Motivation for positive action

The time has come to 'import' a two-tier support for corporate governance in India

On the face of it, Indian corporates of the listed space have duly constituted the SEBI-specified structures of corporate governance. They have also appointed independent directors in specified fashion to ensure independent functioning boards in their respective organisations. So, if compliance was the litmus test, everything about corporate governance in India should have been hunky dory. But, going by the spate of umpteen management mishaps, including the recent tremours in Infosys, it appears that there's a lot left to be desired.

NITIN POTDAR

Why's it so? There's no rocket science needed to spot the root cause lurking in the very basic structure of the board of directors. It's high time SEBI introduced a two-tier board system for Indian companies – such as a supervisory board and a management board.

But, before moving over to highlight the acute need for a two-tier board, it's pertinent to recall SEBI's incredible efforts in the given area. Falling standards of corporate governance have always been a cause of concern in the specific context of largely promoter-driven Indian companies. Ironically, SEBI had constituted the Narayana Murthy Committee in 2003 for recommending a way out.

Subsequently, SEBI introduced a comprehensive chapter on 'corporate governance' under Clause 49 of the Listing Agreement, which dealt with the appointment of independent directors, as also their participation in the remuneration and audit committee. The new Companies Act 2013 defined the term 'independent director' u/s 2 (47) and outlined a rather comprehensive role via Schedule IV of the Companies Act 2013.

Although SEBI's initiative was indeed laudable, the mandatory provisions knowingly or unknowingly overlooked some of the bitter realities. For example, Indian companies are virtually ruled by promoters. In fact, history is replete with instances where neither the management nor the independent directors have been able to perform their respective roles in letter and spirit, thanks to the intervention by adamant promoters.

Also, Schedule IV has needlessly jumbled up the role of independent directors with that of management functions and supervisory role. Consequently, independent directors are often dragged into frivolous litigation over wrongdoings that emanate from poor management decisions.

The author is M&A partner, J. Sagar Associates. Views are personal

The problem with a single-tier board system is that independent directors and executive directors invariably find themselves at loggerheads, with their mandated roles pushing them into the red zone of conflict. Worse, as mentioned above, independent directors are often penalised for no fault of theirs. And, if we have independent directors and executive directors on the same page in some cases, overriding promoters at times spoil the show with their adamant attitude and bulldozing tactics.

The concept of independent directors has already been well-articulated but, if their role is to be distinguished from that of the management, it is imperative to follow the two tier system. Founders (holding not more than 2 per cent) may suitably find place in the 'supervisory board', along with independent directors, thereby guiding the company more effectively and neutrally given their limited economic interest. In an Infosys-like situation, the founders, if placed in the supervisory board, could certainly provide the much-required guidance and mentorship to the respective managements.

So, how exactly does a two-tier board differ from a one-tier one? For one, as far as composition or structure is concerned, in one-tier boards, both executive directors and non-executive directors are part of the same board, whereas in a two-tier board, executive directors and non-executive directors are formally and physically separated in two board layers. Regarding leadership structure, one-tier board allows one person to hold the function of both CEO and chairman, while the roles of CEO and chairman are always separated in two-tier boards. A CEO cannot be assigned the function of chairing a supervisory board.

Further, in one-tier boards, one board fulfils all three roles – control, strategy and service. There is no clear legal distinction between the roles and functions of executive and non-executive directors, as they share the same legal responsibilities and legal liabilities. In the case of the two-tier boards, the management board fulfils the strategy and service roles, while the supervisory board fulfils the control role. There is generally a clear separation of legal responsibilities and legal liabilities of executive and non-executive directors here.

One-tier boards are most common in countries influenced by the Anglo-Saxon style of corporate

governance. Examples include the UK, Ireland, the US, Canada, Belgium, Sweden, Spain, Portugal, Greece, Singapore and India. Two-tier boards are more common in continental Europe. Examples include Austria, Bulgaria, the Czech Republic, Denmark, Finland, Germany, Latvia, Poland, Slovakia and Switzerland. Some countries, such as France, permit companies to adopt either structure.

Two-tier boards: a closer look

It's easily discernible that two-tier boards allow for a greater opportunity for stakeholder inclusion than one-tier boards. Given the stakeholder-focussed model, the interests of stakeholders other than shareholders, such as employees, are automatically taken into consideration. Some models, such as the 'work council' in the Netherlands, permit workers to participate in strategic decision-making by recommending supervisory board members who, they feel, would safeguard their interests.

A supervisory board is independent of day-to-day management and, hence, impartial control can be ensured, which is not possible in case of single-tier system. Can a director ever efficiently monitor his own decisions? In order to reduce potential management influence on the selection of a supervisor, which may limit the control role of the supervisory board, the supervisory board can also include an adequate number of independent members. Likewise, appointment of a limited number of former management members on the supervisory board can ensure contextual insider knowledge of the business.

The two-tier board, of course, has certain inadequacies. Information asymmetry is one grey area, where supervisory board may lack in insider business knowledge. But clearly, there are ways out to deal with the inherent weaknesses of the model. The supervisory board's right to inspect all documentation of the company in person and well-defined board practices for data collection and delivery could considerably reduce the information asymmetry. It goes without saying that the supervisory board should be composed of competent members who receive regular and updated training. Moreover, they should have the zest and zeal to get to know the company inside and outside the boardroom.

The German example

The German Stock Corporations Act, 1965 (Aktiengesetz) mandates a two-tier structure for all public limited companies and corporations wherein there is a separation between the management board (Vorstand) and the supervisory board (Aufsichtsrat). The members of the management board are appointed and dismissed for cause by the supervisory board. Members of the management board (all executive directors) cannot be present on the supervisory board (all non-executive directors) and vice versa. The supervisory board may however consist of representatives of the company's employees and external managers.

The management board operates as the head of the business and fulfils the company's objectives by implementing required measures and controlling the strategic focus of the company. Meanwhile, the non-executive directors on the supervisory board (Aufsichtsrat) review these decisions on behalf of other stakeholders.

Corporate governance in Germany is further controlled by the co-determination system. Co-determination requires that a certain proportion of the supervisory board's members must be elected by employees.

Vis-a-vis India's single-tier system

Indian laws do not make a clear legal distinction between the roles and functions of executive and non-executive directors as is done in Germany. In India, companies are compulsorily required to appoint a managing director, whereas the presence of a supervisory board in Germany makes such a requirement redundant.

In addition, the appointment, remuneration and removal of management board are governed by supervisory board; however, single tier boards have no such power. Key management decisions are subject to approval by supervisory board in Germany while, in India, no such supervisory body oversees the functioning of the board of directors save for the fact that large management decisions are subject to approval of shareholders. Employees have participation in appointment of supervisory board members in Germany in order to ensure that their interests are not neglected, whereas there is no such provision in the Indian model. The German model is thus apt for a roll out in India. This 'import' could go a long way towards cleansing the Indian corporate environment.

The presence of non-executive and independent directors on single-tier boards is often erroneously held synonymous with a shift in favour of the two-tier system. But, given the high probability of bias among board members, eventually manifested in promotion of private interests and instances of corporate scams, such assumptions can prove fatal.

In India, given instances of insider trading and lack of transparency in large listed companies, it is crucial to have a supervisory body overseeing the management to protect the interests of all stakeholders including public interest at large. ♦