Decoding Boardroom Dilemmas (Part III): Can Nominee Directors Share UPSI with Nominating Shareholders?

Key Takeaways

- No express framework exists for nominee directors to share UPSI with nominating shareholders
- Natural expectation that nominee directors should represent their nominators' interests – not permitted under law
- Since nominee directors' fiduciary duty remains towards the company and stakeholders, nominee directors are paradoxically placed and exposed to significant liabilities
- Judicial precedents have implicitly endorsed a more practical view, where the nominee director protects the nominating shareholder's interests

Introduction to Series

Directors, now more than ever, are under heightened public and regulatory scrutiny – fiduciary duties around the world, and more recently in India, require directors to consider diversity of interests. While this position is well-grounded in law (s.166), growth in Indian shareholder activism has ensured that the import of directors' duties is clear to market participants across the board.

As part of this series, we examine and break down critical dilemmas faced by directors in listed companies in discharge of their fiduciary obligations while simultaneously achieving commercial objectives – including (under)valuation in fundraises (here) and fundraising through a hive-off strategy (here). In this edition, we examine one of the most common questions raised in a public M&A – can a shareholder nominated director communicate with and protect the interests of the nominating shareholder?

Background - Information Sharing in Light of Investors' Boards Rights

Global institutional investors are increasingly taking comfort in Indian public markets – investing directly and with significant stakes. A significant part of their comfort and the target's marketability comes from the ring-side visibility that these investors obtain through board representation. Naturally, once an institutional shareholder has nominated a director, there is an expectation for the shareholder to receive information about the target company so that their collective interests are protected by the nominee director. But, is such information flow protected under law and can nominee directors legitimately share insider information, known as unpublished price sensitive information (***UPSI***), with their nominating shareholder?

Nominee Director? Hold on to your UPSI

Directors (especially nominee directors) should be wary that the answer may be in the negative where UPSI is involved. The SEBI (Prohibition on Insider Trading) Regulations, 2015 (***PIT Regulations***) prohibit sharing or procuring UPSI, except in the following cases: (a) for legitimate purposes; (b) for performance of duties; or (c) for discharge of legal obligations. The PIT Regulations do not specifically mention if sharing of UPSI by a nominee director with their nominating institutional investor falls within any of these 3 categories.

In addition, since listing regulations expressly provide that all shareholders of a listed company should have access to an equal amount of information (one of the main reasons why selective sharing of UPSI is prohibited under the PIT Regulations), nominee directors often find themselves in a dilemma: should they be guided by the interests of their

© Resolut Partners 2022

nominating shareholder, or by the interests of shareholders in general?

Picking up on the concern, the SEBI's Kotak Committee (2017) recognized that the lack of an express framework legitimizing information sharing by nominee directors could lead to business challenges – a consequence of the legitimate expectation that if a shareholder is nominating a director, that director will represent the shareholder's interests. The committee even went on to propose a draft framework to enable information sharing with nominating shareholders, though its suggestions were ultimately rejected by the SEBI, citing concerns of preferential shareholder treatment (i.e., no one shareholder should unduly benefit over others).[1] As a result, under law, each case of information sharing between a nominee director and their nominating shareholder would require an individual, facts-based assessment under the PIT Regulations.

The Indian Supreme Court in the Tata-Mistry judgement (Tata Consultancy Services Limited v. Cyrus Investments) has also picked up on the debate, highlighting that the very construct of 'independent' directors may be an implicit acceptance that nominee directors will otherwise be interested/representative parties. It may follow that institutional shareholders will require information when decisions are being made by the board/ shareholders – which is likely to come from the nominee directors. The Court also identifies that nominee directors carry twin fiduciary duties: towards their nominator and towards the company on whose Board they are nominated and suggests that these twin duties should be balanced by directors. The Court does however caveat that the two interests are likely to be aligned in their ultimate objectives (success and profit making), as opposed to being interests which are always competing in nature.

While the Tata-Mistry judgement furthers the groundwork for a legitimate information sharing framework, it does not assertively uphold duality of nominee directors' fiduciary duties, nor does it legitimize sharing of UPSI by nominee directors. Further, the judgement seems to tide against extensive judicial precedents which hold that directors owe their primary (if not exclusive) duty towards protecting the interests of the company in which they work.[2]

In practice, SEBI seems to have been rather light-touch in its approach, and the practical reality remains that several nominee directors continue to share UPSI with their nominating investor (which is also clearly acknowledged in the Kotak Committee Report). In well-

[1] In its Board Memorandum dated April 1, 2018 ('View on the Recommendations of Kotak Committee on Corporate Governance'), the SEBI stated that "*It is felt that giving any shareholder preferential treatment compared to other shareholders for getting access to information may have far reaching implications and therefore may not be desirable; the recommendation may not be considered*."

[2] Ionic Metalliks v. Union of India; Nikhil P. Gandhi v. State of Gujarat; Joginder Singh Juneja v. State of Gujarat.

© Resolut Partners 2022

governed companies, such an information sharing arrangement stands on the foundation of an appropriate advisory framework and documentation, which may give credence to the argument that UPSI is being shared for legitimate purposes, or for performance of duties (see: TCS' code of corporate disclosures which permits TCS to share UPSI with its *promoters* for business strategies).[3] Therefore, it remains critical to understand the character in which such information is being shared.

Paradoxes Abound

The Tata-Mistry case and the Kotak Committee's findings raise a more foundational concern which strikes at the heart of nominee directors – if there is nothing more that nominee directors can legally do when compared to independent directors, why recognise rights to nominate directors as a seperate category in the first place?

It can be contended that investor appointed nominee directors function as a reasoned voice on the board i.e., someone who investors trust to use business judgement to enhance the company's performance. But is it really possible for nominee directors to separate themselves from the influence of the nominating investor? Typically, global financial investors name one of their full-time employees to be a non-executive director on the board of portfolio companies. By simply requiring a nominee director to act independently, can the law really nullify the inherent inclination that a nominee director may have to share information with and primarily protect the nominating investor's interest?

A deeming fiction under law aimed at controlling the psychological status of an individual seems like a weak strategy to enforce governance. Also, while the legislative intent may have been to only regulate nominee directors, in effect, nominee directors have been restricted entirely, and reduced to a position where they are no different from independent directors, and this is assuming that nominee directors are capable of eliminating natural biases.

Therefore, if asked the question: what would you call a nominee, non-executive director who is required to protect the interests of all stakeholders? The two simple words one can respond with are: independent directors, which begs the question – why should nominee directors be nominated in the first place? Since there is no clear answer to this, nominee directors are uniquely placed as a paradox that lives amongst the Indian company law.

---

[3] Tata Consultancy Services' Code of Corporate Disclosures for example allows the company to disclose UPSI with its promoters where it is "*for the purposes of promoting business of the Company, advice in relation to fund-raising, strategies of business, statutory consolidation requirements or related customary disclosure obligations which may require sharing of UPSI with any outsider or Promoter of the Company, who in turn may share it with their Promoter*".

© Resolut Partners 2022

Conclusion

In conclusion, is there a green-channel that permits nominee directors to legally share UPSI with their nominating investor? The answer appears to be no. Selective disclosure of UPSI with a shareholder will necessarily require a detailed analysis of whether such disclosure falls within one of the recognized exceptions under PIT Regulations, at every instance of information sharing. Even if it is legally permissible, directors must take into account the adverse impact that selective sharing UPSI has on shareholders (due to disparity created between institutional and public shareholders). The existing legal position also opens up a far more concerning issue: nominee directors have little to no tools which enable them to give effect to their representative mandates. Investors should therefore be cautious when assessing the value-add that nominee directors may appear to represent (vis-à-vis say appointing a non-voting observer) – especially in a climate where the frontiers of directors' liabilities are being pushed frequently.

Authors:



Shivam Yadav

Shivam's practice focuses on cross-border corporate transactions which involves private credit, structured finance, and private equity. He has represented asset management funds, sovereign wealth funds, sponsors, and investors on a wide breadth of corporate and regulatory deal-related issues, including corporate governance, corporate finance, and securities, primarily in the infrastructure and technology sectors. Shivam also advises investors and funds on aspects related to ESG, security enforcement, and employment....*read more*



Shreyas Bhushan

Shreyas' practice entails advising on cross-border PE, M&A and Structured Finance transactions from a legal, strategic and tax perspective. Shreyas also leads the public M&A and corporate governance practice at the firm, and has represented leading global funds and corporate houses on a broad range of matters such as PIPE deals, tender offers, take privates, business acquisitions, activist shareholder efforts and corporate governance issues.

Shreyas actively provides pro-bono legal services to start-ups and helps entrepreneurs in understanding the legal and commercial landscape of deal-making. He is also involved in policy advocacy initiatives through industry associations, and regularly submits recommendations to SEBI and RBI on the workability of existing and proposed legislation...*read more*

© Resolut Partners 2022

About our Stakeholder Governance and Stewardship Practice:

Stakeholder governance has occupied centre-stage in the context of complex corporate transactions in the public M&A sphere. Board responsibility is assuming greater significance especially when questions regarding true value realization, internal control systems and risk management are involved...*read more*

About our Public Equity Practice:

Public M&A / PE is arguably the most nuanced field of deal-making in India, considering the myriad legislations and constantly evolving corporate governance practices. Over the last decade, India's public markets have successfully attracted some of the largest financial and strategic investors, both domestic and foreign...*read more*

© Resolut Partners 2022