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THE SETTING OF ENTREPRENEURSHIP IN INDIA*

By ANDREW F. BRIMMER

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I. INTRODUCTION

The purpose of this paper is to introduce non-Indian readers to the existence in that country of a rather unusual type of industrial organization known as the managing agency system. An attempt will be made to explain its origin and growth and to indicate some of the contributions it has made to economic development. Another objective of the paper is to call the attention of Indian students to an approach to the study and appreciation of this institution which is different from the view most frequently taken. The legal aspects of the managing agency system are usually focused on, and most investigations which the author has seen rapidly become inquiries into, the nature and provisions of Indian company law and the agents' behavior within these limits. The result is that the "illegal acts" and transgressions of specific managing agents constitute the subject matter for discussion.

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Our present concern is not primarily with the correctness of this approach, considered by itself, but with the substance of economic activity obscured by preoccupation with the managing agency system as a legal entity. In a wider context, the author would argue that the whole system of company law in India, like the organization of commercial banking, is simply irrelevant. Both of these represent the importation of British institutions into an environment which was alien and inhospitable. However, this broader field is not the one examined here. This writer asserts that legal and economic arrangements developed in the United Kingdom to solve problems arising in the latter were unsuited for India. It is suggested, therefore, that the managing agency system is the Indian answer to the imposition of British institutions as well as a response to the challenge of relative backwardness which characterized the economic scene in India.

II. Nature and Origin of the Managing Agency System

The managing agency system is a type of industrial organization unique to India in which the promotion, finance, and administration of one or more legally separate and presumably independent companies are controlled by a single firm. It is a system of economic and legal relationships which pervades the entire field of economic activity — especially modern industry and trade and commercial agriculture.[1] The system operates within the framework of company law, and both public and private limited joint stock companies as well as partnership undertakings are controlled by managing agency firms. At the very center of the system is the managing agency firm which may take the organizational form of either a partnership, private or public limited company, or a single individual. The formal and informal relationships between this firm and the operating companies controlled by it constitute the managing agency system. The name of the system arises from the so-called "managing agency contract" between the agency firm and each company.

A. Critical Role of the Agency Firm

It is extremely important, if the system is to be understood, that the nature of the managing agency firm and its relation to the controlled company be fully comprehended. It should be noted that the managing agency firm *is the firm* in the sense in which this term is known in institutional economics. If the firm is defined as the institu-

1. P. S. Lokanathan, *Industrial Organization in India* (London: George Allen & Unwin, Ltd., 1933), p. 5.

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tional setting in which entrepreneurial decisions are made, it is immediately clear why the managing agency firm should be so designated. Managing agents, the businessmen operating through the managing agency firm, are the real entrepreneurs in India. They have been the ones primarily responsible for the introduction of new products, new methods of production, and new sources of raw materials; they have discovered and exploited new markets and have usually undertaken whatever reorganization Indian industry has experienced.[2] To achieve these ends, the managing agents have generally made use of the joint stock form of organization for the companies launched to undertake actual production and trade. These latter companies should be considered as operating units of the central, decision-making unit — the managing agency firm.

Whatever the legal form which the managing agency firm assumes, it is typically composed of a group of individuals who have either large financial resources (or access to such) or a considerable amount of general business and technical ability, or both. The composition and functioning of the agency firm may vary depending upon whether it is controlled primarily by Indian or British businessmen. (Why this is so is explained below.) The managing agency firm has many instruments by which it maintains control over the operating company. The most important of these are: (1) the management contract, (2) financial practices, and (3) share and voting arrangements. The management contract is an agreement between the agency firm and the operating company which specifies their respective rights and obligations. It is drawn within the framework of the Indian Companies Act, 1913 (amended, 1936). Consequently, the agreement is a legal document and has status in the law courts. Financial holdings of the agency firm in the controlled companies were once the chief means of securing control. In recent years there has been a tendency for agency firms to reduce their holdings of shares issued by operating companies, but they continue to occupy a crucial place in matters of finance. A proven instrument for control exists in the use of shares with special voting rights which are issued to the managing agents only.[3]

Although the operating companies may appear to be independent entities with their own boards of directors, they are usually legal and accounting fictions which serve to give the agents a greater degree of

2. Daniel H. Buchanan, *Development of Capitalistic Enterprise in India* (New York: 1934), p. 145.

3. M. A. Mulky, *The New Capital Issue Market in India* (Bombay: New Book Company), p. 75.

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freedom, financial and otherwise. In most cases the board of directors of the operating company is selected by the agency firm.[4] In practically every instance several members of the agency firm are also directors of the controlled company. More often than not, one of these agency directors is chairman or managing director of such a company. While the managing agent presumably functions under the supervision of the board of directors, the latter is frequently nothing more than a fiduciary body which exists to persuade the public to invest and to fulfill legal requirements. A look at the large number of "prestige" directors — "Sirs," "Rajas," "Rao Bhadurs," etc. — on the boards of Indian companies will make this suggestion quite obvious. Thus, the managing agency firm is responsible for practically all decisions made in the companies under its control.

B. British and Indian Agency Firms Contrasted

The above picture of the managing agency system is a generalized one. If British and Indian agency firms are examined separately, some modifications must be made in regard to details. However, the general outlines of the system are not greatly changed. The typical British agency firm is a partnership which continues to combine financial resources and technical and business ability through the selection of its members.[5] Such a firm is likely to have one or two "old family" men who have inherited their position. They may or may not be technically competent. However, they usually are, and if they are not they are unlikely to be in a position to obstruct the efficient operation of the agency firm. In either case, they give continuity to the firm through the maintenance of the family name. In addition to such family representatives, there are always two or three partners selected from the group of senior assistants. The latter officers have usually progressed through the various operating companies under the control of the agency firm and have acquired considerable knowledge of their activities. In most cases, they have begun as junior assistants brought out from England and Scotland in their early twenties. Frequently, they come with the idea of making a career of service with an agency firm and eventually becoming a partner in it. Many succeed.

Each partner in the British agency firm usually rotates as executive officer of one or more of the "departments" within the firm. A

4. Bombay Shareholders' Association, *Memorandum on Directors* (Bombay: 1949), pp. 8–9.

5. Lokanathan, *op. cit.*, and Wilfred Russell, *Indian Summer* (Bombay: 1951), p. 47.

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typical British agency firm will have the following departments: accounts and finance, export and import, labor welfare, mills and works, purchasing, research and development, sales and advertising, transportation. In addition, each partner will serve as director, managing director, or senior officer of one or more of the operating companies. When the nonfamily partners retire from the agency firm, they are almost never replaced by their sons. Consequently, the British agency firm is constantly drawing in new blood and new money when the senior assistants become partners.[6]

The typical Indian agency firm differs from its British counterpart in several respects. However, these differences can be understood only in the context of the traditional organization of Indian business. For centuries practically all business activity was concentrated in the so-called trading communities. The latter are remnants of the process of fragmentation through which the older fourfold caste system has gone. The origins of this system need not detain us here, for it is sufficient to note that occupational stratification was one of its cardinal features.[7] Within each Hindu trading community the common unit of economic activity was coterminous with the familial organization. The eldest male, so long as he was not incapacitated, was the chief administrator of the family fortune. Other male members — and sometimes females — participated in the activities of the firm under the direction of the family head and shared (not always equally) in the gains. As long as the family remained a unit, the firm continued to function, for both tradition and law clearly specified the rights of succession.[8] This was, of course, a great element of stability, but it may not have fostered maximum efficiency. Finally, there existed between the family-firm and the trading community of which it was a member an informal relationship symbolized by a very strong sense of responsibility for the well-being of one's community fellows and an overt preference for dealing with them.

Of course, it is not necessary to dwell upon the fact that the traditional bonds and conditions discussed above have been weakened considerably. The trading communities are no longer the sole Indian participants in business activity. The joint-family has lost much of

6. Russell, *op. cit.*, p. 58.

7. D. R. Gadgil, "Notes on the Rise of the Business Communities in India" (New York: Institute of Pacific Relations, 1951), pp. v–vi.

8. G. S. Ghurye, *Caste and Race in India* (London: 1932), pp. 28–29. And Sir Edward Blunt, "The Economic Aspects of the Caste System," in R. Mukerjee (ed.), *Economic Problems of Modern India* (London: 1939), p. 64.

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its former hold on the individual members, and the family-firm is no longer the only crucible of family fortunes. The overt preferences for caste fellows is not so frequently met as it once was. Nevertheless, the legacy of the past has a reality all its own and serves to shape the mode of operation of the Indian managing agency firms.

The managing agency form of organization was adopted quite widely by the Indian merchants when they began to operate in the industrial field. But unlike the British agency firms, the Indian agency houses are primarily financial in character.[9] Apart from a few exceptions,[1] the Indian agency firm is typically a simple extension of the older family-firm relationships. This fact is reflected in the composition of the firm, its sources of finance and the way in which it operates the companies under its control. While one encounters Indian agency firms organized in the form of private limited companies, the usual form is a partnership. Within the partnership, the members are most frequently related by blood or marriage, and in practically every case, they are — at the very least — members of the same caste. The sons of the partners, irrespective of ability — tend to follow the fathers in unbroken succession.[2] Despite the relatively large size of Indian families, this means that the field from which senior members of the firm are recruited is extremely limited. In addition, the Indian agency firm tends to look for junior assistants and other staff members first among the members of the agents' family and secondly among their community or subcaste. Only very infrequently do they go beyond these bounds to obtain persons for staff and administrative posts.[3]

Since members of the Indian agency firms, in general, have little technical competence, they occupy their position chiefly on the basis of the family funds invested therein. These funds have frequently been accumulated through trade and constitute the major contribution which the Indian managing agents make to the agency firm as well as to the operating company or companies under the latter's control. Another way in which the financial character of the Indian firms is revealed is the transfer of managing agency rights in an operating company from one agency firm to another. The receiving agency firm almost invariably has greater financial resources than

9. Lokanathan, *op. cit.*, pp. 315–19.

1. The most widely known of these exceptions are the House of Tata, Birla Bros., Khatau & Sons, and Wadia and Sons, Ltd.

2. Gadgil, *op. cit.*, p. vii.

3. Leslie Sawhny, "Management and Training in Industry," *Commerce and Industry* (Madras: February 14, 1954).

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the vending firm and only occasionally is the former superior to the latter in the way of industrial experience.[4]

With a few notable exceptions,[5] the Indian agency firms seem to administer the operating companies under their control with a view to obtaining the maximum amount of profit in the shortest possible time. There appears to be little attention given to the maintenance of plant and equipment or to the long-run planning and development of markets and raw materials. As indicated above, there is practically no effort made to recruit and train a staff on the basis of objective personnel criteria. Though the technical staff of most Indian agency firms must be employed, questions of tenure and job security apparently are seldom, if ever, discussed. When Indian firms adopt accounting procedures (as required by law for the public limited companies under the agents' control), they often do so in order to conceal rather than explain the operations of the company.[6]

In general, most of the British agency firms approximate in structure and functioning the desirable aspects of the managing agency system. With few exceptions Indian firms seem to embody many of the undesirable features. In reaching this conclusion, it is necessary, of course, to distinguish between the desirable and undesirable features of the managing agency system and those practices followed by specific agency firms. The contributions which the British agency firms have made to the development of Indian industry are contributions made by seasoned entrepreneurs operating through the agency firm. Likewise, the detractions made by Indian agency firms have been made by businessmen still in the process of maturing. Consequently, the worthiness of the system must be judged in terms of what use various business groups have made of it. In the hands of the British and the more advanced Indians, the system has been a powerful instrument of economic development; in the hands of the more irresponsible Indian businessmen, it has been an equally powerful instrument for manipulating enterprises to the advantage of controlling families but usually to the disadvantage of the country as a whole.

C. Origin and Development of the Managing Agency System

The exact origins of the managing agency system are still disputed. However, most writers on the subject seem to agree that its

4. Bombay Shareholders' Association, *Memorandum on Managing Agents* (Bombay: 1949), pp. 1–31.

5. See the agency houses listed in note 1, p. 558.

6. S. D. Mehta, "Some Aspects of the Managing Agency System," *Journal of the University of Bombay*, Jan. 1953.

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roots go deep into the social and economic conditions prevailing in India at the time the East India Company lost its monopoly of trade. The evidence indicates that the system evolved out of attempts to overcome two limitations on the appropriation of business opportunities then prevailing in India:[7] (1) a shortage of entrepreneurial ability and (2) a shortage of venture capital. The continuing presence of these limitations seems to go a long way in explaining the continued existence of the system.

During the early nineteenth century, India offered a number of opportunities to energetic businessmen. Its large population, despite the low standard of living, presented a relatively large demand for consumer goods — especially cotton textiles. Although the latter were widely produced in India, the methods of production were backward when compared with the power-driven mechanical techniques which were then revolutionizing industry in England. Also, India's large capacity to produce industrial raw materials was as yet underdeveloped. At the same time, the supply of business leadership was small. There were very few indigenous Indian businessmen who were able to move from the traditional trading and financing in local markets to the new forms of production. To profit by the opportunities then available, required a knowledge of foreign markets and sources of supply. It also required a mastery of new forms of organization and widespread connections in the world economy then in the process of emerging. The field was open in India, and the British general merchants were on the scene.[8]

There is some evidence which suggests that several British firms were trading in Bengal in the late 1790's with arrangements similar to those which characterize the modern agency firm.[9] In general, it seems that former servants of the East India Company set out as general merchants on their own account. As general traders and factors, they acquired a detailed knowledge of local markets and ways to exploit them. Given their connections with firms in England, America, and other parts of the world, this new knowledge of Indian conditions placed these merchants in a position to appropriate new opportunities as they emerged.

In addition to the relative shortage of entrepreneurial ability, there was also a drastic shortage of venture capital. Despite the numerous fortunes accumulated by Indians in trading and agricultural activity, the supply of funds to finance the projects of the British

7. Lokanathan, *op. cit.*, pp. 15–16.
8. William W. Hunter, *The Indian Empire* (London: 1893), pp. 658–59.
9. *Ibid.*

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general merchants came primarily from the merchants and a few of their friends and associates.[1] The usual procedure followed by the agents in the launching of new enterprises was as follows: As promoters, the agents would make the necessary investigations concerning cost and availability of labor, raw materials and other inputs and the nature and extent of markets. The agents would also organize and register the company as a legal entity, selecting in the process the first board of directors. Initially, the agents would issue only a small part of the authorized capital of the new company and — with their friends and associates — would take up most of the issued shares. If debentures were floated, the agents would also hold these. Once the enterprise had proved itself, the agents would issue most of the remainder of the authorized capital — usually preference shares — and invite the public to subscribe to the securities. At the same time, the agents would very likely throw some portion of the shares originally held by themselves onto the market. In this way, the agents supplied capital to the new enterprise in the most critical time.[2] Once he had regained his initial investment — frequently with a considerable profit — the agent was able to repeat the process with a new enterprise. As will be more fully explained below, the agent was also able to shift funds from one enterprise to another through the medium of the agency firm.

Although the conditions discussed above may explain why the British merchants developed the managing agency system, the question of why Indian businessmen adopted it must be answered. The first clue, of course, must be sought in the same conditions which made the British develop the system. The supply of Indian entrepreneurs was equally as limited as that of the British. The more enterprising of the Indian traders (notably Parsis and Gujeratis) turned to trading in cotton and similar goods soon after the British came to India. By the middle of the nineteenth century, the Parsis, who had forged the strongest connections with the British whom they served initially as middlemen, were able to branch out into the manufacture of cotton textiles.[3] The latter industry has been the basis of most of the accumulations which have gone into other industries in which Indians have played a major part. The agency system proved a highly useful framework within which business ability could be put to the best advantage. Like the British, Indian businessmen found

1. Russell, *op. cit.*, p. 63.
2. Lokanathan, *op. cit.*, pp. 14–27.
3. Buchanan, *op. cit.*, pp. 270–71 and Gadgil, *op. cit.*, vi–vii.

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that the agency system could be used to overcome the handicap of capital shortage.

Another factor contributing to the widespread use of the system by Indians lay in the nature and functioning of the banking system in India.[4] The loan criteria used by the Imperial Bank of India, and other leading joint stock banks before it, gave to the managing agents a crucial role in obtaining bank credit. Like the English banks on which they were patterned, Indian joint stock banks limited their loans to the supply of working capital, accepting the hypothecation of goods as security. However, the banks argued that goods were likely to vary greatly in price — and price instability was especially true of cotton and piece goods in which Indians traded to a large extent — and it was, therefore, necessary to have someone on whom the bank could rely to make good the loan. This someone was clearly the managing agent; for while Indian joint stock companies showed a high propensity to go bankrupt, the agency firm displayed a much higher survival rate. As a result, the practice grew up of having two signatures on notes of indebtedness, one a director of the company and the other the managing agent.[5] Thus, in order for a company to obtain even the limited amount of credit the banks were willing to advance, it was mandatory for the company to be under the control of a managing agent.

Finally, as indicated above, the agency system possessed much flexibility from the point of view of a small group of businessmen with a limited amount of capital but looking to the development of industrial and commercial enterprises. At the same time, the system was equally as flexible in the hands of persons who were primarily interested in manipulating finances among various companies for the sole purpose of enriching the managing agents. An agency firm was able to transfer funds from one company to another regardless of the soundness of the receiving unit. A prosperous undertaking could be made the basis for raising funds in the capital market for use by companies whose own credit standing would not warrant confidence.[6] Because of the concentration in the hands of the managing agents of purchasing and marketing arrangements of various controlled companies, the best interests of any individual company were not always served. This ability to conceal the actual status of each operating company behind the multiplicity of interlocking balance sheets also

4. S. K. Muranjan, *Modern Banking in India* (Bombay: 1952), pp. 289–321.

5. D. R. Samant and M. A. Mulky, *Organization and Finance of Industries in India* (Calcutta: 1937), p. 45.

6. Bombay Shareholders' Association, *Managing Agents*, pp. 41–74.

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gave the agents a considerable amount of leeway if they chose to utilize it in escaping taxation of earnings. The evidence suggests that many Indian agency firms selected the agency system as much for these predatory activities as for the more socially desirable ones described above.[7]

Despite the transgressions which the managing agency system allows to businessmen who wish to make them, one cannot avoid concluding that the system has gone a long way in reducing the limitations and disadvantages which enterprising businessmen had to face in their attempts to answer the challenge of industrial backwardness in India. For one who wishes to explore them, the numerous problems created by the separation of ownership and control in joint stock enterprises are multiplied many times in the agency system. But this writer argues that if one focuses not on the legal aspects of the agency system but on its economic characteristics, the managing agency firm comes into full view as the heart of industrial organization in India. Consequently, if this organization is to be fully appreciated, the numerous, legally distinct, producing companies must be treated simply as operating arms of the managing agency firm.

III. The Scope of the Managing Agency System

No matter how extensively one reads in the various standard works on Indian economics, it is not possible to obtain a clear view of the place the managing agency system plays in that country's economy. A comprehensive, quantitative appraisal of its scope is yet to be made. It is obvious, however, that such a task will be almost impossible to carry out. In the first place, as explained above, the activities of managing agency firms — while the substance of Indian enterprise — are generally hidden behind the shadow of joint stock and private companies through which the agents operate. The operating companies, when publicly registered, constitute the visible superstructure: beneath them, in the byways of partnership and private arrangements, are the crucial mechanisms of business activity encompassed by the managing agency firm. Almost no public records exist to illuminate these.

Secondly, much of general economic activity is not carried on through the instrument of publicly registered joint stock companies. Under the Indian Companies Act, 1913 (amended, 1936), any group containing not more than fifty members can register itself with the proper authorities as a private company with limited liability. It can

7. *Ibid.*

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issue stock of a specified nature, and so long as this stock is privately held, it can engage in any kind of business except scheduled banking and insurance.[8] It is in this form that a significant portion of Indian business is carried on.

A. Industrial Distribution of the Agency System

Nevertheless, the need for such statistical knowledge is obvious. Otherwise, discussion of the managing agency system must continue to have an air of unreality about it. In an effort to cast some light on this area, the author undertook an exploratory investigation using data from one of the largest *Yearbooks*[9] which contains information relating to companies registered on the various Indian stock exchanges. Of the 1,427 companies for which complete information was given, 94 were banks, 70 insurance companies and 20 managing agency firms. These 184 companies were set aside, the banks and insurance companies for the reason explained in note 8 above, and the managing agency firms because they were not likely to have other managing agency firms directing them. Thus, there were 1,243 companies studied. All of these could have been legally controlled by managing agency firms. The number with managing agency contracts was 1,064 — leaving only 179 companies without managing agents. This meant that managing agents dominated more than 85 per cent of the companies listed on the stock exchanges. While it is not possible to give a close estimate of the proportion of total production handled by these firms, other data suggest that the ratio is very high in the industrial sector.[1]

The 1,064 companies were classified under seventeen industries. There were three industries, coal, shipping and cement, in which all the companies found were controlled by managing agents. In four others — jute, cotton, railways and North India Tea estates — more than 90 per cent of the companies were under the direction of managing agents. These seven industries had 523 or 42 per cent of the companies analyzed. With the possible exception of railways (most of which are owned by the government) and cotton textiles (in which handicraft and small-scale units play a large part), the publicly

8. Scheduled banks are those with deposits of Rs. 500,000 and are included within the Reserve Bank System. Both scheduled banks and insurance companies must be publicly registered joint stock companies. Neither can enter into a managing agency contract with another firm or individual.

9. *Investors' Encyclopedia* (Madras: Kothari and Sons), 16th Edition, 1951–1952.

1. Mehta, *op. cit.*

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registered joint stock companies are responsible for the bulk of the output in these industries. These are among the most fully developed industries in India.

Four other industries in which managing agents controlled more than 80 per cent of the producing units are engineering, electric power, vegetable oils and planting (mostly coffee, rubber and nuts). Out of 310 companies in these industries, 265 (85 per cent) had managing agents. It should be noted that the engineering industry contains such crucial firms as those producing iron and steel, industrial machinery and agricultural implements. Actually, industries in which 70 per cent of the firms are controlled by managing agents probably could be classified as being under the latter's domination. Sugar, paper manufacturing and mining and chemicals are in this category. In conclusion, one can say with a high degree of confidence that the managing agency system permeates the entire field of modern industry in India in which private enterprise is most active.

B. Type and Size of Agency Firms

The exploratory study also revealed another interesting feature of the managing agency system. The 1,427 companies analyzed were under the direction of 844 management units. These latter consisted of 524 managing agency firms and 320 individuals. With respect to the agency firms, it was found that the private limited company is the most popular organizational framework. About 66 per cent (346) of the agency firms fall into this category. The number of partnerships (156) is less than half as large. Public limited companies were 22 in number and only 5 per cent of the total management firms. Two of the managing agency firms with public registration were actually operating companies which also held managing agency contracts with other operating companies. There were 363 companies with individual managers. This number includes the 184 companies which were either banks, insurance companies or managing agents. It follows then that only 179 of these companies could have had managing agents. Further, the bulk of these 363 companies (82 per cent) was managed by an individual with only one company under his direction. Even so, one should not conclude that such an individual was not a hired servant of some managing agency firm. For example, it is reported that some of the large banks are owned or controlled by several of the leading managing agents. (Tata is said to control the Central Bank of India, Birla, the United Bank and Dalmia, the Bharat Bank). The 23 individuals who managed the

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remaining 66 companies seem to have between two and three companies each under their direction.

What is probably one of the most interesting aspects of the managing agency system was thrown into focus by the study. It was discovered that 77 per cent of the managing agency firms (404) controlled only one company each. On the other hand, the remaining 120 firms controlled 660 operating companies — 62 per cent of the total number of companies controlled by agents. From these statistics, it is obvious that the managing agency system is not composed of firms possessing comparable economic power. On the contrary, there appear to be scattered groupings of very large firms surrounded by an extensive field of small units. What is the reason for the existence of the one-company agencies?

The author confesses that he has no satisfactory explanation. However, certain aspects of the matter may point toward an answer. The first thing to note is that every one of the 404 one-company agencies is Indian. Secondly, the bulk of them is found in cotton textiles and among such miscellaneous industries as soap-making, biscuit and bobbin manufacture, coir, glass, woodworking, etc. In this section of the cotton textile industry as well as in the miscellaneous industries, the amount of capital invested in each operating unit is quite small. There is almost no public participation despite the adoption of the joint stock form of organization.[2] The incentives to use the managing agency system were discussed in Section II. Of the 404 one-company agencies, 255 represented that many *separate* businessmen or associated groups. These 255 perhaps can be explained by the conditions mentioned in the above discussion. The data indicate, however, that there are 28 individual businessmen in control of the remaining 149 one-company agencies. This is an average of about *five one-company agencies per individual.* Why do these businessmen follow the practice of setting up a new agency firm when they decide to undertake an additional producing activity? It has been pointed out that some of the largest British and Indian agency firms control operating companies in such diverse fields as cement, cotton textiles, jute, sugar, shipping, planting as well as trade. Why, then, this effort at separateness among some Indian businessmen?

The reason for this behavior probably lies in the fact that most Indian businessmen launch their business careers as traders and continue to rely on trade as the chief source of income.[3] If such a businessman were to concentrate all of his assets in one agency firm

2. Samant and Mulky, *op. cit.*, pp. 224–49.
3. Gadgil, *op. cit.*, pp. 29–32.

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and engage in both trade — a relatively safe activity — and experimental manufacturing, he would expose his entire fortune to the vicissitudes of a field in which he possessed little competence. If the manufacturing ventures employed borrowed funds (and most would have to borrow working capital even when the businessmen as owners and agents supplied the fixed investment), the managing agents would have to guarantee the loan personally. Under these conditions, it is safer to launch a new agency firm for each project than to group several unproven projects under the same firm. The financial losses arising from the risk of failure of a single operating enterprise are restricted to that enterprise and its immediate managing agency firm; the gains from the same can be appropriated by the businessman who controls all of them.

From the above discussion, it is clear that the managing agency system has been an important instrument for reducing the limitations imposed on industrial growth by shortages of capital and business ability. It has also been a powerful lever in the hands of those who wish to manipulate investments and investors so as to improve their own positions rather than that of the country as a whole. The data presented show that the system is employed throughout the industrial sector of the Indian economy, and its influence extends even further.

IV. Relations Between the Agency Firm and Operating Companies

The scarcity of material for studying the relations between the managing agency firm and the companies controlled by it is extremely difficult to overcome. It is practically impossible for one not connected with the firm to get inside to observe its organization and functioning. Such a position is required, however, before an account of the decision-making process can be given. This author hastens to admit that he was not so fortunate as to study any agency firm from that vantage point. The writer did have the opportunity of meeting representatives from several agency firms who were kind enough to answer most of his questions. In addition, officers of the Bombay Shareholders' Association, who concern themselves primarily with the affairs of companies in which the Association's members have invested, were quite helpful in providing material from their files. These data, combined with information from the stock exchange yearbooks, made it possible to draw several of the major outlines of the relations between the agency firms and the operating companies.

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Available materials throw light on four areas of agency-company interrelations. These concern the nature of the managing agency contract and the rights and obligations it specifies, financial relations between managing agents and controlled companies, the use of special shares to maintain control, and the position and authority of company directors.

A. The Managing Agency Contract

It is not an easy task to obtain copies of managing agency agreements. The author, through the facilities of the Bombay Shareholders' Association, was able to examine two dozen of these contracts.[4] These were said to be representative of the general contents of such agreements. The more common aspects are the following:

Each agreement specifies the parties to it (agency firm and operating company) and sets forth the period of time during which it is to be effective. The conditions of termination and renewal are also indicated. The average duration of the twenty-four contracts was twenty years. Five were made for a period of thirty years. Although this group of contracts contained none with a life longer than thirty years, the author was informed that several companies investigated by the Bombay Shareholders' Association had contracts which covered the entire life of the company. The Government of India is currently considering a proposal which would limit the length of managing agency agreements to fifteen years.

One of the most important provisions of the agreement specifies the amount of remuneration the managing agent will receive and the methods by which it is to be computed. A typical provision sets compensation in the form of a commission of 10 per cent of annual net profits of the company. Other provisions usually specify whether the managing agents are to share in profits by the operating company from the sale of assets or capital gains. In most instances, companies pay the managing agents a monthly allowance to defray the cost of office administration on behalf of the operating company. Among the twenty-four contracts examined, eighteen provided for office allowances ranging from Rs. 1,000 to Rs. 10,000 per month, the average being Rs. 2,500.

Although most agency agreements pledge the agents not to undertake business on their own account in direct competition with the managed company, few prevent the agents from acting as manag-

4. As a condition for obtaining access to these contracts, the author had to agree not to identify the companies concerned.

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ing agents for other companies engaged in the same type of activity. That this situation frequently leads to conflicting interests between agents and the different companies under their control has been commented on many times. However, if one takes the view presented in this paper — that the managing agency firm is the crucial decision-making unit and the companies under its control are simply operating arms — this conflict will lose much of its apparent significance.

A study of the twenty-four contracts mentioned above, shows the wide scope the agency firm has in the affairs of the controlled company. Subject to the control of the directors of the company (extremely weak), the managing agents have the general conduct and management of the business and affairs of the company. The agents have the power to enter into all contracts (except the one with themselves!!) on behalf of the company. They have the authority to initiate and abandon on their own decision all legal proceedings involving the company. The agents are solely responsible for the purchase, maintenance and sale of all raw materials, and with the sanction of the board of directors they decide all expenditures on fixed investments. Likewise, the agents have complete control of the financial affairs of the company. It is they who receive all money payable to the company from all sources; it is they who pay all bills. Their signature appears on all financial instruments, and they alone buy and sell government bonds on behalf of the company. All employees of the company — professional, clerical, skilled and unskilled — are engaged and dismissed by the managing agents. These employees are placed on the payroll of the company, but it is the managing agents who decide the salaries, wages and other benefits they receive.

B. Financial Relations

The financial holdings of the managing agency firm in the operating companies were once considered to be the primary basis of the former's control over the latter. This is no longer true. Although the extent of holdings will vary, almost every agency firm will hold some portion of the capital of the companies under its control. Different writers have given percentages for the agency firm's share which show considerable range. These have varied from as low as 1 per cent to as much as 75 per cent.[5] Of course, it is practically impossible to obtain reliable information on this question on any significant scale.

5. See the Appendices to chap. I of P. S. Lokanathan, *Industrial Organization in India* (London: 1933).

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The author was able to obtain information which may cast some light on the subject. The statistics in Table I relate to the holdings of a Bombay managing agency firm in seven operating companies under its control, its holdings in another managing agency firm, and the extent of investment of the first agency firm in one of the operating companies controlled by the latter.

Because of the lack of comparative data, the author is not in a position to appraise the representativeness of these figures. Nevertheless, the table is interesting in itself, for it gives some indication of the variety of activity in which a managing agency firm engages.

A more important aspect of industrial finance in India under the managing agency system is shown in Table II. The meaning of the column headings is as follows: Column (2) includes the funds raised in the capital market on the account of one company under the managing agency firm listed in column (1) but subsequently transferred to another company under the same agency firm. Column (3) shows the amount of loans and advances made by one operating company to another, both being under the control of the same agency firm. Likewise, column (4) shows intercompany investments by companies under the same agency firm. Book debts in column (5) are those which reflect the net value of goods and services supplied on credit to each other by various operating companies. Column (6) is the net amount loaned to the agency firm by the operating companies. The number of companies involved in each group varies widely, from more than fifty on the part of the Dalmia and Birla Groups to less than five for the Narang agency firm. The data have been compiled from the source indicated in the table.

The financial advantages of the managing agency system when looked at from the point of view of the agency firm are quite obvious when one realizes that the behavior pattern indicated in the table is followed quite generally by a considerable number of managing agency firms, British and Indian. With the agency firm in a position to transfer funds from one operating company to another at will, it is clear that an agent can nourish or strangle any company under his control to any extent he desires, his power to do so being limited only by the total amount of funds available to all the companies. The ability of the agency firm to carry out such financial maneuvers is often criticized by stockholders, but the latter are helpless to do anything about it. They must rely on either their vote or the authority of the directors of the company to prevent such practices. As shown below, the directors are mostly straw-men shield-

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TABLE I

KILLICK INDUSTRIES, LTD., INVESTMENTS IN OPERATING COMPANIES (RS. IN THOUSANDS)

Name of Operating Company	Capital of Company			Agency Holding			Ratio of Agency Holdings to Total		
	Total	Equity	Debt	Total	Equity	Debt	Total	Equity	Debt
Ahmedabad Electric	47,466	34,966	12,500	993	793	200	2.1	2.3	1.6
Bombay Suburban Electric	9,373	9,373	—	500	500	—	5.3	5.3	—
C. P. Railway	9,400	9,400	—	n.a.	n.a.	n.a.	—	—	—
Hingir Rampur (Metal Mining)	1,200	1,200	—	237	237	—	19.7	19.7	—
Kohinoor Mills (Cotton)	10,000	10,000	—	449	449	—	1.5	1.5	—
Shrivjapur Syndicate (Mica Mining)	525	525	—	10	10	—	1.9	1.9	—
Surat Electric	2,500	2,500	—	103	103	—	4.1	4.1	—
Total	80,464	67,964	12,500	—	—	—	—	—	—
Cement Agencies, Ltd.	800	800	—	240	240	—	30.0	30.0	—
Associated Cement Co.	88,038	88,038	—	569	569	—	0.6	0.6	—

Source: *Commerce* (Bombay: Nov. 1948).
n.a. = not available.

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TABLE II

INTERCOMPANY FINANCING UNDER MANAGING AGENCY FIRMS, 1947 (RS. IN THOUSANDS)

(1) Managing Agency Firm	(2) Transfer of Capital, Market Borrowings	(3) Net Intercompany Loans and Advances	(4) Intercompany Investments	(5) Book Debts	(6) Net Loans to Managing Agents
1. Dalmia Group	16,976	13,991	34,463	12,893	—
2. Walchand Hirachand Group	1,297	5,800	12,958	—	—
3. Narang Group	546	—	3,800	—	—
4. Birla Group	3,000	2,400	10,858	—	—
5. Kamani Group	1,000	704	—	1,200	728
6. Cassamally Munjee Group	—	—	—	—	237
7. A. V. Thomas Group	—	—	507	—	17
8. Andhra Engineering Group	—	—	—	—	225
9. Modi Group	—	2,760	—	—	—
10. Hukumchand Group	487	—	—	—	1,762
11. Karamchand Thaper Group	1,250	1,729	150	—	1,414

Source: Bombay Shareholders' Association, *Memorandum On Managing Agents* (Bombay: 1949), pp. 41–74.

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ing the managing agents who can usually muster enough votes through their own holdings and proxies to dominate any shareholders' meeting.

C. Control of Voting Rights by the Agency Firm

Another facet of agency-company relations is the tendency of the promoters of the operating company to keep control in their hands by the issuance of deferred and other types of shares with special voting rights. (These shares are also issued at times for the agency firm itself if it adopts the form of a limited liability company.) Such deferred shares are usually of low denomination with disproportionate rights as to voting, dividends and distribution of assets on winding up as compared with the other high denomination shares. Invariably, the deferred shares are allotted to the managing agents and their associates. Thus, with a small total investment, the managing agents can control the firm, for these shares always have the same voting power as ordinary shares. They do not normally receive dividends until the common shares have received a specified percentage — often between 5 and 8 per cent. Then, however, these securities almost always participate *pari passu* with the common shares, which means that the rate of return on deferred shares is extremely high. The author was able to examine the capital structure of twenty managing agency firms which are public limited companies. Among these firms, three had issued deferred shares. In two cases, the firm had raised 25 per cent of the total capital from deferred shares, but these shares entitled the managing agents who subscribed to them to 50 per cent of the total voting stock. In the other case, deferred shares accounted for only 5 per cent of the capital raised but had 55 per cent of the voting power. The data relating to the operating companies controlled by the agents show that about 60 per cent of the former have issued deferred shares. However, it was not possible to discover who owns them. These examples seem to indicate that the use of special voting shares is resorted to by managing agents as one of the chief means of maintaining control of the operating companies.

D. Role of Boards of Directors

The author heard much discussion in India about revitalizing the boards of directors of joint stock companies by turning over to them the affairs of these companies. Such steps, it was argued, would lead to a closing of the breach between ownership and control

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and removal of the managing agents as the dominant force in industrial organization. This author suggests that the legal abolition of the managing agents would not result in removal of the agents as controlling factors. Aside from the contractual relations between the agency firm and the company as defined in the agreement, the managing agents occupy their position because of the business ability of the members and employees of the agency firm. Destruction of the agreement would leave the latter very much intact.

In this area, as with other aspects of the problem, it is difficult to obtain data with which to appraise the role of the managing agents in their relations with the controlled company. In an effort to remedy this situation, the author analyzed data relating to the twenty managing agency firms with public registration mentioned above. Of course, the generality of these data is limited by the preponderance of British agency firms among the twenty. The picture for an equal number of Indian firms would probably change some of the details.

Among the twenty agency firms were four controlled by Indians and sixteen by British. There were in these firms 120 directors: 77 British and 43 Indian. Of these 120 directors, 73 held directorships in the 208 operating companies controlled by the agency firms. The 208 controlled companies provided 968 directorships. Although the 73 agency directors were only 15 per cent of the 488 men serving on the boards of the 208 companies, they held 32 per cent of the directorships in the latter.

The dominant position of the agents is emphasized more strongly when one isolates the "working" directors from those found on the boards for "prestige" purposes. In India, the latter are mainly titled persons who occupy their seats through the invitation of the managing agents. Among the 488 men holding directorships in the 208 companies were 129 with titles. Nineteen of the latter were also on the boards of managing agency firms. All of the remaining 110 titled directors found only on the boards of the operating companies were Indians. Their titles included 23 "Sirs" and 87 "Rajas," "Rao Bhadurs," etc. These 110 purely prestige directors held 269 directorships, while 19 agency directors with titles held another 57. If the agency directors and the prestige directors are combined on the basis of a common interest, they number 183 persons with 581 directorships. This is 38 per cent of the total number of directors with 60 per cent of the total directorships in the 208 operating companies. This means that the 305 directors not connected with the managing agency firm in either a working or prestige capacity held only 387

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directorships. Thus, managing agency directors held an average of 4.7 directorships in the controlled companies and prestige directors held an average of 2.5 each. On the other hand, nonagency and non-prestige directors held only 1.1 directorships per man.

The above statistics, of course, do not answer the crucial question concerning the distribution of authority among agency and non-agency directors on the various boards of the operating companies. Yet, they suggest that the agency directors occupy strategic positions within the operating companies and are in a position to influence greatly the decisions made in those companies. Consequently, this author is prepared to argue that in nearly all operating companies in India, British and Indian, the role of directors performing independently of managing agents — or in opposition to them — is most infrequently met with. The managing agency firm dominates the board of directors in the same way that it dominates all other aspects of enterprise in the modern sector of the Indian economy.

V. Conclusion

The conclusions reached by the author in this paper have been set forth at the end of each section. These will simply be summarized here for convenience. It is argued that the managing agency system of industrial organization is the result of efforts by British and Indian entrepreneurs to overcome the limitations imposed by a shortage in India of venture capital and business ability. The managing agency firm must be considered the heart of the system, for the legally separate joint stock companies in which the producing and trading activities of managing agents are carried on are, in fact, simply operating arms of the key unit — the decision-making agency firm. Although the data supporting this conclusion are not very voluminous and come from varied sources, the author thinks the information is sufficient to outline the major contours and behavior patterns within the system.

One area of current discussion of the managing agency system has not been touched on here. That is the nature of criticism which is frequently leveled at it by various persons — many of them highly-placed in government, law, journalism and economics. Most of these censures are directed at the manipulations and transgressions indicated in the body of the paper. Some of the proposed reforms strike at the entire system even though the evidence used to show why they are necessary relate only to the shortcomings of specific managing agents. Whereas the acts of irresponsible agents receive

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the most publicity, the achievements of those who use the system as an instrument of much-needed development go unheralded.

The whole question of the managing agency system was studied recently by a company law committee appointed by the Government of India. The lengthy report of the committee boiled down to a set of specific recommendations to remove some of the more obvious opportunities for wrongdoing by agents. These were mainly technical recommendations and need not be discussed here. The Central Government still has the subject under consideration, and will probably legislate a new company law in the near future. Nevertheless, it is doubtful whether the fundamental character of the managing agency system will be changed. For this reason, the author thinks the system is an institution worthy of further study by those interested in economic development in India.

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