Ignorance and apathy behind the NPA problem

Since 2011, the author estimates that close to Rs4 trillion of shareholder value was eroded when the stock price of non-performing assets (NPA) and stressed companies fell by 95% to 99% from their pre-default days. This massive erosion of shareholder value is a direct outcome of a system-wide corporate governance failure. Specifically, it refers to the failure of the defaulted company's management and board to promptly disclose the company's default to the exchange. To the extent that a debt-servicing default can potentially erode equity value, in terms of shareholder impact it ranks in the same category as mergers/acquisitions. The absence of prompt disclosure is a disservice to investors.

Minority shareholders' morale was boosted when on 4 August, the Securities and Exchange Board of India (Sebi) mandated that from 1 October, listed companies are to report "default" in servicing a bank loan within 24 hours of the default. However, shareholders' euphoria was short-lived, as on 29 September the regulator announced an indefinite deferment in implementation of the move. This piece argues that even without this mandate, the board of directors (BoD) of listed and defaulted companies still remain answerable to the minority shareholders for non-disclosure of critical information about their company's default. In fact it may be argued that even under the existing rules of Sebi and company law, at least some BoD of defaulted companies may be found negligent and it is a surprise that till date no class-action suits have been initiated against some of them.

'Materiality' of default implicit in LODR

The original Listing Obligation and Disclosure Requirement (LODR), does have clauses such as "The company should ensure timely and accurate disclosure on all material matters including the financial situation, performance, ownership, and governance of the company." Further, when Sebi enhanced the LODR in September 2015, it provided an overarching definition of "materiality" by stating "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 it provided guidance on 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 BoD of defaulted companies should have known, if not from corporate finance 101 text books, by observing global and Indian markets that stock prices crash by 95% to 99% when information of debt/loan default reaches the market. Given the LODR's guidance of materiality and the anticipated competence level of reputed BoD, it's a surprise that they failed to promptly share details of the default with shareholders.

Of course one may argue that a BoD may not have access to information on whether the company was defaulting on any financial obligation. However, as per LODR, the mandatory list of minimum information that is supposed to be placed before the BoD is supposed to include "any material default in financial obligations to and by the listed entity, or substantial non-payment for goods sold by the listed entity." If the management has been hiding this information from the board, it's another governance lapse.

BoD negligent or incompetent?

If the BoD failed to identify default as a material event then questions may be raised on their

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competence. However, if they failed to ensure that the information promptly reached the exchange then it may be an issue of negligence. The September 2015 LODR enhancement articulated the responsibilities of the board as:

—The board of directors and senior management shall conduct themselves so as to meet the expectations of operational transparency to stakeholders.

—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.

—Overseeing the process of disclosure and communications.

It may be argued that non-disclosure of the event of default reflects poorly on operational transparency and integrity of a reporting system with respect to risk management and financial control. This shows that the BoD may not be acting on the lines expected under LODR.

Apathy and ignorance of market

While much conjecture had been made of why Sebi reversed its 4 August circular, little has been publicly discussed on whether the regulator can take action against defaulted companies for non-disclosure of default information even under existing LODR with respect to non-disclosure of material information about default.

Despite the fact that the Companies Act 2013 allows shareholders to file class-action suits, none of the companies with bad loans has been sued for negligence in duty for non-disclosure of material information despite shareholders experiencing massive losses. It appears that incompetent boards thrive under ignorant, apathetic investors.

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