Extending the boards reach

The governance of group companies will increasingly be an area of focus for SEBI.

The Infrastructure Leasing and Financial Services (IL&FS) group at the time of its collapse operated through 347 entities. Some were wholly owned subsidiaries, a few were joint ventures (with State governments or foreign partners), it had a few associate companies and quite a few special purpose vehicles. A few of these entities were direct subsidiaries, but many others were upto four levels below the parent company. 60% of these were operating in India with the remainder 40% domiciled offshore. IL&FS' precipitous fall, may be explained away by reciting Sir Walter Scott's familiar lines from poem, Marmion 'Oh, what a tangled web we weave, when we first practice to deceive.' But this is simplistic and maybe even specious. It also leaves unanswered the role of the board in the company itself, and what were its responsibilities across the various group companies. OECD's recently released publication focuses on the boards oversight over group companies[1].

[1] Duties and Responsibilities of Boards in Company Groups, OECD, 3 June 2020
http://www.oecd.org/corporate/duties-and-responsibilities-of-boards-in-company-groups-859ec8fe-en.htm

Following a review of the implementation of the G20/OECD Principles of Corporate Governance, OECD decided to review the 'duties and responsibilities of boards in company groups.' They did so by collecting information from 42 jurisdictions. SEBI was an active participant, with an entire chapter devoted to an 'India Case Study' – (four of the five chapters are case studies, covering India, Colombia, Israel, and Korea. Importantly, it's a pointer to SEBI's thinking).

The report does not evaluate the "relative advantages and disadvantages of the legal/regulatory and self-regulatory approaches reported by respondents." Rather it is a listing of the issues and practices and policies followed in different jurisdictions. But even this stocktaking helps identify gaps and provides a pointer to a policy framework to regulators, helping think through if these should be black letter law or guidelines.

As very few jurisdictions even define a 'business group' - regulations around these are expectedly fuzzy. Like most countries, India too does not have an overarching definition of 'group.' And like most, it too defines 'group' based on a set of conditions, using 'associate company', 'subsidiary', 'holding company'. Criteria like control over the board composition, voting rights, or significant influence, either directly or together with its subsidiaries and associates, help answer 'what is a group company'?

An important aspect while looking at groups relates to the fiduciary duty of the board. The classic approach is that a director's fiduciary duties of loyalty and care, exclusively relate to the company on whose board the director serves. Each time an abusive related party transaction is announced or there is a blow-up in the furthest corner of the corporate structure, this question gets asked.

One established way to address this is through '*Konzernrecht*', the German model of company group governance. *Konzernrecht* has already influenced many jurisdictions that make a distinction between the duties and responsibilities of directors in a company from those on the boards of group companies. Under this law any negative influence that a say a parent exercises, is 'disclosed, audited and compensated.' This compensation offers boards protection from dereliction of 'duty of loyalty', as it is believed that since companies are compensated, the directors have exercised their 'duty of care'. Needless to add, the compensation needs to be appropriate and immediate.

Another way that a few countries have addressed this issue is by lowering the threshold while determining whether directors exercised their fiduciary duties, using the 'Rozenblum doctrine'. This doctrine recognizes that there may be costs today, which will perhaps be compensated by benefits that flow in the longer term by being a part of a larger group. It clearly is woolly, and not one I will advocate.

The challenge with both these is that even if you begin today, and codify these into law, it will be a while before practices get established in case law.

As "ownership of capital is a principal indicator of control at the company level, there are several arrangements available in corporate governance frameworks that allow control without holding a majority of the company's actual equity capital," the starting point for a meaningful frameworks has to be disclosures: major shareholders, ultimate beneficial ownership, corporate group structures, special voting rights, shareholder agreements, cross shareholdings and shareholdings of directors.

In India, while we tick quite many of the boxes, still there are some missing pieces. These missing blocks lie along a continuum beginning with easy to those that are thorny, and it is important we start putting regulations in place.

Regulations regarding the flow of information from subsidiaries to parents, is being dealt with through insider trading regulations. The Kotak Committee had recommended a separate framework for dealing with this, and maybe now is the time to accept it [disclosure, Amit Tandon, from IiAS was a member of the committee]. Checking the use of subsidiaries to circumvent the law (- which we see happen often), is hard to control, but needs immediate focus.

Finally, there are aspects that are more difficult to put a regulatory arm around and will need debate. These include the liability of the parent for actions of its subsidiaries. Even more intractable is how are business opportunities allocated within the group?

We began by referencing the large number of subsidiaries in IL&FS, which simplistically is purported to be the reason for its collapse. OECD cites an NSE study showing that every listed entity in the top 500 by market capitalisation has at least one subsidiary (including step-down subsidiaries in several cases) or a holding company or an associate NSE-500 was 18 and median six. 20 listed entities among the top 500 have 100 or more subsidiaries /associates /holding companies in totality, the highest being a company with 308 subsidiaries/associates/holding companies. Today this is how business is done, which is why it must remain an area of regulatory focus.

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https://www.business-standard.com/article/opinion/extending-the-board-s-reach-120062502069_1.html

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