. If we recast this book as a “clarion call” as she would have us do (p. xv), and not (only) as a scholarly work, we might no longer expect her to apologize for her overstatement. Indeed, what advocacy effort has succeeded without some radical overstatement, some poking at the embers to get the debate fired up?

#### IV. PART III: WHY THIS BOOK IS IMPORTANT

There is no doubt that this book has some flaws. However, we can, and should, take a lot from *Dead Aid*'s prescriptions, and Moyo has made an important contribution to the aid dialogue with the book and with its response.

The book itself offers much needed financial prescriptions as described above. The second part details a persuasive argument, practical details, and helpful examples. And, this book fills a gap. Most development or aid books which have gained popularity in the West are mostly theory (all first half). Not only does *Dead Aid* offer solutions, but it offers another way of looking at development, one based on positive action as opposed to negativity and pity.<sup>22</sup>

Moyo's writing style is accessible, and the book's popularity across a wide readership proves this point. She writes in an easy to read style, and stays clear of development jargon. When she explains the financial instruments which she is recommending, she does so in incredibly clear and simple terms. The frugal length might also prove that she meant her book to be easily read and

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20 On the back of the book cover, Annan gives the following quote:

Dambisa Moyo makes a compelling case for a new approach in Africa. Her message is that “Africa's time is now”. It is time for Africans to assume full control over their economic and political destiny. Africans should grasp the many means and opportunities available to them for improving the quality of life. Dambisa is hard – perhaps too hard – on the role of aid. But her central point is indisputable. The determination of Africans, and genuine partnership between Africa and the rest of the world, is the basis for growth and development.

21 Paul Kagame, *Africa has to find its own road to prosperity*, THE FINANCIAL TIMES, May 7, 2009, available at [http://www.ft.com/cms/s/0/0d1218c8-3b35-11de-ba91-00144feabdc0.html?nclick\\_check=1](http://www.ft.com/cms/s/0/0d1218c8-3b35-11de-ba91-00144feabdc0.html?nclick_check=1).

(Dambisa Moyo's controversial book, *Dead Aid*, has given us an accurate evaluation of the aid culture today. The cycle of aid and poverty is durable: as long as poor nations are focused on receiving aid they will not work to improve their economies. Some of Ms. Moyo's prescriptions, such as ending all aid within five years, are aggressive. But I always thought this was the discussion we should be having: when to end aid and how best to end it.)

22 See Magatte Wade, *Jeffrey Sachs' Misguided Foreign Aid Efforts*, THE HUFFINGTON POST, June 29, 2009, available at [http://www.huffingtonpost.com/magatte-wade/does-jeffrey-sachs-believe\\_b\\_217785.html](http://www.huffingtonpost.com/magatte-wade/does-jeffrey-sachs-believe_b_217785.html).

remembered, and not a heavy tome extrapolating high theory and collecting dust on shelves across the West. Her book was meant to reach a wide audience, and it has. It was on a *New York Times Bestseller's List*.<sup>23</sup> Development economists such as Paul Collier and Jeffrey Sachs have published reviews of it. Political leaders such as Kofi Annan and Paul Kagame have praised it.

This response is in itself accomplishing something. It has catalyzed dialogue where there wasn't enough of one. What remains to be seen are the fruits of such dialogue. What happens next? Will African countries pursue financial alternatives? Will donors find a welcome reason to cut back on aid (a fear shared by Sachs and Adejabo alike)?<sup>24</sup> And, most importantly, will the least developed African countries finally achieve sustained measurable growth or alleviation of poverty?<sup>25</sup>

## V. CONCLUSION

*Dead Aid* is a fascinating book, not only for its content but also for its phenomenon. In a time of tightened purse strings of donor countries, and in an often patronizing or condescending Western dialogue<sup>26</sup> about aid, *Dead Aid* offers some feasible, positive alternatives for African policymakers.

So why did people react so strongly to the book? It is succinct, easily understood, and has a timely and incendiary message. Moreover, it comes from an articulate woman who has both the Western educational and professional qualifications so highly valued in development policy circles as well as an 'African' upbringing.

Perhaps the response would have been more shocking if it had been any less than it was.

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23 *April's Poli-Book Best-Seller List*, The N.Y. Times, Apr.18, 2009, available at <http://thecaucus.blogs.nytimes.com/2009/04/18/aprils-poli-book-best-seller-listhfo/?scp=4&sq=%22dead%20aid%22&st=cse>.

24 Sachs, *Aid Ironies*, *supra* note 13 ("Americans are predisposed to like the anti-aid message. They believe that the poor have only themselves (or perhaps their governments) to blame"); Adejabo, *supra* note 12.

25 It is worth noting that GDP growth in sub-Saharan Africa averaged 5 – 6% in the decade preceding 2009, albeit led by South Africa, Nigeria, and oil exporters. *Economic Growth*, African Economic Outlook, available at <http://www.africaneconomicoutlook.org/en/outlook/macroeconomic-performances-in-africa/economic-growth>.

26 See Wade, *supra* note 22.





# **THE INDIAN JOURNAL OF LAW AND ECONOMICS**

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The comments (including case comments and legislative comments) should not be more than 5000 words, wherein the author gives a critical summary of the case or legislation they have chosen to study. It should be contextual and ideally must apply the analytical tools of economics to the legal concepts involved

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Fax: +91 40 23227310.