Article

Disqualification under Section 164 (2): a tainting provision left so unclear

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Disqualification under Section 164 (2): a tainting provision left so unclear

Certain provisions of Companies Act, 2013 (Act) seems to have been written with a broken pencil- it's pointless! Provisions which are tainting provisions, crucial for determining the tenure of a director in a Company, have been drafted so loosely that companies are struggling with the interpretation. Additionally, a statutory auditor is also mandated under Section 143 (3) (g) of Act, 2013 [corresponding to Section 227 (3) (f) of Act, 1956] to report whether any director is disqualified from being appointed as a director under Section 164 (2) in the Auditor's report. Similarly, a secretarial auditor in their report provided under Section 204 in form MR-3 is required to comment on the composition of the Board. This article intends to discuss the applicability of one such provision as specified under Section 164 (2) of the Act read with Section 167.

Section 164 (2) of Companies Act, 2013 (Act, 2013):

"xxxx (2) No person who is or has been a director of a company which—

(a) has not filed financial statements or annual returns for any continuous period of three financial years; or

(b) has failed to repay the deposits accepted by it or pay interest thereon or to redeem any debentures on the due date or pay interest due thereon or pay any dividend declared and such failure to pay or redeem continues for one year or more,

shall be eligible to be re-appointed as a director of that company or appointed in other company for a period of five years from the date on which the said company fails to do so."

There are two situations when the disqualification arises:

1. Non filing of financial statements and annual return for any continuous period of 3 years;

2. failure to repay interest on deposit/ debentures or repayment of deposit/debentures and such failure continues for a period of 1 year or more.

If any of the two situations arises, all the directors of such company get tainted with such disqualification. Consequence of the disqualification, as per Section 164 (2), is that such director neither can be re-appointed in that company not appointed as a director in any other company. This will be the case till 5 years from when the company fails to do so. So, in a way Section 164 (2) not only cites the situation in which the disqualification gets attracted but also specifies the tenure of disqualification. What is the consequence if Section 164 (2) is not complied? Since there is no specific penalty provided under the said section, by virtue of Section 172 the

company and every officer of the company who is in default shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees.

Position under Companies Act, 1956:

Section 274 (1) (g) was the corresponding provision to Section 164 (2) with the difference that Section 274 (1) (g) was not applicable to private companies. The offending company was required to be a public company and since the offending company did not include a private company there was no reason to include private companies within the ambit of affected companies as well. Further, Section 274 (1) (g) was inserted vide Companies (Amendment) Act, 2000 w.e.f December 13, 2000. In view of the same, the disqualification was attracted in case of failure of company to file annual returns, or failure to repay deposits, or pay interest on deposits for three consecutive financial years commencing on or after April 1, 1999. Thus, if there was a default in filing the documents for three consecutive financial years, i.e., financial years ending 31st March of 2000, 2001 and 2002, the disqualification under clause (g)(a) was attracted. The disqualification commenced on the expiry of the due date for filing of the documents. Additionally, the disqualification under Section 274 (1) (g) did not result in vacation of office under Section 283 of Companies Act, 1956.

Position under Act, 2013:

Impact of Section 167:

Section 167 corresponds to Section 283 of Companies Act, 1956 pertaining to vacation of office of a director. Section 167 (1) provides the premises when office of a director shall become vacant and Section 167 (2) specifies the consequence if a director continues to hold the office despite attracting any of the premises under Section 167 (1).

"(1) The office of a director shall become vacant in case—

(a) he incurs any of the disqualifications specified in section 164; xxxx

(2) If a person, functions as a director even when he knows that the office of director held by him has become vacant on account of any of the disqualifications specified in sub- section (1), he shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees, or with both."

Section 167 (3) provides the remedy in case the entire Board of the company vacates office under Section 167 (1). Section 167 (4) empowers a private company to provide for additional

grounds for vacation of office. Looking at the provisions it seems that the vacation of office has to happen immediately. However, Section 283 of Companies Act, 1956 did not formerly include the disqualifications under Section 274. In the present case, Section 167 (1) stipulates vacation of office if the director attains any of the disqualification under Section 164.

Conflicting provisions under Section 164 (2) and Section 167[1]

In case a director was to incur disqualification under section 164(2), then he shall not be eligible to be re-appointed as a director of that company or be appointed in other company for a further period of 5 years from the date on which the company fails to do so. While the disqualification is immediate but the director is allowed to serve his present tenure in that company and in other companies in which he is a director. In view of the provisions one can infer that disqualification under Section 164(2) does not envisage immediate vacation. A company can possibly not function without a board and it is keeping this in mind that Section 164(2) provides a carve-out to the boards of companies which have defaulted under this section. Further, one may note that similar provision existed under Section 274(1)(g) of Companies Act, 1956. However, that section was not applicable to private companies and neither did it attract the provisions of Section 283 of Companies Act, 1956 which pertained to disqualification.

Act, 2013 has thus linked Section 164 to Section 167 leading to an impression that disqualification under Section 164 leads to automatic vacation. This may seem logical if one were to be disqualified under Section 164(1) i.e. become an undischarged insolvent or is declared as being of unsound mind by a Court. Most certainly such a person cannot continue as a director. However, Section 164(2) is on a different footing than Section 164(1). The failure to file financial statements or inability to redeem debentures may be due to circumstances beyond the control of the Company. Section 164 (1) specifies disqualification due to personal default while Section 164 (2) specifies about disqualification arising due to corporate default. It is under such circumstances that the board of the defaulting company will have to take steps to make good the failure. If the board is required to immediately vacate the office, question of being disqualified at the time of re-appointment does not arise at all. As evident from the aforesaid discussion there seems to be a mismatch of language, both provisions seems to be talking at each other rather than stipulating provision in line with another.

In such a case, one has to harmoniously interpret the provisions of Section 164(2) and Section 167 of Act, 2013. The intent of law cannot be to incorporate such a provision which will render some other provision completely useless. If one were to conclude that Sections 164(2) and 167 were to be read together, then Section 164(2) will be rendered completely useless. Thus, Section 164(2) does not lead to ipso facto vacation. It envisages vacation only at the end of the present tenure which is logical also. To conclude, a plain reading of Sections 164 and 167(1)(a) may give an impression that both are co-linked. However, given the intent behind Section 164(2), it can be

[1] As discussed in the article - The dichotomy between the provisions of sections 164(2) and 167 of Companies Act, 2013 springs an unsuspected surprise! written by CS Nivedita Shankar.

considered that section 167 pertains to vacation in case of disqualifications under Section 164(1) only. The intent is to allow time to the Board to make good the default and not worsen the problem.

On a separate note, if we look into the provisions of Section 164 (1) (d), (e) and (g) read with proviso to Section 164 (3) it has been clearly specified when the disqualification shall not take effect. Thus, one has to harmoniously interpret when the office of such director will be vacated under Section 167 (1) after taking note of the carve outs provided under proviso to Section 164 (3). In terms of Section 167 (3), one may argue that if all the directors of a company vacate their offices under any of the disqualifications specified in sub-section (1), the promoter or, in his absence, the Central Government shall appoint the required number of directors who shall hold office till the directors are appointed by the company in the general meeting. This provision was not provided under Section 283 of Companies Act, 1956. If we try to ascertain the intent on a parallel reading of Section 164 (2) read with Section 167 (1) and (3), the objective of Central Government to ensure discipline cannot be by vacating the Board instantaneous. Further, in case of private companies, the directors are also the shareholders of the Company as these are closely held companies. The defaulting directors, as shareholders will elect new directors to make good the default in filing on their behalf – seems unrealistic.

MCA circulars create confusion:

MCA vide General Circular No. 34/2014 dated 12th August, 2014[2] was benevolent enough to introduce Company Law Settlement Scheme, 2014, in exercise of powers conferred under Section 403 and 460[3] of Act, 2013, in view of the stricter regime prescribed under Act, 2013 for defaulting companies thereby condoning the delay in filing the statutory documents, granting immunity for prosecution and charging a reduced additional fee. The Scheme was valid till 15th October, 2015, extended till 15th November, 2014[4] and thereafter extended till 31st December, 2014[5] . Additionally, MCA vide General Circular No. 41/2014[6] gave a strange clarification to the following effect:

"The matter has been examined and it is hereby clarified that in case of companies who have filed their balance sheets and annual returns on or after 1st April, 2014 but prior to launch of CLSS-2014, disqualification under Section 164 (2) (a) ***shall apply only for prospective defaults, if any, by such companies."***

This means that where a company has failed to file annual financial statements for periods prior to enforcement of Act, 2013 and could not file even under CLSS 2014, disqualifications are likely to get attracted. While the law does not expressly provide for retrospective operation of

[2] http://www.mca.gov.in/Ministry/pdf/circular_34_13082014.pdf
[3] 403 pertains to fee filing and 460 pertains to condonation of delay in certain cases.
[4] http://www.mca.gov.in/Ministry/pdf/General_Circular_40-2014.pdf
[5] http://www.mca.gov.in/Ministry/pdf/General_Circular_44-2014.pdf
[6] http://www.mca.gov.in/Ministry/pdf/General_Circular_41-2014.pdf

Section 164 (2), the said MCA circular expressly seems to provide that the defaulting status will get attracted even for non-filings for the period prior to April 1, 2014. MCA circular mandated all existing defaulting companies to either regularize the filings under CLSS-2014 or regard itself as inactive companies and make an application for being declared as 'dormant company'.

Date from when a director will be regarded as disqualified:

If any public company had defaulted in terms of Section 274 (1) (g), will the office of directors get vacated as on April 1, 2014 by virtue of Section 167 (1)? If any private company had not filed the financial statements and annual returns for 4 years immediately preceding April 1, 2014, will the directors be said to have vacated their office under Section 167 (1)? Or will the disqualification arise only in case of defaults made for FY – 2013-14 onwards (as the filing for FY 2013-14 was required to be done post April 1, 2014.

Law to be made prospectively applicable:

It was discussed in the Supreme Court Judgment in case of **Maharaja Chintamani Saran Nath ... vs State Of Bihar And Ors on October 7, 1999** that the true principle is that Lex prospicit non respicit (law looks forward not back). As Willes, J. said, retrospective legislation is `contrary to the general principle that legislation by which the conduct of mankind is to be regulated ought, when introduced for the first time, to deal with future acts, and ought not to change the character of past transactions carried on upon the faith of the then existing law. Similarly, the Supreme Court of India in **Hitendra Vishnu Thakur and Others v. State of Maharashtra and Others**, [1994] 4 SCC 602 has culled out the principles with regard to the ambit and scope of an amending Act and its retrospective operation as follows:

(i) A statute which affects substantive rights is presumed to be prospective in operation unless made retrospective, either expressly or by necessary intendment, whereas a statute which merely affects procedure, unless such a construction is textually impossible, is presumed to be retrospective in its application, should not be given an extended meaning and should be strictly confined to its clearly defined limits.

(ii) Law relating to forum and limitation is procedural in nature, whereas law relating to right of action and right of appeal even though remedial is substantive in nature.

(iii) Every litigant has a vested right in substantive law but no such right exists in procedural law.

(iv) A procedural statute should not generally speaking be applied retrospectively where the result would be to create new disabilities or obligations or to impose new duties in respect of transactions already accomplished.

(v) A statute which not only changes the procedure but also creates new rights and liabilities shall be construed to be prospective in operation, unless otherwise provided, either expressly or by necessary implication.

Thus, the disqualifications under Section 164 (2) cannot become applicable as on April 1, 2014 for any annual filings not done in any of the previous financial years by a private company. Similarly, it cannot lead to immediate vacation of office under Section 167 (1).

When can a law be said to apply retrospectively?

There are laws which have been made applicable retrospectively, viz Securitisation Asset Reconstruction & Enforcement of Security Interests Act, 2002 (hereinafter referred to as SARFAESI). SARFAESI did not cast any new burden on the borrower, as a borrower was anyways liable to repay loan even prior to enactment of the same. SARFAESI intended to remedy a situation where recovery of loans of specified financial institutions were held up and intended to be speedily recovered, without reference to procedure of the Court, by a substituted procedure and forum. Provisions of SARFAESI did not create any new offence or any substantial right. It has been provided presumption against retrospectivity is not applicable to enactments which merely affect procedure or change forum or are declaratory.

As discussed above, if a law creates a new obligation or restrains a person of their rights, in such cases law cannot be regarded to apply retrospectively. Had that been the case, all directors of such private companies with a default in annual filing for 3 or more continuous period will be required to vacate their offices on April 1, 2014. As expressly specified under Section 274 (1) (g) regarding the disqualification to arise for non –filings for a continuous period of 3 years from April 1, 1999, Section 164 (2) (a) is silent on the applicability. Silence cannot be said to mean retrospective applicability of the section.

Relevant discussion made in a recent High Court ruling[7]:

There is a similar disqualifying provision under Section 196 (3) with respect to appointment or continuation of employment of a person appointed as MD, WTD or manager as reproduced hereunder:
"196 – Appointment of managing director, whole-time director or manager.

(3) No company shall appoint or continue the employment of any person as managing director, whole-time director or manager who —

[7] Read detailed article "Age is no bar for mid-term disqualification under Section 196(3)(a)" by CS Aditi Jhunjhunwala and Aman Nijhawan

(a) is below the age of twenty-one years or has attained the age of seventy years:
Provided that appointment of a person who has attained the age of seventy years may be made by passing a special resolution in which case the explanatory statement annexed to the notice for such motion shall indicate the justification for appointing such person;

(b) is an undischarged insolvent or has at any time been adjudged as an insolvent;

(c) has at any time suspended payment to his creditors or makes, or has at any time made, a composition with them; or

(d) has at any time been convicted by a court of an offence and sentenced for a period of more than six months."

In case of Sridhar Sundararajan vs Ultramarine & Pigments Limited[8] decided by Bombay High Court on July 16, 2015 it was discussed as to in what manner words 'continue the employment' should be interpreted as under:

"18. The only conclusion that one can draw is that the word 'continue' is correctly used in its strict sense in relation to clauses (b), (c) and (d) of Section 196(3), i.e., as a cessation eo instante on the occurrence of any of the events those sub-clauses contemplate, but in the context of Section 196(3)(a), it means, and can only mean 'appointment' and 'reappointment'.

19. Correctly read, therefore, Section 196(3) does not operate to interrupt the appointment of any Director made prior to the coming into force of the 2013 Act, even in a case where the Managing Director crosses the age of 70 years during the term of his appointment; and it also does not interrupt the appointment of a Managing Director appointed after 1st April 2014 where at the date of such appointment or re-appointment the Managing Director was below the age of 70 years but crossed that age during his tenure. There is no mid-tenure cessation of Managing Directorship as a result of Section 196(3)(a). All that Section 196(3)(a) does is to sound a note of caution in the public interest and to demand from the company a special resolution when a person who has already crossed the age of 70 at the date is proposed to be appointed or re-appointed. The word 'continue', therefore, must be read contextually."

Similarly, where a director of a company attains the disqualification under Section 164 (2), it has to be looked into at the time of appointment or re-appointment and not requiring immediate vacation of office.

[8] http://indiankanoon.org/doc/40254826/

Additional immunity under Section 149 (12)

Section 149 (12) of Act, 2013 provides as under:

"Section 149 – Company to have Board of Directors

(12) ***Notwithstanding anything contained in this Act,—***

(i) an independent director;

(ii) a non-executive director not being promoter or key managerial personnel, shall be held liable, only in respect of such acts of omission or commission by a company which had occurred with his knowledge, attributable through Board processes, and with his consent or connivance or where he had not acted diligently."

The sub-section begins with a non-obstante clause, thereby having an overriding effect. An ID or NED, not being a promoter or KMP, shall be held liable, only in respect of such acts of omission (eg. non filing of financial statements) or commission (non payment of dues, additional fees) by a company which had occurred with his knowledge, attributable through Board processes, and with his consent or connivance or where he had not acted diligently. In order to avoid a disqualification, such director can best act diligently only by reminding the company to ensure filing of financial statements or insisting on payment of interest on debentures etc. If the same has been duly done, vacation of office under cannot be resulted in view of the non-obstante clause of the aforesaid immunity.

Conclusion

While Sections 164 and 167 came into force on April 1, 2014, the disqualifications under Section 164 (2) cannot become applicable as on April 1, 2014 for any annual filings not done in any of the previous financial years. Section 164 (2) curtails the right of directors of such companies to continue as directors, casts a new burden, imposes a new liability on such directors for having defaulted in filing financial statements for any 3 continuous financial years. In view of Section 164 (2), the disqualification will get attracted in case of non filings made for years commencing from FY 2013-14 onwards. The remedies available to a director are to either regularize the filings or make an application for regarding such company as a dormant company under Section 455 of Act, 2013. However, it will be inappropriate to regard that this will lead to immediate vacation of office under Section 167 (1). Further, independent and non-executive directors, not being promoter or KMP, can also avail the immunity under Section 149 (12) as discussed above.

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