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GUEST COLUMN

How Board Members of Defaulted companies Oversaw Shareholder Value Erosion

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SEBI redeemed itself on 4th August, 2017. This it did by issuing a circular which mandated listed companies to report 'default' in servicing bank loan, within 24 hours of the default. The circular which will become effective on 1st October 2017, a day before Gandhi Jayanti, would go a long way in enhancing the level, quality and urgency in disclosures to investors in Indian markets. As such, the markets have to make do with much inferior quality corporate disclosure than is the case is more developed markets. The circular unambiguously defines default as 'non-payment of interest or principal amount in full on the pre-agreed date". That the globally accepted definition of default would come from market regulator, and not the banking regulator, is a thought provoking matter in itself.

This mandate from SEBI will go a long way in reducing the likelihood of another corporate credit blow-up, on the lines India is currently experiencing. However, this had come in 2011, it might have prevented at least INR 4 lakh crore shareholder value erosion which happened in the following six years. While SEBI may have redeemed itself the same cannot be said about the Board Members of NPA companies. The Board particularly the independent member, of over 500 listed and defaulted companies, have still to answer to their shareholders whether they have been doing their job at all or not.

Board members, particularly independent members, usually are experienced individuals with expertise in fields such as accounting, legal, banking, economics or business. Most of them are expected to know that in the event of a payment default the company's equity value technically becomes negligible, if not zero. The debt holders have economic and legal claim (in most countries and now also in India) to the assets of such a defaulted company thereby causing the equity holders' stake ie;stock price to crash. As the information of default 'leaks' out into the market the share price nose-dives. From the time a company moves to an NPA or acknowledged default state typically stock price erodes by 95% to 99% of pre-default peak price.

The board member had ample opportunities and examples from Indian markets about stock price crash of defaulted companies. Thus they can clearly figure out the supreme importance of information about delinquency status of the company and how valuable the information is to minority shareholder. It is not too much to expect that board members may have figured out that 'default' on any debt is a material event from the perspective of the shareholder. Now that SEBI has issued the circular and expect compliance from 1st October 2017, we still do not see companies under the aegis of their board members proactively reporting to exchange about their delinquency status. Of course it may be a case that none of the companies in India are currently in stage of unacknowledged default, but given the economic situation this appears less likely.

Are Board Members of NPA Companies Negligent?

Indian regulators, thus far, have been behind the curve in terms of creation of rules which reduce information asymmetry with respect to investors and minority shareholders of the company. It may not have been so much an intent issue but possibly a lack of appreciation of the importance of 'default' information to shareholders.

In the original Listing Obligation and Disclosure Requirement (LODR), a listed company was expected to share information about material events ranging from disruptions of operations due to calamity, commencement of commercial productions, litigation, organisational restructuring, issuance or forfeiture of shares, non-payment of dividend and the like. These are clearly material events but it is arguable whether any of them can erode shareholder value by 95% to 99% the way a corporate default does. To be fair to the board members of defaulted companies the fact that any default on financial obligation is a material event for the company has not been on top of mind of both the market regulator as well as the banking regulator prior to 2015.

In the earliest versions of LODR, reference to default of payment on financial obligations was absent. Gradually, non-payment of dividends was introduced as an event requiring disclosures, subsequently default on redemption of hybrid instruments such as foreign currency convertible bonds (FCCB) was identified as an event requiring disclosures and more recent inclusion was default on listed debt instrument such as Non-Convertible Debenture (NCD). Strangely, a time period was not specified other than the requirement that the news is to be shared with the exchange 'promptly'. Even when such defaults happened it was more often via a news leak that investors got information about default events and only thereafter would the company inform the exchange.

But then the original version of listing agreement did contain a clause which read "The company *should ensure timely and accurate disclosure on all material matters including the financial situation, performance, ownership, and governance of the company*". That none of the independent directors, pushed a company to proactively disclose event of default on any debt obligation may be a comment on the maturity of all market participants which include regulators, institutional investors, retail investors , market commentators and of course the Board Members. The 4th August 2017 regulation of SEBI possibly underscores the fact that unless pushed, the market

forces by themselves may not push most Indian companies, in general, to adopt world class disclosure norms and governance practises.

Did the Management and Board Neglect the September Wakeup Call?

On September 2015, SEBI enhanced the LODR to provide further regulatory clarity on the responsibilities of the Board and Key Management Personnel (KMP) with respect to disclosure of information to the exchanges. An argument can be made that Board Members and KMPs of defaulted companies may not have been complying with this regulation in spirit and possibly also in letter, when they did not share the information of a default/delinquency event to the exchange. Let's get into the details of this argument by focussing on responsibilities of the board members, interpretation of materiality and access to information.

The enhanced LODR specifically articulated the responsibilities of the board . The prominent ones are the following:

-*The board of directors and senior management shall conduct themselves so as to meet the expectations of operational transparency of stakeholders while at the same time maintaining confidentiality of information in order to foster a culture of good decision-making.*

-*Ensuring the integrity of the listed entity's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.*

- *Overseeing the process of disclosure and communications*.

Here one may argue that not disclosing event of default due to non-payment of bank loans does not speak highly of operational transparency and reflects poorly on integrity of reporting system with respect to risk management and financial control.

Arguably, there was a enough clear guidance in the September 2015 regulation which may have prompted a prudent board to report a default in payment of bank loan to the exchange. Further there was an a more overarching requirement which requires "*Every listed entity shall make disclosures of any events or information which, in the opinion of the board of directors of the listed company, is material*." Further the regulator provided guidance for determination of materiality of events/information.

Two points that highlight what may constitute a material event:

(a) the omission of an event or information, which is likely to result in discontinuity or alteration of event or information already available publicly

(b) the omission of an event or information is likely to result in significant market reaction if the said omission came to light at a later date;

The company management and the board members clearly know that information on 'event of default' on financial obligations always cause quite violent market reactions leading to sharp correction in the stock price. It beats conventional logic on why the board members refused to identify non-payment of bank loans as a material event requiring disclosure to stock exchange.

Of course, some may point out that the Board Members may not have access to information on whether the company was defaulting on payment of bank loans. Here it may be mentioned that among the mandatory list of minimum information that is supposed to be placed before the board of directors, the disclosure on "a*ny material default in financial obligations to and by the listed entity, or substantial non-payment for goods sold by the listed entity* " is loud and clear.

So if the management is not placing the default information to the board, the KMP is violating the LODR.

Selective Bouts of Investor Activism Does Not Help

It is a surprise that despite Company's Act 2013 allowing for filing of class action suits by the shareholders none of the present NPA companies or their boards has been sued for negligence in duty or non-disclosure of material information such as those related to default which caused shareholders to lose massive wealth in stock market. Clearly institutional investors, corporate governance firms as well as informed individual investors have missed to highlight this massive and widespread lapse of corporate governance. As such, in most instances, Indian investing community wakes up to only those instances of corporate governance violations where the violations are disclosed by disgruntled promoters themselves! It is surprising that while everything from policy paralysis, to bank's over lending to corporates, to global commodity price moderation, has been blamed for the Indian credit blow-up, this significant lapse in duty of the Board members of such defaulted company has not been highlighted.