Board permanency gives promoters leverage against investors

Recent instances suggest that giving promoters a permanent seat on the board can be detrimental to investor interest. As companies' performance deteriorates and promoter shareholding declines, promoters continue to hang on to their board seats in a last-ditch effort to maintain control. This makes it harder for investors to effect management change and arrest value destruction.

Some promoters have long believed that their right to run a company that they or their ancestors founded, is absolute. Several of these promoters have embedded themselves into the company permanently. There are two ways in which this is being done.

The first is by naming themselves as permanent directors in the company's Articles of Association (AoA).

This issue took centre stage when Diageo plc (Diageo) wanted to remove Vijay Mallya from the board, after it had established control over United Spirits Limited (USL). Vijay Mallya refused, saying he had a legal right to stay on the board. USL's AoA had incorporated within it the right of Vijay Mallya to remain Chairperson of the board, which he continued to assert even as he escaped the country's law enforcement. It was only after a USD 75mn settlement[1] with Diageo that Vijay Mallya agreed to remove himself. Some other instances where directors have been embedded as permanent directors or Chairpersons include Sharad Parekh in Nilkamal Limited, and Onkar Kanwar (Chairperson) and Neeraj Kanwar (Vice-Chairperson) in Apollo Tyres Limited.

Founders of start-ups too are using this route for them to stay in control independent of shareholding levels. In Zomato's case, Deepinder Goel and a set of investors have embedded in the company's AOA their right to nominate board members *even* if they are diluted by more 50%. Deepinder Goel owned 4.69% equity in Zomato on 30 June 2022 and he gets to nominate one board member until he owns 27,573 shares (founder shares, adjusted for bonus and or consolidation). This is 0.00035% of the paid-up share capital (as on 30 June 2022). And if he divests or donates these, even then he can appoint his nominee so long as he holds an executive position in the company. This right is premised on his right to build equity through stock options. Given the low shareholding threshold for him to have board nomination rights, he will likely remain on the board until he decides otherwise.

The other way to board permanency is for directors to get appointed but not be liable to retire by rotation.

Recently, Jawahar Goel's reappointment as Managing Director of Dish TV Limited was defeated by shareholders in the 2022 AGM – yet he continues on the board as a non-executive director. He has board permanency – since he was appointed as a director not liable to retire by rotation. The Companies Act 2013 requires at least a third of the board to retire by rotation. But Independent Directors do not retire by rotation – they are appointed for a specific term. Emulating this, companies have appointed executive directors not liable to retire by rotation for a fixed term. The issue is greater when non-executive directors or promoters are appointed but are not liable to retire by rotation. Effectively, this means that once such directors are appointed, they do not come up for reappointment subsequently, and therefore have board permanency.

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[1] *There were subsequent disputes on the settlement and other issues between Diageo and Vijay Mallya which took to the courts.*

Promoters tend to get their permanent positions when they have sufficient shareholding to vote themselves in. These are usually times when the company's performance is not a concern, leading shareholders to overlook the longer-term consequences of the resolution. The concern over board permanency becomes central when the company performance deteriorates or there are significant corporate governance concerns, especially with respect to related party transactions. In instances where promoters lose their dominant shareholding, either through reduction in shareholding or a significant dilution post debt-restructuring, they continue to remain in control. With a compliant board, these promoters seldom face pressure from their peers. It is then left to investors to fight for a change in board and management.

Under these circumstances, for investors to effect change, they need to seek the removal of the director. This is a far more difficult battle than simply voting against a director's reappointment. To now remove a director, a special notice must be sent by shareholders owning at least 1% voting power or shares valued at Rs. 500,000 in paid-up capital, and then the management is obligated to put the request to a shareholder vote. Otherwise, shareholders owning 10% or more of the paid-up capital can ask for an EGM to be held and the resolution to remove directors can be brought to shareholder for a vote. The resolution to remove a director needs a simple majority to pass (75% majority if it is the removal of an independent director). And all this only if the board does not fight the investor in support of the entrenched promoters.

The battle between a lender and an institutional investor with a media and a cable company is evidence of both, how long drawn and uncertain this process of removal then is, and the costs of promoter entrenchment. Even as regulations on shareholder rights (and activism) are being tested in the courts, investors are better-off not appointing promoters permanently to the board in the first instance itself.

moneycontrol

A modified version of this column by Hetal Dalal was published on www.moneycontrol.com on 4 August 2022, and it can be accessed here: https://bit.ly/3zWTTVu

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