

ROLE OF CREDITORS IN CORPORATE GOVERNANCE

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INTRODUCTION

The source for every problem in the corporate governance is the allocation of resources to different class, so how the vast revenues are allocated have a profound effect on the performance. It also depends on who makes the investment decisions in corporations and how returns from investments are distributed. One entire class i.e., the shareholders play a dominant role in the corporate governance due to the Board's accountability to them (Hire and fire senior executives and approve or reject important policies and strategies of the firm) and so having the right to treat the firm as a vehicle to maximize the return on their investment, neglecting the interests of the stakeholders. If we look into the main objective of the corporate law, it is to serve the interests of the society as a whole, in particular to all who are affected by a firm's activities, including the firm's shareholders, employees, suppliers, and customers, as well as third parties such as local communities. Where does these Creditors Stand, they too contribute to the capital but why play a second fiddle? On one hand, it can be said that the creditors are also contributing to the capital of the company, though it is debt capital, so they are also should be considered as investors and be a part of the investor ownership, which is one of the five basic characteristics of a company.

However, as explained below, at least one group other than the shareholders also have a strong claim to be recognized in discussions of corporate governance. While some have written about governance in the context of a multi-stakeholder theory of the firm, this paper complements the debates by examining the position of the creditor – a party (or stakeholder) that is often omitted from the debates about corporate governance. Stakeholders may need protection against unjust outcomes (similar to the constitutional protections enjoyed by the citizens of majority rule democracies) beyond what they negotiate in the contracting process. These protections need not always take the form of legislation; they could be internalized as corporate

or managerial codes of conduct. In the absence of extensive legislation or detailed corporate codes of conduct that mitigate the deleterious outcomes for stakeholder groups (including investors), the ethical values and the capability for moral reasoning of the manager may be the only guiding forces in the face of difficult decisions.

CORPORATE GOVERNANCE AND MANAGEMENT

The debate about corporate governance “at its broadest level involves the issue of the relationship between stakeholders in a company and those who manage its affairs i.e., the board of directors. Essentially corporate governance is about the way power is exercised over corporate entities. It covers the activities of the board and its relationships with the shareholders or members, and with those managing the enterprise, as well as with the external auditors, regulators, and other legitimate stakeholders. To infer, the stakeholders also can play a role in it as their interest is also dependent on the activities of the company, to be specific the Board. To note further, there is an explicit difference between governance and management, where the latter runs the business and the former ensures that it is being well run in the right direction. This simple contrast nicely brings out the “oversight” aspect of corporate governance, but it begs the question of in whose interest the oversight is exercised, particularly by directors. So generally, the board sits in the top of the hierarchy of the management and does the job. The shareholder’s role in governance is defined by the accountability of the directors, which involves responding externally, reflecting corporate activities and performance to the shareholders and other stakeholders with legitimate claims to accountability.

The Board of a corporation is elected, at least in substantial part, by the firm’s shareholders. The obvious utility of this approach is to help assure that the board remains responsive to the interests of the firm’s owners, who bear the costs and benefits of the firm’s decisions and whose interests, unlike those of other corporate constituencies, are not strongly protected by contract. Does this mean that the BOD is duty bound and be made responsive only to the shareholders and not the other stakeholders, especially the creditors? Does this imply, since creditors are protected under the contract, the BOD is not responsive to them and does that mean their interests are not affected by the firm’s decision? The creditors interest will be equal to that of the long-term shareholders (i.e., in the case their interest meets with even the interests of the company, (which is actually the need of the corporate governance) that is the growth and

smooth functioning of the company as pointed out earlier, which forms the basis for the Stakeholder approach. One main problem with shareholder theory which says, the creditors are entitled only to their fixed claims, it is said to be more worthwhile for the shareholders to have a control. By this the overall control falls almost naturally to the shareholders, by means of which the shareholders put forth and take actions that benefit their class leaving out the others which leads to the suppression of the rights of the other stakeholders and also against the goals of the company. One more aspect by which the creditors are affected is with that of the limited liability, which is a crucial feature, increasing the risk of non-payment when compared with an unincorporated business such as a sole trader or a traditional partnership. Even within the limited liability, if the shareholders divert the assets of the company towards any other investments by exercising their rights over the Board, then that would add to the detriment of the stakeholders especially the creditors. The financial protection of creditors could involve requiring companies to put aside a sum of money to cover what they owe, but, that would make it very unattractive business rather attempts can be made to prevent the assets being run down inappropriately, by restricting payments to shareholders.

If we go by the Nexus of Contract theory is excessively stockholder-centered to the detriment of other stakeholders and thus inadequate. The stakeholder's theory, in its base level provides two solutions viz., the 1st solution consists of rights to be adjudicated at the time the contracts are negotiated. The three measures that are proposed are 1) All the stakeholders should have board representation, and those who have firm specific assets and face residual risk should have voting rights; 2) That managers should be fiduciaries to all stakeholders and 3) That the firm should be conceived of as a set of multilateral contracts between all stakeholders. The 2nd solution focuses on managerial decision making, by which the manager has to take into consideration the interests of the stakeholders beyond what they have contracted with the firm.

The challenge to the board trying to adopt a stakeholder approach is that they no longer have a single constituency to satisfy but need to balance the potentially conflicting interests of a diverse set of stakeholders. But, if this stakeholder's theory is accepted and practiced instead of the stewardship theory there arises a practical difficulty as the stakeholder's interest differs, it would be difficult to satisfy their interests without conflicting and losing out the interests of others. So, it would be better to find a balance between the both.

But, fiduciary obligations arise when the beneficiary has some special disadvantage, i.e., when he is especially vulnerable without the ministrations of the fiduciary. Passive investors i.e., the non-equity investors, is in a disadvantageous position when they try to protect their investment against a management in control of the firm and in possession of all the requisite knowledge. So, we can say that the firm has and/or its management has a stronger affirmative moral duty than mere contract or promise would imply. Stakeholder representation promotes procedural fairness by providing a means of ensuring that stakeholder considerations are more directly represented in corporate decision making and also it is as central in legitimating and safeguarding the interests of corporate stakeholders. The idea of appointing one of the stakeholders as a director as proposed by the author, for creating the representation of stakeholder's interest in the board is again doubtful as to its merit due to the influence in the board, so making the board as a whole accountable would add to the merit. A fourfold cast of shareholders, board, management and creditors should be considered as the "Primary" participants in corporate governance, even if the creditors are not actively involved or their interests prioritized most of the time.

PROBLEMS WITH AGENCY RELATION

But the relationships among the participants in a corporation are, to an important degree, contractual. This also includes shareholders and by virtue of it are they also be given protection under the contract. There arises a problem in motivating the agent to act in the interest of the principal rather than the agent's own interest. It is to be noted that whenever there is separation between the members and the governing body put in place to protect their interests and to deliver the required outcomes, the agency dilemma will arise and corporate governance issue occurs. Being said that, with regard to the second and third agency problems, where in the former case the non-controlling owners are thought of as the principal and the controlling owners as agents and in the latter the firm as an agent and the other parties i.e., The creditors, employees, customers are the principals, the problem is that it is more difficult for the principles to ensure that the agent does the right thing. If such is the case can the principal directly play their role rather than doing it through agents.

Though there are governance strategies deployed (like Initiation and ratification) and so the shareholders are holding the whip of the directors, but what's the case with the creditors; they fall under the third agency problem that is between the creditors and the firm including the firm owners, so what to do here. Whether the creditor who is the principle be given the right to interfere in the firm's management. To Infer from the agency problems, in the 3rd agency problem the Creditors are the principles and the Firm & Firm owners are the agents, but in the 1st agency problem which is a conflict between the Firm's owners and the hired managers where the Owners are the principles and the Hired managers as the agents. With that it can be derived that, for the Creditors whose agent is the firm's owner, the Hired managers is also an agent indirectly and so the creditors can be considered as the principle and also should be given the right to interfere in the management decision making. With that the creditor's interest is also being taken into consideration. Thus, even if widening the scope of governance discussions to other stakeholders is deemed unwarranted, creditors should not be omitted.

CONCLUSION

Rather than sticking on to the traditional methods like claiming only the contractual rights against the debtors ; also taking a floating charge in a security ; asking for personal guarantee form the directors by piercing the corporate veil of limited liability in case of small or medium sized business; and if the company is unable to meet all its obligations to creditors at last the insolvency proceedings when the , at the first instance itself if the creditors place themselves as a watchdog and also take part in the decision making along with the shareholders invoking their right as a contributor to the capital (implying as an investor having the guarantee, through contract as a stakeholder ,of the Principal amount being returned back). But the creditors interference should not act as detriment to the right of the shareholders as such. So, the possible solution to that is including creditors in decision making. Where there is a clear split of one class i.e., shareholders into majority and minority, the creditors have to be given the voting rights proportionate to that of their contribution to the capital (Comparing the capital contributed with that of the share price to determine the number of votes per creditor). The reasoning behind adopting this method of creditors interference is that the Creditors interest would in consonance with that of the Best interest of the company and so as the minority

shareholders (assuming here as a long-term shareholder), so in such a case of minority versus the majority to fulfil the goal of the Corporate governance i.e., achieving the best interest of the company. Even by deploying independent directors, with the probabilities of familiarity, providing rights to the creditors in the management can be considered as a positive approach towards the Company's best interest. But the prevailing principle that at the time of distress the creditors take control from shareholders.

