Tata Vs Mistry: Corporate Governance And Judgment Calls

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It has been widely reported that the Supreme Court of India has decided to hear Cyrus Mistry's (SP Group) review petition in open court this week. This increases the probability of the Supreme Court reviewing (and amending) its decision made last year in the dispute between Tata Sons and SP Group that began in 2016 with the firing of Cyrus Mistry as executive chairman of Tata Sons.

In this article, we seek to make the case that Supreme Court ought to relook at some of the principles undergirding its judgment, especially those that relate to the role of the board of directors of a corporation.

In an earlier article, we had argued that the Tata-Mistry case provided a platform for the Supreme Court to clarify whether decision-making powers vested in a board of directors was a *basic foundation* of corporate governance (board primacy model) or if such decision-making powers were derived from shareholders who may opt to exercise the powers when deemed necessary (shareholder primacy model).

Below, we discuss a few observations made by the Supreme Court in this regard, analyse the implications, and argue why they ought to be reconsidered.

Beneficiary Of Fiduciary Duties

One of the major points of contention in the dispute was the affirmative voting rights granted to the three directors of Tata Sons who were nominated by Tata Trusts. For specified matters, the articles required the approval of a majority of nominee directors for a board resolution to pass. This raised a question of whether the nominee directors were expected to act in the interests of the company *as a whole* or in the interests of Tata Trusts, the majority shareholders. Section 166 of Companies Act, 2013 requires all directors of a company to act in the best interests of the company and promote the objects of the company.

The Supreme Court resolved this issue by stating that nominee directors have fiduciary duties towards both the company and the nominating shareholder. To arrive at this conclusion, the court referred to the fact that there is a separate category of directors called independent directors and inferred that such a category would not be necessary if all directors were expected to exercise independent judgement. Though the court did not address the question of what happens in the event of differing interest between the two (ie: the company interest and the majority shareholder interest), this observation of the Supreme Court has at the minimum, reduced the scope of Section 166 as it applied to nominee directors or non-independent directors.

The Supreme Court was careful in restricting its observation in the case to directors nominated by public charitable trusts such as Tata Trusts who already have public benefit considerations.

Perhaps not.

But there is still a risk that the same reasoning process used here – of looking at the category of independent directors and reading down the requirement to exercise independent judgement for other directors – can also be extended to public listed companies in a future judgment.

At a time when SEBI is grappling with the issue of board capture by promoters (typically majority shareholders) and trying to ensure board independence, there is a good case for the Supreme Court to relook at this observation.

A company is a separate legal person with the board of directors as its voice (or mind). The requirement to exercise independent judgement under Section 166 must be seen from this perspective.

Equating Right To Elect With Right To Control

In seeking to justify the affirmative voting rights granted to nominee directors, the Supreme Court drew a parallel with the mechanism used for decision making at the shareholder general meetings.

In shareholder meetings, the majority shareholders can control the voting outcome on resolutions by virtue of their majority voting rights. Consequently, the Supreme Court concluded that the “Trusts which own 66% of the paid-up capital of Tata Sons will be entitled to pack the Board with their own men as Directors.” It also noted that majority shareholders “can always seek to be in the driving seat by reserving affirmative voting rights”.

There are two major consequences of the above observations.

First, use of the phrases “own men” and “driving seat” suggest that right to elect directors implies a right to control the decisions made by the directors. A natural question to be asked is whether shareholders elect directors to control how they behave (follow their directions) or if they elect directors for their business judgement. The Supreme Court observations suggest the former, but this allows majority shareholdersto benefit from control without the concomitant responsibility that directors have under law: ie: duty of care and loyalty.

Second, the framing of board decision-making as akin to shareholder decision-making fails to account for the distribution of decision-making inherent in the corporate form of enterprise. Under law, boards are vested with most of the decision-making authority, with shareholders having limited decision-making authority on specified matters (which could be revised/expanded). There are strong efficiency reasons for this distribution. The Supreme Court’s observations may undermine this and ought to be reconsidered.

Conflict Of Interest

The Supreme Court also observed that “the best interests of the majority shareholders need not necessarily be in conflict with the interests of the minority shareholders or best interest of the members of the company as a whole, unless there is siphoning off or diversion.”

This was perhaps another reason why the Supreme Court prescribed dual duties to nominee directors and saw nominee directors as extensions of the nominating shareholders. The logic is that any decision taken by the majority shareholder will be proportionally (to

shareholding) beneficial or detrimental to them as it is to other minority shareholders. The exception is when there is diversion of resources or tunnelling (for example, related party transactions) when majority shareholders receive outsized gains to the detriment of minority shareholders.

A combined reading of the earlier observations on independent judgement with this would indicate that independence from majority shareholders is relevant only in case of decisions where there is conflict of interest.

There are potentially two problems that are overlooked by this observation.

- First, conflict of interest is seen here only in terms of misappropriation of resources (tunnelling). It overlooks the possibility of conflict between decision makers regarding what is the appropriate course of action(s). For example, a conflict in terms of whether Air India is an appropriate investment for Tata Sons or not does not involve diversion of resources or tunnelling, but it is certainly a significant decision where minority shareholders may not want to blindly trust the judgement of majority shareholders.

- Second, it overlooks the possibility that a majority shareholder is a bounded rational individual(s) with biases and narrow competence. Decision making at the highest levels are judgement calls as they pertain to strategic choices which are commitment intensive with uncertain future outcomes, where the problems of bounded rationality may be accentuated. Absent a structured process enabling careful consideration of alternate and independent perspectives, minority shareholders are likely to be vulnerable to poor decisions, even if they are well intentioned.

Caveats and Conclusion
To clarify, we do not state that our arguments necessarily constitute a legal basis for review of the decision.

As scholars studying corporate governance from a strategic management tradition, we make this case from the perspective of what would be a superior arrangement for decision making in an uncertainty-laden operating environment for corporations.

Further, we also do not imply that the current judgment has binding precedential value with implication for the decision-making structures at all companies. We note that peculiarity of a public charitable trust being a majority shareholder and Tata Sons being virtually a private company indicates that the judgment is unlikely to have direct implication for other public companies.

However, the principles used to arrive at the conclusion can be transposed and be made applicable to other companies, including listed companies, with significant impact on the functioning of the board of directors and the companies. In our view, this is the real risk of the Supreme Court judgment, which ought to be reconsidered.

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