COMPENSATION AGREEMENTS.

Introduction

The Securities and Exchange Board of India (SEBI) drew attention to the issue of compensation arrangement that takes place between the Private Equity (PE) and the promoters, directors and Key Managerial Person (KMP) (the 'management') of the listed entities (investee companies) and certain disclosure issues arising from these arrangements. SEBI felt that such agreements are not desirable and shall not take place in case of listed companies. There is a need to scrutinise such agreements between the management and the private equity as these agreements hamper the principle of transparency and disclosure in governance of listed entities. Therefore, SEBI has come out with a consultative paper with a proposal to disclosure of all such agreements between the private equity and the management.

What are Compensation Agreements?

Compensation agreement is an agreement between the private equity (PE) and the promoters, directors and Key Managerial Person (KMP) of the listed entities whereby the PE agrees to share an agreed proportion of the profits above a certain threshold limit made by them at the time of selling the shares and is also dependent on the fact that the company attains a performance criteria. These rewards are a proportion of the extra profit earned by such PE through the management's extra effort to make the PE earn such high returns. So, these agreements can also be termed as a reward agreement. The management of the company will therefore be willing to enter into such agreements as they will be rewarded to enhance the value of the shares.

SEBI felt that as these agreements between the PE and the management of the listed entities will lead to aggressive measures being taken by the management of the company may lead to a downfall in the price of the shares. The management may give preference to their personal interest over the shareholders' interest as a whole. Such Compensation agreements have both advantages and disadvantages. The advantage is that the management will work hard to enhance the performance of the company and in return he shall get extra incentive by the PE. Also, the shareholders will benefit if the PE benefits from the same as the share price will rise. However, this extra effort from the management could be for a short period (the time period could be till the PE holds the shares of the company as because after the PE exit, the extra incentive that the management was gaining for putting in extra effort will also be gone).Also, this may lead to unfair practise as the management is getting twisted incentive which may make them to think for themselves before the company and the shareholders.

SEBI's Paper

In regard to the same, SEBI issued a [Consultative Paper on Corporate Governance Issues in Compensation Agreements]() which highlighted the aforesaid issue and proposed to curb the same by advising that the management of the listed companies should enter into a Compensation Arrangements only after getting prior approval from the shareholders and the board of directors by passing an Ordinary Resolution. SEBI proposes to add the following sub-regulation (6) to Regulation 26(pertaining to obligations with respect to directors and senior management):

- *"No employee, including key managerial personnel, director or promoter of a listed entity shall enter into any agreement with any individual shareholder(s) or any other* *third party with regard to compensation or profit sharing unless prior approval has been obtained from the Board as well as shareholders by way of an ordinary resolution".*

Having that said, the same has been offered for implementation by inserting a new provision to Regulation 26 (Obligations with respect to directors and senior management) of the SEBI (Listing Obligations and Disclosure Requirements) Regulations 2015 (the 'LODR' Regulations). What SEBI was referring to can be explained with an example,' PE firms make a pact with a promoter to transfer 20% of the profit earned beyond a 30% internal rate of return on the sale of shares". The 20% incentive to the promoters is given by the PE as a reward for handling the day to day business in such a way that the share price has grown enough to help investor enjoy such returns.

Also, SEBI denounced that such practice has to be regulated as because such arrangements are not considered prudent, to which SEBI quoted-

- *It is felt that such agreements are not desirable and hence it is necessary to regulate such practices. One view is that there is no place at all for such side agreements in case of listed companies. Another view is that the focus may be on the principle of disclosure and transparency in governance of listed entities.*

The exit of certain investors from PVR Limited could be a case which bought SEBI's attention towards these types of side arrangement. An 'Incentive Fee Structure' was signed between the MD and CEO of PVR, which was not disclosed to the shareholder or the stock exchanges based on the thought that any future payments to the MD will not be made from the books of PVR. The MD was to receive additional 20% of the amount received by the investors in excess of 30% return on their investments. Also, the compensation limits of the promoters as described in the companies act, 2013 (which states *that if the remuneration is more than 11% of the net profits of the company or the limits specified in Schedule V of the Act depending on the profitability of the company)* is not breached as the act uses the language "*remuneration payable by a public company*".

Conclusion

An argument can be made on non- regulation of such compensation arrangement as because the company itself is not involved in this arrangement. The PE being the shareholder and the management, who could themselves be holding proportionate number of shares. Neither the company is made liable for anything nor is there any financial outflow from the company in respect of these arrangements. So, they do not fall within the purview of a related party transaction as regulated by section 188 of the Companies Act, 2013 and regulation 23 of the LODR Regulations. But this is not a viable option as because although there is no financial outflow from the company but the incentive that the management is generating through this agreement is giving rise to governance issues which could financially affect the shareholders of the company. Therefore, a disclosure for the same arrangement is necessary for the shareholder to have full information regarding the nature of the arrangement.

This new provision if inserted will frighten the KMP's of the listed entities as because their side agreement with the Private Equity may be taken away even if they try to improve or enhance the company's performance. These rewards shall lead to aggressive measures being adopted by the management leading to huge risks being taken by the promoters, directors and key managerial personnel (KMPs) which in return can bring the price of the shares down. However, these agreements are not illegal and they merely create a reward arrangement for the KMPs of the investee company. SEBI’s proposal for obtaining an Ordinary Resolution by such KMPs before getting into such agreements with the Private Equity is correct and shall help in full disclosure and transparency for the benefit of the shareholders.