Corporate Governance Crises: On Fraud, Board Failure and Enforceability

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2018 was an eventful year for board room discussions and the corporate governance in India. The Securities and Exchange Board of India (SEBI) approved the Kotak Committee recommendations by amending the Listing Obligations and Disclosure Requirements (LODR).

Simultaneously, the liability of directors appears to be at an evolving state of jurisprudence. The courts in the recent cases have set a precautionary tone, where the corporate veil is readily lifted, personal assets of independent directors frozen, and corporate boundaries ignored. Therefore, the cost of overreaching and unpredictable judicial precedents and enforcement against independent directors (IDs), also has to be certainly weighed.

However, over the last two years, several high-profile crises erupted in well-known companies, raising questions on the role of the board of directors, and probably rightly so.

These range from incidents of high-profile fraud and mismanagement to underperformance, conflicts of interest and culture clashes, within companies. One may consider the notion that the governance norms in India, while robust on paper, are an abject failure.

While it is quite apparent that corporate governance norms have made it rather robust - why does corporate India witness governance crises periodically?

This leads us to question whether boards are equipped to combat not just corporate governance failures but identifying early signs of fraudulent activities in an organisation. It also brings into question various market regulators' failure to create adequate deterrent through prosecution of such illegal activities. It is therefore pertinent to note (i) the systemic hindrances that board faces in current day corporate India; and (ii) the issues with lack of enforcement action by regulators. Perhaps, brain-storming following points may help us to understand these situations and probably the way forward to deal with such situations.

Culture of majority-controlled boards

India still has predominantly family held or closely held listed companies and the promoters more often than not, have an overwhelming influence over decision making. This encourages a culture (knowingly or unknowingly) where the board tilts towards the dictate of the majority shareholders. This results in precluding their independence quotient, as well as fiduciary duty to act for the overall benefit of the company and all stakeholders. Aggressive legal reforms in corporate governance have been successful in curtailing some of the promoters' influence on the board - by requiring disclosure and shareholder approval for related party transactions and empowering small, minority shareholders to appoint directors. However, we have a long way to go when it comes to changing the culture of maintaining an independent board.

Further, many non-executive directors exhibit a culture of apathy believing that it is fatal to their continuing on the board to stand in the way of the controlling shareholder. Even where directors believe that a proposal could seriously harm the company, they will often not go beyond raising objections. They will then be content if the management assures them of a successful execution of the proposal, however weak that assurance may be. Only a few will record dissent even if a plan could adversely affect a company. This culture of course cannot be remedied merely by legislations and regulations but requires strong enforcement, public admonition and strictures by shareholders and other stakeholders.

It is imperative that a culture develops where frank conversation in board rooms steers away from mere crisis management, to risk management. The board meeting agenda should go beyond mere items of goal setting and approving financial numbers every quarter. Board member (especially IDs) should deep dive into modelling out risk of each major decision and accordingly making informed decisions.

Need for Meaningful Board Participation and Continuous Training

Listed companies with massive activities have inadequate board meetings and discussion times. This does not allow for non-executive directors to deliberate on matters. The 2-5 hour discussions per board meeting for 4-6 times a year, may not be enough to grasp operational and financial complexity of large businesses and their numerous subsidiaries. Risk management committee meeting does not take place even once in the year. The role of an independent director has to be much more qualitative in nature, with more emphasis on providing objective strategic advice at board meetings. They should help in providing long-term vision and also act as coaches and mentors to the KMP.

Further, like for other profession, directors should also require certification and continuous training. The MCA may consider mandating courses and training for directors, such that the position and responsibility is not taken for granted. More specifically, such training may also enable directors to identify potential threats hidden among mundane corporate affairs, and more importantly identify early signs of fraud or non-compliance, if any.

Selection of Independent Directors

The Companies Act, 2013 and various SEBI regulations provide detailed, stringent definition of what makes a director 'independent'. But the law can only draw boundaries, the rest must be supplied by people of quality and independent spirit. While on paper the appointment of independent directors is to be independent of management and determined by shareholder vote, the reality is often different among Indian companies. Perhaps, the nomination and remuneration committees of boards must go beyond the "old boys clubs" mentality while selecting IDs where camaraderie precedes fit. Selection of IDs should perhaps be diversified to exhibit a varied portfolio of skills and expertise, which holistically shall result in deeper and more precise involvement by IDs. Solving this structural anomaly may lead to the growth of truly "independent" directors.

Risk-reward imbalance for IDs

The disproportionality of capped remuneration and unlimited liability raises the question of whether there is adequate regulatory and judicial will to address the structural gaps that inhibit high quality professionals from accepting directorships. More crucially, the said disproportionality forces steadfast IDs to tender their resignation once they spot impropriety, instead of the ID going deeper to unravel it. This process also makes for a more pliant" ID, which perpetuates the vicious cycle. Further, even measures like D&O insurance does not cover incidents like fraud, and therefore no downside protection is afforded to conscientious IDs.

Lack of Enforceability

It is important to note that, to a large extent, the efficacy of corporate governance reforms boils down to enforceability. In India, actions taken by the Ministry of Corporate Affairs and SEBI have been the primary form of public enforcement. However, we have hardly seen any successful criminal convictions in any of the high-profile cases of corporate governance failures even when there has been blatant fraud. While the use of civil penalties has yielded relatively stronger results, it has remained unsurprisingly inadequate in instilling an improved sense governance in the higher echelons of corporate India. Weak enforcement action against corporate governance irregularities provides a safety net to errant management. A case in point would be that of Satyam scam. The holders of American depository receipts in the U.S. initiated a class action that compelled the company to settle by paying USD 125 million to the holders, and the auditors had to pay USD 25.5 million. In stark contrast, the Indian shareholders were unable to successfully bring an action for private enforcement before the Indian courts, and hence received no compensation.

In conjunction to the above, a distressing concern with public enforcement lies in the delays in regulatory action by the SEBI, MCA and RBI. For instance, while SEBI has passed orders in the decade-long Satyam scandal, enforcement is far from reaching a logical conclusion given the possibilities of judicial systems and appeals that leads to uncertainty. That can hardly be considered any deterrence at all.

Perhaps, more effective and time bound use of both public and private enforcement methods need to be created.

Conclusion

As aptly mentioned by a veteran lawyer "In India, it's less about board management and more about 'managed' boards" – this succinctly captures the corporate governance fiascos over the last couple of years. Corporate governance in India is at crossroads. With existing robust legal provisions coupled with conscientious IDs and swift enforcement action by regulators, we may well be able to detect failures at an early stage and hopefully prevent the magnitude of corporate fraud that we have witnessed in the recent past.

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