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Board's Fiduciary Duties – To Shareholders or All Stakeholders? Examination of Section 166 (2) of the Companies Act 2013

Asish K Bhattacharyya

Asish K Bhattacharyya is a Distinguished Professor at Shiv Nadar University and founder of Nonlinear Insights. He was a Professor at the Indian Institute of Management Calcutta and the Indian Institute of Corporate Affairs. Besides, he was Director of the Institute of Management Technology Ghaziabad and the Head of the School of Corporate Governance, Indian Institute of Corporate Affairs. Dr. Bhattacharya started the Centre for Corporate Governance at IIM Calcutta. He was a regular columnist for Business Standard from 2008 to 2020. He is also on the editorial board of A₹tha.

ABSTRACT

Section 166(2) of the Companies Act 2013 creates an impression that the new Companies Act has extended the board's fiduciary duties to all the stakeholders. This view is further strengthened as the Environmental, Social, and Governance (ESG) investment is gathering momentum. This article examines the issue. It concludes that the board has a fiduciary relationship only with the company (collective of shareholders) and not to any particular stakeholder group. However, section 166(2) and ESG investment require significant change in board composition and role.

Introduction

The separation of ownership and control is inherent in the company structure. The governance and management of a company is centralized with its board of directors (hereafter, board). Shareholders have no right to participate in the day-to-day decision-making. They participate in deciding only the issues reserved for the shareholder body. The board derives its power from corporate law, capital market regulations, and the Articles of Association (Articles). The view that the shareholder body delegates power to the board for managing and governing the company is incorrect.

Corporate governance rules are shareholder centric. La Porta et al. (1997, 1998, 1999), who studied shareholder and creditor protection across the countries, hypothesize that the legal environment – law and its enforcement, for protecting shareholders' interest determines the flow of capital to companies and development of the capital market. Many believe that the hypothesis is still valid, for example, Lele and Mathias (2007).

This article endeavors to examine whether section 166 (2) dilutes the board's fiduciary relationship with shareholders by asking it to balance the conflicting and often competing interests of all stakeholders.

Core Objective Function of a Company - ESV

Enlightened Stakeholder Value (ESV) or 'Enlightened value maximization' theory propounded by Jensen (2001) captures the current, dominant view on what should be the core objective function of a company. According to that theory, boards should use resources and efforts to maximize their firm's long-term value. Jensen (2001) argues that managers cannot preserve and create long-term firm value if they ignore or mistreat any important constituency and fail to maintain good relations with customers, employees, financial backers, suppliers, regulators, and communities.

ESV is finding support, at least on paper, from the business. In August 2019, the Business Roundtable adopted a resolution signed by nearly 200 CEOs of large American Corporations, delineating their fundamental commitment to (i) deliver value to customers, (ii) invest in employees, (iii) deal fairly and ethically with suppliers, (iv) support the communities in which they work, and (v) generate long-term value for shareholders.[1]

The model has also found its place in the statute book. For example, section 166 (2) of the Indian Companies Act 2013 stipulates,

> "A director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of environment."

[1] Available at: https://www.businessroundtable.org/purposeanniversary, extracted on December 8, 2021

A close reading of section 166 (2) of the Indian Companies Act 2013 makes it clear that it has two distinct clauses, which are:

1.A director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole; and

2.While promoting the company's object, it will act in the best interests of the company, its employees, the shareholders, the community and for the protection of environment.

Good faith, also called *bona fides*, is defined as a state of mind which includes honesty, faithfulness, observance of reasonable commercial standards, and absence of intent to defraud.[2]

Directors are duty-bound to promote the objects of the company. Companies usually include a large number of objects in the Memorandum of Association, all of which are in the nature of commercial venture. Therefore, it is appropriate to infer that the board has the fiduciary duty to preserve and create long-term value for the firm. The second part of the clause makes it obligatory that the directors in performing that fiduciary duty shall act in the best interest of the company, its employees, the shareholders, and the community, whose interests are conflicting and often competing. According to Sterzenbach and Sitkoff (2020), the best interest in dealing with competing interests should be construed as *'total fairness'* requiring fair price and fair dealing. Therefore, directors' duties towards the company and that towards the stakeholders are different. The board has fiduciary duties towards the company (and not individual shareholders), and in performing those duties, it should deal with stakeholders applying the principle of total fairness.

Section 166 (2) is yet to be tested in the Indian courts. However, it is unlikely that the court will intervene on a suit filed by employees or members of the local communities (around which the company operates) for a remedy against the board's failure to comply with the requirement of section 166 (2) unless they can establish that directors have taken a decision that a reasonable prudent man will not take while pursuing its goal (in case of a company, commercial considerations).

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[2] *Black's Law Dictionary* 713 (8th Ed. 2004).

The Companies Act 2013 retains the shareholder primacy and does not protect the stakeholders' interests. For example, it is only the shareholders who have the voting right. Furthermore, section 241 of the Indian Companies Act 2013 empowers only shareholders and depositors to proceed with class-action suits. It does not provide any remedy against mismanagement to stakeholders other than the shareholders. The interests of stakeholder groups are subordinate that to the company's interest. Section 166 (2) does not require the directors to "balance" the interests of the members of various stakeholder groups. In *Percival* v *Wright*, a case based on the UK company law, a celebrated authority on the subject ruled that the fiduciary duty of the director extends only towards the company and not towards individual shareholders. [3] Section 166 (2) has not changed the settled position in corporate law.

Ernest (2018) observes that although none disputed that recklessness and failure to provide oversight had nearly resulted in collapse of financial institutions during the 2008 financial crisis, but none of those directors were held liable for the collapse of financial institutions, which could only be saved through government bailout.

Pitfalls of ESV

Jenson (2000) in an interview clarified that 'value maximization' is the score card to evaluate the company's and manager's performance like goal scored in football matches in a year is used to measure the performance of the club and the players. Managers should develop the firm's vision and craft the strategy for achieving that goal as the coaches of football clubs craft strategy for winning football matches.

For long analysts and researchers measure firm performance using a proxy for Tobin's Q. Tobin's Q is calculated using the following formula:

$$Tobin's\ Q = \frac{(Market\ Value\ of\ Equity + Market\ Value\ of\ Debt)}{(Book\ Value\ of\ Equity + Book\ Value\ of\ Debt)}$$

In the long-term, a firm's market value converges with its fundamental value. Although mispricing of shares in the capital market is an important issue, market value is considered a good measure to evaluate a manager's performance.

[3] (1902) 2 Ch 421

There are real-life examples, such as the WorldCom scandal (in the calendar year 2002), the Volkswagen scandal (in 2015), and the Boeing 737 Max crashes (in 2019). These examples illustrate that when a firm's market value is used as the guidepost for crafting and implementing strategy, managers get tempted to ignore the interests of stakeholders other than shareholders. The goal of creating long-term firm value acts as a blinder. Investigation of two fatal crashes of Boeing 737 Max within five months reveals how key employees behave in a capital-market-focused organization culture. To make their company more profitable, they defraud the regulators and compromise other stakeholders' interests. A federal grand jury indicted a former key executive of Boeing for fraud, alleging he deceived the Federal Aviation Administration about the design flaws that would cause two fatal crashes. Isidore of CNN news (2021) reported that Nadia Milleron, mother of Samya Rose Stumo, who was killed in the second fatal crash in March of 2019, said the indictment of one former executive does not go far enough. She said that Mark Forkner was operating within a system which rewarded short-term financial gains over safety. Therefore, the board of directors should take the responsibility and directors should be penalized.

Robison (2021) demonstrates that the ultimate blame for the crashes lies with the highly paid executives. They led the transformation of Boeing from a company known for engineering excellence into one of the most shareholder-friendly company.

The second pitfall of the ESV is that it guides managers to take care of the interests of *important constituencies.* Even before the ESV was propounded, managers used to manage stakeholders based on their power and position. They took care of those stakeholder groups who could hurt the company's operations and not those who are hurt by its operations. The ESV theory fails to change this managerial approach.

Company's Purpose and ESG Investment

The purpose of business cannot be anything but to earn money. When entrepreneurs conceive a business idea, their main consideration is whether they will make money by implementing that idea. According to Peter Drucker (1993), "an institution exists for a specific purpose and mission, a specific social function. In the business enterprise, this means economic performance." He further wrote, "Business management must always, in every decision and action, put economic performance first". Drucker's theory is as true today as it was in the past. Managers aim to internalize the benefits of everything they do. Investible funds flow only to those firms that demonstrate better economic performance. Companies invent products (and services) using scientific discoveries and create customers for those products. Their economic performance depends on their ability to sell products at prices that are higher than their production and distribution costs. The price that the customers are ready to pay

for a product depends on how they value it, which depends on how good it is in fulfilling their needs. In maximizing firm value, a firm serves those segments of the society which can pay for products and services. Firms look at the 'bottom of the pyramid' to explore the opportunities for making money or to manage reputation risks.

ESG investment should be viewed in the above context. Schanzenbach and Sitkoff (2020) classified ESG factors into two categories – 'collateral benefits ESG' and 'risk-return ESG'. Collateral benefits ESG is the classic socially responsible investing (SRI). The investment strategy is not to invest in sin stocks. Managing Risk-return ESG improves return on investment. Institutional investors (like pension funds and mutual funds) fail in their fiduciary duty when they exclude sin stocks from their portfolios unless the investors in the units of those funds agree to the Fund's approach of screening their investment strategy through collateral benefits ESG factors. Institutional investors fulfill their fiduciary duties when they screen their investment strategy through risk-return ESG factors, as the aim is the preserve and create long-term firm value.

Changing board role

The ESG investment movement has not demolished the basic premise of ESV that the core objective function of a firm is to preserve and create the long-term firm value. Furthermore, it has yet to weaken Drucker's proposition that a firm's economic performance be the metric for management's performance. ESG investment movement has changed the ESV theory's proposition that managers can create value only by managing the interests of and relationships with important constituencies. ESG factors include the overall social and environmental impacts of the company's policy, strategy, and operation.

Companies that ignore ESG factors are considered irresponsible. In the digital environment, the irresponsible behavior of companies spreads fast like a wildfire. It hurts the firm's reputation and the reputation of key actors who drive its mission and strategy. Therefore, irresponsible companies fail to attract talent.

In view of the above discussion, I propose the following:

1. The concept of a monitoring board should give way to an advisory board. The board should not focus too much on its monitoring role. It should concentrate on its advisory roles and thoughtfully design business

models, formulate policy, business and corporate strategy, and manage risk. It should be cautious that the goal of creating firm value acts as a blinder unless the ESV culture percolates down to the bottom. Therefore, it should play an active role in building the right organizational culture. It should set the tone not only at the top but also across the organization.

2. At present, audit committees are in the limelight, and boards are spending too many resources in analyzing quantitative details. Financial statements are losing relevance, as accounting numbers fail to capture the outcome of strategy and efforts in preserving and creating long-term firm value. Even the International Accounting Standard Board is revising its practice statement on management commentary, and the IFRS Foundation has set up a separate board for setting IFRS sustainability standards. The board should spend time and efforts in discussing qualitative ESG issues from different perspectives to clearly understand the impact of its operations on the society beyond the neighboring community.

3. The board should build its capabilities to understand the social issues and the social impact of its decisions. To this end, it should achieve diversification beyond gender diversity. For example, on August 6, 2021, SEC has approved new listing requirements proposed by NASDAQ. The new provisions stipulate issuers to have at least one director from an underrepresented minority and one female director. The new rules prescribe disclosure regarding the gender composition of the board and the demographic background of board members (Board Composition Disclosure) and establish a disclosure-based framework, not a mandate or quota. The board should include representatives of various stakeholder groups. Initially, the board might create positions such as non-voting members and observers to enhance its capabilities.

4. Section 166 (2) should replace the word “employees” with the word “workforce” to ensure fair treatment to gig workers, migrant workers, and other contract workers. The U.K. Corporate Governance Code has used that term instead of employees.

5. Boards should require the CEO to present a structured report on performance using ESG parameters and metrics to be developed by the board. It should ensure that the company policy is aligned with national priorities of eradicating social ills and that the policy is implemented effectively.

6. The board should reconsider top managements' variable compensation based on the stock market performance given the mispricing in stock prices.

Conclusion

Companies will continue to pursue the goal of maximizing long-term firm value. They should evaluate business models and business strategy through risk-return ESG factors. This will not require dismantling the extant corporate governance model. However, it would require reconstitution of the board to build capabilities to examine strategies and policies from a risk-return ESG perspective. The board's monitoring role should give way to the advisory role, and its efforts and resources should be augmented for discussing qualitative issues. Empowering shareholders makes the institutional shareholders more powerful, leading to a higher level of shareholder activism. It is time to examine whether heightened shareholder activism is good for companies that focus on long-term value creation by managing risks using a model that incorporates risk-return ESG factors.

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