Corporate Governance: The Law in India

Let's dive into the statutory framework for corporate governance in India in Part 2 of our series.

The Companies Act, 2013 (**Act**) is the primary legislation governing companies in India. It replaced the Companies Act, 1956, introducing several reforms to enhance corporate governance standards. The Securities and Exchange Board of India Act, 1992 oversees the securities market, with the Securities and Exchange Board of India (SEBI) acting as the regulator for listed companies. Companies operating in industries with systemic implications or in which public interest is at stake such as the banking, finance and insurance are subject to additional governance norms by their respective industry regulators like SEBI, Reserve Bank of India (RBI), and Insurance Regulatory and Development Authority (IRDAI) and the regulations issued by them.

Who governs a company and how?

In India, the bodies/persons which govern a private company are the (i) board of directors (and its sub-committees), (ii) shareholders (exercising their powers through voting and activism) and (iii) the key managerial personnel which include chief executive officer, chief financial officer, managing director etc.

1. Board of directors and committees

   - *Composition:* Every company under the Act must have a board with a minimum number of directors. Listed public companies have stricter requirements, including having at least one-third independent directors on their boards. Similar principles have been prescribed for board committees as well.

   - *Duties and fiduciary obligations:* Directors must act in good faith, with care and independent judgment, prioritizing the interests of the company, its stakeholders as a whole, and the environment, as per Section 166 of the Act. The section also enshrines the principle that a director must absolve herself / himself in a conflict-of-interest situation. Collectively, these form the basic tenants of their fiduciary responsibility. Notably, nominee directors too must keep the interest of the company and all its stakeholders in the forefront. Courts have clarified that nominee directors owe duties to both their nominator and the company, but in conflicts, the company's interests take precedence (*Supreme Court of India in Associate Bank's Officers Association vs State Bank of India and Ors. reported in 1998 (1) SCC 428*).

2. Shareholders

   - *Voting rights:* Equity shareholders make decisions by voting on resolutions at general meetings. Ordinary resolutions require a simple majority (more votes for, than against). Special resolutions need at least three times as many votes in favour as against, along with additional procedural and notice requirements (as per Section 114 of the Act). Preference shareholders can traditionally vote only on matters affecting their rights or alongside equity holders, if dividends

remained unpaid to them for more than 2 years. However, private companies can now bring the voting rights of preference shareholders at par with equity shareholders by extending voting rights to them for all matters in a company, by excluding the statutory voting rights provisions in their articles.

- *General Meetings:* All companies (except one-person companies) must hold an AGM within prescribed timelines prescribed under Section 96 of the Act. An extraordinary general meeting (EGM) can be called by the board at its discretion. Pertinently, the board is obligated to call an EGM if requested by members holding at least 10% of the paid-up share capital or 10% of voting power (for companies without share capital).

- *Powers of Shareholders:* Certain major decisions (like asset sales, raising considerable debt, private placements of shares / debentures etc., changes to constitutional documents etc.) require a shareholder approval via a special resolution under Section 180 of the Act. However, some of these restrictions have been relaxed in recent exemptions extended to private companies.

In addition to the statutory rights available under the Act, investors typically enter into shareholders agreements with a company and its shareholders, setting out a wide variety of rights that they would enjoy in respect to the Company, including right to appoint observers or directors to the board and providing for affirmative voting matters.

3. Key Managerial Personnel

While the board of directors and the shareholders serve as the higher decision-making authorities for major decisions, the day-to-day functioning is run by the executive officers, which may include the managing director, chief executive officer (CEO), other C-suite members. The CEO, managing director, company secretary, whole-time directors and chief financial officers are classified as 'key managerial personnel' and hold a fiduciary responsibility to the company and its stakeholders. They are also deemed to be 'officers in default' for the purposes of penal provisions of the Act.

4. Creditors

Creditors usually do not take part in a company's governance, but in cases of debt default, they may gain rights to oversee or even take over management, as allowed under various laws. It is the duty of a debenture trustee to appoint a nominee director on the board upon payment defaults or default in creation of security in respect of debentures under Rule 18 of the Companies (Share Capital and Debentures) Rules, 2014]. Section 17 of the Insolvency and Bankruptcy Code, 2016 (IBC) provides that if a company undergoes a corporate insolvency resolution process, the powers of the board of directors is suspended and are taken over by the resolution professional who acts in sync the NCLT and the committee of creditors. The question that arises is, whether such nominees of creditors have any fiduciary duties towards the debtor company and its shareholders? Judicial pronouncements have shown that they indeed do, albeit to a limited context. A resolution professional has a duty to protect the assets of the corporate debtor, including its continued business operations (Section. 25 of IBC). Courts

have also held that lenders have a duty to act fairly and in good faith towards borrower companies (*Supreme Court of India in Mardia Chemicals Ltd. and Ors. Vs. Respondent: Union of India (UOI) and Ors., reported at AIR 2004 SC 2371*).

Governance standards for listed entities

Given that significant public money is at stake, SEBI has mandated a comprehensive governance framework for listed entities under the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations 2015 and certain other regulations. The are principally based on the tenants of disclosure and transparency.

Governance related compliance requirements y mandatory for listed entities illustratively include requirements for a compliance officer, investor grievance redressal mechanisms, specific requirements for composition of directors such as mandatory inclusion of women and independent directors, mandatory independent audit committees and nomination and remuneration committees, increased compliances for related party transactions, reporting requirements for compliances with corporate governance etc..

Anti-corruption and bribery laws

The Prevention of Corruption Act, 1988, with its amendments and modifications (PCA) prohibits and punishes the use of corrupt means and bribery of public servants, including by company directors if committed on behalf of a company. Directors are responsible for preventing such misconduct. Additionally, internal corporate fraud is addressed under Section 447 of the Act, which mandates imprisonment for fraud exceeding a certain amount. Thus, directors have a responsibility to prevent the company and its officers from engaging in corrupt practices.

Penal Consequences under various statutes

The Act provides monetary penalties for breach of its provisions, which may range from a few thousand Indian rupees to as high as a few crores (see sections42, 46 and 76 of the Act), and these penalties are more often than not applicable to the company as well as its officers in default. Keeping in mind the objective of ease of doing business, the government has attempted to decriminalise certain violations of the Act over the years by providing for monetary penalties, with the exception of serious offences like fraud, impersonation of shareholders, non-compliances in financial statements, etc.,) which are punishable by imprisonment.

It is pertinent to note that while the penal provisions under the Act are stringent, the implications of non-compliance often extend far beyond statutory punishment. Orders relating to prosecution and penalties are published in the public domain, and the resulting reputational damage can be significantly more detrimental to a company and its stakeholders than the legal consequences alone. Moreover, such violations are closely scrutinized by investors and lenders, who increasingly consider compliance records when assessing financial exposure and making investment or lending decisions.

In this context, adherence to the relevant corporate governance legislations and contractual obligations is not just a legal obligation, but a vital aspect of maintaining credibility and financial stability for an organisation.

More on contractual protections in our next part of the series!

Authors:

Nausheen Ansari | Poonam Sharma | Karan Kalra

Contact: poonam@bombaylawchambers.com | karan@bombaychambers.com