The Tata-Mistry Dispute: Does Corporate Governance Have A Basic Foundation?

The ongoing dispute between Tata Sons and the Shapoorji Pallonji Group is affording the Supreme Court of India a very rich opportunity to opine on some of the fundamental questions related to corporate governance. In October, when Tata Sons, the unlisted holding company of the Tata Group, sought to prevent the Shapoorji Pallonji Group from pledging their shares, questions were raised about the rights of a shareholder in a company. The final hearings this month is raising questions about the fundamental nature of a company.

Harish Salve, the senior lawyer representing Tata Sons, argued that certain amendments to the Articles of Association of Tata Sons that gave affirmative rights to Tata Trusts as the majority shareholder were justified. Interestingly, Salve stated that such an amendment can only be questioned by the Courts if it altered the basic foundation of the company. This was an allusion to the basic structure doctrine which has dominated the constitutional jurisprudence in the country for the past five decades. In this context, it is worth asking if there is indeed any basic foundation or 'basic structure' in relation to corporate governance.

Basic Structure Doctrine

When the legislature frames a law, there can be a judicial challenge on the validity of the law based on whether the legislature was competent to pass such a law and whether the law violates the fundamental rights protected by the constitution. However, when the legislature amends the constitution itself (which as elected representatives they are empowered to do), it was not clear if there was any scope for the judiciary to interfere with such amendments to the constitution if the procedural requirements were satisfied. This meant that the Parliament could potentially remove or alter any part of the constitution, including that on fundamental rights.

It was in this context that the Supreme Court of India, in the landmark Kesavananda Bharati v State of Kerala case, introduced the basic structure doctrine. This doctrine prevents the legislature from altering the 'basic structure', or 'essential elements/basic features' of the constitution. The list of 'elements' or 'features' constituting the 'basic structure' was left open-ended and has evolved over the years. Examples of features that fall within the 'basic structure' of the constitution include rule of law, separation of powers, objectives specified in the preamble, the principles underlying fundamental rights, the principle of equality, independence of the judiciary, etc.

Foundation Of Corporate Governance

Salve's reference to the basic foundation of the company raises issues regarding the nature and constituents of the foundation and importantly the purpose that such a foundation would serve in the context of a company. Given that the reference was made in the context of the role of the board, we restrict our analysis here to address whether the decision-making authority of the board is part of such a basic foundation. The response would vary drastically based on the theoretical model of corporate governance that one chooses to adopt.

Shareholder Primacy Model This model of corporate governance assumes that shareholders own the corporation as they are the providers of financial capital. The corporation is seen as similar to a sole proprietorship or partnership except for the limitation of liability granted to the shareholders. By extension, the shareholders are the 'principals' for whom the managers and board of directors work as 'agents'. As the ultimate owners of the corporation, the shareholders would have the right to take decisions pertaining to the capital employed. They may choose to delegate decision-making rights to managers and monitoring rights to the board of directors, but it is the act of delegation by the shareholders from which the agents derive their authority. As a corollary, the rights delegated could be taken back by the shareholders if they choose to do so.

In effect, under this model, the board of directors and managers are relevant only to the extent the shareholders do not choose to run the corporation themselves. Consequently, the shareholders are also free to determine the extent and the manner of involvement of the board of directors. They may choose to take away certain decision-making rights from the board of directors and directly be involved in those decisions as principals. They may also alter the way the board arrives at a decision i.e., affirmative rights or veto rights. As long as the shareholders inter se agree on this mode of governance, it should be binding on the shareholders as well as the corporation.

Board Primacy Model

The shareholder primacy model does not fully consider certain peculiar features of laws governing corporations as formulated across most jurisdictions. Corporations are recognized as separate legal persons independent of the stakeholders that contribute or represent the corporations. Given the status as an independent legal person, the question of who determines the voice of the corporation becomes paramount. Within the board primacy model, the directors are seen as the autonomous 'fiduciaries' who represent the voice of the corporation. They represent the interests of the corporation rather than that of the shareholders who elect them. The shareholders who provide the financial capital are only one of the relevant stakeholders whose interest is considered.

The relegation of the shareholders' interest is justified given that their liability is limited, and their risk is capped to the amount of money invested. From a social contract perspective, it could be argued that in return for granting the shareholders limited liability and capping their risk, much of their rights to drive decision making is taken away and vested on the corporation as the legal person. The bargain for limited liability is the separation of ownership and control. While the shareholders may still choose to run the company as the Chairperson/Chief Executive Officer/Managing Director, the decision-making authority in such cases vests on them because of their position and not because of their shareholding. In those positions, they serve the interests of the corporation and not themselves as shareholders.

Which Model Is the Basic Foundation?

If the shareholder primacy model is adopted, then the shareholders determine all the decision-making rights in the corporation and the board of directors are relevant only to the extent and in the form shareholders deem necessary. This agency-theoretic conceptualization of the relationship has become the commonly accepted norm in the past few decades which is why the principle of maximising shareholder value has dominated corporate governance discourse. If this model is adopted, the board of directors is not part of the basic foundation of the company.

But, if we take a closer look at some of the fundamental requirements specified in the companies and securities laws, a role of the board that is closer to the one theorized in the board primacy model emerges. The directors are expected to exercise independent judgment and act in the best interest of the company, its employees, its shareholders, the community, and for the protection of the environment. In certain circumstances, the law also requires companies to have independent directors where the expectation to act independently in the interest of the corporation is higher, even if not explicitly specified.

If we expect the board of directors to consider a variety of stakeholders' interests in determining the interests of the corporation, they should be granted decision-making rights independent of the shareholders; these rights should not (cannot) be taken away by the shareholders as it would violate the position of the directors as autonomous fiduciaries of the corporation. Thus, in the board primacy model, the independent existence of the board of directors becomes a fundamental characteristic or basic foundation of the company. To clarify, this does not mean that the board is omnipotent or that there are no limits to the decision-making rights granted to the board. The basic foundation principle here only implies that the shareholders cannot make the board redundant.

Some concomitant questions emerge if the board primacy model is adopted: Should it apply to all companies including private companies? Should the obligation of the directors be the same for all types of directors: executive, nominee, non-executive, and independent? Is there a position at all for nominee directors? Is there a position at all for nominee directors? In our view, the board primacy model has the strongest claim where companies are required to have independent directors. Taking away the rights of the independent directors by requiring the directors to follow the dictates of the shareholders electing them or denying them the rights to take decisions that may be in the interest of the corporation but not necessarily in the interests of the shareholders would effectively defeat the purpose of having independent directors.

The Question Before The Supreme Court

What happened in the case of Tata Sons? The nominee directors proposed by the majority shareholders Tata Trusts had an affirmative right without whose approval the resolutions could not be passed by the board of Tata Sons. This meant that even if all the other directors including the independent directors on the board of Tata Sons deemed a resolution to be in the interest of Tata Sons, it could not be passed if two Trust nominated directors believed it was not in Tata Trusts' interest.

The challenge before the Supreme Court of India now is to decide if the decision-making powers of the board of directors are indeed an unalterable basic foundation of a company or if shareholders are the ultimate decision-making authority who may choose to delegate decision making to agents as they see fit. Which model of corporate governance will the Supreme Court adopt?

J Ramachandran is Professor of Strategy, and Savithran Ramesh is Research Associate, at IIM Bangalore. KS Manikandan is Associate Professor of Strategy at IIM Tiruchirappalli.

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