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Defaulter Companies to seek Lender's nod to pay managerial remuneration

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MCA vide its notification dated September 12, 2018¹ brought into life some major changes in the various sections of the Act, 2013 which *inter-alia* include amendment in the provisions of Section 197 which deals with limits on overall maximum managerial remuneration and managerial remuneration payable in case of absence or inadequacy of profits.

Companies Act, 2013 (the Act, 2013) which was thought to be a boon for the corporate sector continues to be a nightmare for the corporate from the date of its enactment. In the past, government has come up with dozens of amendments, clarifications, circulars to address the difficulties of various stakeholders in implementing the Act, 2013. After several flip flops in the Act, 2013 the Government has again amended several provisions of the Act, 2013 vide Companies (Amendment) Act, 2017 ('Amended Act, 2017') to ensure ease of doing business in India.

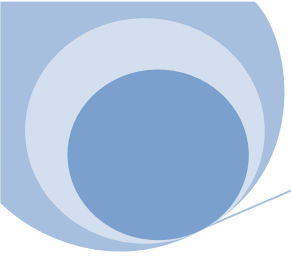
Key Concerns discussed in the CLC Report related to Section 197

- Restrictive regime of seeking Central Government and shareholders' approval (by way of special resolution) for the payment of remuneration to Managerial Personnel by companies having inadequate/no profits result in talented professionals to move away from such companies in search of higher assured compensation.
- The requirement to pass a special resolution shall be replaced with an ordinary resolution, where the managerial person was not a promoter, and a professional with domain knowledge / relevant experience; and was not related to any director or promoter of the company and did not hold more than two per cent of the paid-up equity share capital of the company or its holding company. In other cases, however, the requirement for special resolution of the shareholders should be retained.
- The limits of yearly remuneration prescribed in the Schedule V to be enhanced to attract good managerial talent.
- The requirement for Central Government approval to be omitted altogether and necessary safeguards in the form of additional disclosures, audit, higher penalties, etc. may be prescribed instead.

Amendments in Companies (Amendment) Act, 2017

On the recommendation of CLC report, the changes vide the Amended Act, 2017 propose to omit the requirement of taking approval of Central Government under various provisions of section 197

¹ http://www.mca.gov.in/Ministry/pdf/commencementnoti_13092018.pdf



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of the Act, 2013. Following are the amendments notified by the MCA in section 197 of the Act, 2013:

- Do away with seeking approval of Central Government and substitution of ordinary resolution with special resolution;
- Remuneration payable by the Company to its directors, including managing director and whole-time director, and its manager exceeding eleven percent of the net profits of the company can be paid with the approval of members' by way of ordinary resolution subject to the provisions of Schedule V.

The requirement of seeking approval of Central Government for making payment of remuneration beyond eleven percent of the net profits by the company to its directors, including managing director and whole-time director, and its manager has been done away with

- Approval of members by way of special resolution in case the remuneration paid exceeds the below mentioned limits:
 - (i) Remuneration payable to any one managing director; or whole-time director or manager exceeds five percent of the net profits of the company and if there is more than one such director remuneration exceeds ten percent of the net profits to all such directors and manager taken together;
 - (ii) Remuneration payable to directors who are neither managing directors nor whole-time directors exceeding-
 - (A) one per cent of the net profits of the company, if there is a managing or whole-time director or manager;
 - (B) three per cent of the net profits in any other case.

The requirement to take approval of members by way of ordinary resolution for making payment of remuneration in excess of the above limits has been made more stringent by substituting ordinary resolution with special resolution.

- Where a company has no profits or has inadequate profits, it shall not pay to its directors, including any managing or whole-time director or manager, any sum by way of remuneration except in accordance with the provisions of Schedule V.

In cases where the company was not able to comply with the provisions of Schedule V then the Act, 2013 provides that the company can pay remuneration to the directors with the previous approval of Central Government. *The provision related to seeking approval of Central*



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Government has been omitted which means that the company will now mandatorily be required to comply with the provisions of Schedule V for making payment of remuneration in case of no profits or inadequate profits.

- Approval of banks, public financial institutions, non-convertible debenture holders and other secured creditors in case of defaulter companies
- Prior approval of the bank or public financial institution or the non-convertible debenture holders or other secured creditor for making payment of remuneration in excess of the limits specified in sub-section (1), in case where the company has defaulted in payment of dues to any bank or public financial institution or non-convertible debenture holders or any other secured creditor, which shall be obtained before obtaining approval of the members' in the general meeting.

The new provision inserted in section 197 of the Amendment Act for making payment of remuneration by the company, in excess of the limits specified in section 197(1) to its directors, including managing director and whole-time director, and its manager have been notified

- The company can waive off the requirement of recovery of any sum refundable to the company by way of excess remuneration by passing special resolution. The company would however required to obtain prior approval of the bank or public financial institution or the non-convertible debenture holders or other secured creditor, in cases where any term loan of any bank or public financial institution is subsisting or the company has defaulted in payment of dues to non-convertible debenture holders or any other secured creditor.

The requirement to obtain approval of Central Government for waiver off excess remuneration paid by the company is deleted.

- Refund of excess remuneration received by the directors of the company within a maximum period of two years.

The Act, 2013 though prescribes for refund of excess remuneration received by the directors of the company but it does not provide the time within which that excess remuneration should be refunded to the company. *The time limit within which the excess remuneration shall be paid back to the company which in no case shall be more than two years* has been notified by the MCA

- The Amended Act, 2017 further inserted a new provision under section 197 requiring *an auditor to make a statement in his report as to whether the remuneration paid by the company is in accordance with the provisions of section 197.* This new provision puts an obligation on the auditors to ensure that the company is paying remuneration to its directors in accordance with



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the limits laid down in section 197 or where it exceeds the prescribed limits, necessary approvals are in place.

- The requirement to *obtain necessary approvals as are required under section 197 on and from the date of commencement of Companies (Amendment) Act, 2017 within a period of one year*, in case of existing applications pending with the Central Government as prescribed by the Amendment Act has been notified by the MCA.

Analysis

Obtaining approval of Central Government is a time consuming process and therefore the amendment made under Amended Act, 2017 surely seeks to provide a relief to the companies. The Amended Act, 2017 requires prior approval of the bank or public financial institution or the non-convertible debenture holders or other secured creditor for making payment of remuneration in excess of the limits specified in sub-section (1), where the company has defaulted in payment of dues to non-convertible debenture holders or bank or public financial institution or any other secured creditor. The new proviso inserted in section 197 provides for seeking prior approval of banks or public financial institutions or secured creditors or non-convertible debentures where there is a default in payment of dues on the part of the company.

Now, the question that arises is why any lender would give its consent for payment of remuneration beyond the prescribed limits, if there is any default on the part of company in making payment of the due amount. So complying with this provision in case of defaulter companies is going to be real tough. Accordingly, some of the key questions that arise from the amendments have been attempted to be answered by way of questions below:

FAQS ON MANAGERIAL REMUNERATION

1. What all defaults are relevant for the purpose of the third proviso which is inserted to section 197 (1)?

The Company needs to take prior approval of financial creditors before passing of a special resolution in the general meeting in the following cases mentioned below:

- a. Default in payment of dues to banks;
- b. Default in payment of dues to public financial institutions;
- c. Default in payment of any dues (the term may include principal, interest or any other dues) in respect of any non convertible debentures;
- d. Default in payment of any dues to any other secured creditor.

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All the above four categories may be collectively be referred to as “financial creditors”.

- 2. The company has taken a loan from an NBFC on which default is subsisting. Can the company pay minimum remuneration to its managerial personnel?**

The company would not require prior approval of the NBFC for making payment of minimum remuneration to its managerial personnel. However, if the company propose to pay remuneration exceeding the limits prescribed under section 197, prior approval will be required provided the financial facility from the NBFC is a secured loan.

- 3. When do we say the loan is a secured loan?**

The loan is considered to be a secured loan where there is a security interest created to back up the loan.

- 4. The company contends that the company has paid all its dues to the lender; however, the lender contends that there are unpaid dues. Will the company be eligible to appoint managerial personnel with minimum remuneration?**

Logically, a default should be recognized as a default based on the books of account of the company. Accordingly, if the books of accounts reflect that the company has paid all its dues then it can appoint managerial personnel with minimum remuneration.

- 5. What is the meaning of “prior approval” for the above purpose? How will such approval be sought? Is it from each of the 4 categories of financial creditors, or from a majority of them at a meeting?**

The prior approval is needed only from such financial creditors, for whom a default is subsisting. Apparently, it has to be bought each of the financial creditors. The company shall take approval from such creditors by calling a separate meeting or by taking written approval prior to the general meeting. However, in case of default towards non convertible debentures the terms and conditions will decide, if the same is silent on the matter, the approval shall be taken in an aforementioned manner.

- 6. Is a default a pre-condition for needing the consent of the financial creditors?**

Yes, since the approval is required only if there is a default.

- 7. Whether the default should be subsisting or continuing default? What if the company has made good such default?**

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The language of the second proviso to sub-section (1) to section 197 is silent on the point that whether approval from only such financial creditors is required whose default is subsisting on the date of approval or from all the secured creditors is required, irrespective of whether the default is subsisting on the present date. However, a view may be taken that where a default is rectified, the approval of the financial creditors will not be required.

8. At what point of time should the default be subsisting?

The default should be subsisting at the time of proposing the resolution in general meeting.

9. If the company passes a resolution in year 1 inter alia for payment of minimum remuneration, for a period of 5 years, and in year 3, the company faces a bad year and is not able to pay the dues to its financial creditors. Can the company go ahead and pay the minimum remuneration?

Yes, after obtaining the prior approval of its financial creditors, as the approval requirement is linked with the passing of the resolution and not with the payment of the remuneration.

10. If the company proposes to pay remuneration as per percentages of profits (11% overall, 10% to all WTDs, and 5% to each MD or WTD), is there a need to seek the approval of the financial creditors?

The approval from the financial creditors is required only in case where the limits based on percentage of profits are exceeded and there is a need to take approval of shareholders by special resolution. Therefore, there is no question of seeking approval where remuneration is being paid within the limits.

11. If a company proposes to pay remuneration exceeding 5% to one MD or WTD but within the overall limit of 11%, is there a need to obtain shareholder's approval?

The approval from the shareholder's is required by way of special resolution in case the limit whether 5%, 10% or 11% based on percentage of profits are exceeded.

12. Whether the payment of minimum remuneration is possible in case of a CEO?

The remuneration payable to CEO is not governed by Section 197, unless the CEO can be regarded as the "manager". Hence, the payment of minimum remuneration can be possible in case of CEO.

13. Whether the statement required to be given by the auditor as amended under section 197 vide Amended Act, 2017 will form part of main report or the report under Companies (Auditor's Report) Order, 2016?

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The new sub-sections (16) inserted in section 197 vide Amended Act, 2017 states that auditor is required to make a statement that the company is paying remuneration to its directors in accordance with the limit prescribed under section 197 in his report prepared under section 143. Whether such a statement will form part of the main report or the report under Companies (Auditor's Report) Order, 2016 needs clarification by the regulators by issuing relevant rules in this regard.

14. What will happen to the existing applications pending processing with Central Government?

With the enforcement of sub-section (17), all the existing application with Central Government shall stand abated and the companies will be required to comply with the revised provisions within 1 year of the enforcement of the Amended Act, 2017.

15. Whether a special resolution will be required to be passed in case of existing applications, with the enforcement of Amended Act, 2017?

Going by the language of sub-section (17), in case a company has passed only ordinary resolution and applied to Central Government under the applicable provisions, it will have to seek the consent of the lenders' and also special resolution in line with the amendment made under Amended Act, 2017.

16. Whether a company will be required to pass special resolution afresh if it has already taken the approval from CG?

With the enforcement of the amendment, the company can seek fresh approval of shareholders in the matter prescribed under schedule V and pay as per the same.

17. Will the lenders' approval be required if a company has already passed a special resolution?

Going by the above where a company has already passed a special resolution, then in order to comply with sub-section (17), it should also seek the approval of the lenders. However, seeking of lenders approval is a condition precedent to a special resolution, therefore, the view may be taken that the approval of lenders may not be required. Alternatively, a view may also be taken that on abatement of the existing applications a company will have to seek both the approval of the lenders as well as seek a fresh special resolution.

18. Is the proposed provision (seeking the consent of lenders) applicable in the case of private companies?



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No, Section 197 requires the consent of shareholders only in the case of public companies. The proviso as proposed is linked with shareholders' approval. Hence, there will be no need to seek lenders' consent in case of private companies, even if such a private company has a running default with its lenders.

19. Whether the limits mentioned in schedule V are the maximum limits and the Company cannot pay remuneration beyond it even by passing a special resolution?

The amended Schedule V provides for payment within the limits specified in Para A simply by passing of ordinary resolution. Pursuant to the passing of special resolution the company can pay remuneration beyond the limits specified in Para A.

20. In the event of no profit or inadequate profit, what are the requirements for unlisted companies post amendment?

To pay remuneration to managerial personal, in the event of no profit or inadequate profit, the provisions have become more stringent for unlisted companies and is now required to comply with the conditions prescribed under Schedule V.