

# **Salient Features of Companies Act No. 7 of 2007**

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Companies Bill gazetted on May 19, 2006 was passed unanimously on a bi-partisan basis by Parliament on October 20, 2006, and certified by the Hon. Speaker on March 20, 2007, enacting the Companies Act No. 7 of 2007, which came into operation on May 3, 2007, as per Order gazetted by the Hon. Minister on April 20, 2007 in Gazette Extra-ordinary No. 1493 / 20.

Thus the Companies Bill having been gazetted on May 19, 2006 i.e. as far back as 10-Months, and having been passed by Parliament on October 20, 2006 i.e. as far back as 5-Months, has been in the public domain for a very considerable period of time.

Companies Act No. 17 of 1982 had been based on the 1948 Companies Act in the United Kingdom. Hence, in terms of multi-faceted global developments in international trade and commerce, the prevalent company law is 'colonial' and nearly 60 years behind contemporary times ! Thus, the need to have enacted a new law, keeping abreast with prevalent 'international laws'. Set out below are some of the salient features of the new law, giving reference to the relevant Sections of the Act.

## **Types of Companies**

As per Section 3, read with Sections 4, 5, 6 and 7, a Company could be incorporated as a 'limited company' or an 'unlimited company' or as a 'company limited by guarantee'. A listed Company, would have the abbreviation 'PLC' at the end of the name, to distinguish from unlisted public companies.

A new concept is introduced by Section 4 (2) to have a 'single individual' Shareholder Company, where small and medium entrepreneurs could limit the risk of resources in venturing into business, protecting personal family assets, essential for the livelihood of their families.

The Secretary to the Treasury is also empowered to incorporate a single Shareholder Company, to be owned by the Government, eliminating the prevalent need to have a minimum of 7 Shareholders, where public officers at the time, being made Shareholders in trust for the Government.

Also when a Government Corporation is converted into a public company under the 'Conversion of Public Corporations or Government owned Business Undertakings into Public Companies Act No. 23 of 1987', the entirety of the Share Capital vests in the Secretary to the Treasury, which is contradictory to the provisions in the prevalent Companies Act.

## **Rights of the Government**

In addition to Section 4 (2) enabling the Secretary to the Treasury on behalf of the Government to also incorporate a single Shareholder Company, Section 139 provides for the Secretary to the Treasury to appoint another person, as his proxy for every 10% or part thereof, of a Shareholding of a Company held by the Secretary to the Treasury on behalf of the Government, and to appoint 3 other persons, as his proxies, when the Secretary to the Treasury on behalf of the Government is a holder of a 'Golden Share' in a Company, to attend Shareholders' Meetings on the same occasion.

In terms of Section 144, subject to the Company's Articles, a Resolution signed by not less than 85% of the Shareholders of a Company entitled to vote, enables the Company to pass Resolutions in writing on a matter that is required by the Act or by the Articles to be deciding at a Meeting of the Shareholders, including not holding the Annual General Meeting of the Company and everything required to be done thereat being done by Resolution.

However, where the Secretary to the Treasury is a holder of a Share in a Company, any such Resolution referred to in Section 144 shall not be valid, unless the consent in writing of the Secretary to the Treasury is obtained in favour of such Resolution.

## **Objects & Articles**

Articles of Association of a Company, as per Section 13 may provide for, the objects, the rights and obligations of Shareholders, and the management and administration of the Company. The First Schedule gives a model set of Articles, which may be adapted as appropriate or amended, read with Sections 13, 14 and 15.

Section 17 stipulates the restriction placed to confine business activity, where objects are set out in the Articles, whilst Section 33 mandates a 'company limited by guarantee' to set out the objects in its Articles.

In seeking public subscription of Shares, Section 37, read with the Fourth Schedule, mandates the Prospectus to specify the business, which the Company is to carry out during the period of 5 years from the date of commencement of business.

In terms of Section 185 defining a 'major transaction', a Company cannot substantially alter the nature of its business, unless approved by a Special Resolution of the Shareholders, which as per Section 143 requires a majority of 75% of those entitled to vote.

The Board of Investment (BOI), Controller of Exchange, etc., could require Companies to have limited objects, as warranted.

## **Pre-incorporation Contracts**

Sections 23, 24 and 25 make provisions for dealing with 'pre-incorporation contracts' i.e. contracts entered into by a person on behalf of a Company, prior to its incorporation, to be ratified to be in the name of the Company.

Such provisions are practically warranted, particularly where a BOI Company is incorporated only after its Articles are approved by the BOI, consequent to the BOI having granted approval for a Project, in the promotion of which several pre-incorporation contracts and arrangements would have been entered into by the promoters.

## **Major Transactions**

As per Section 185, a Company shall not enter into any major transaction, unless it is approved by a Special Resolution or is expressly authorised to be entered into by its Articles at the time of incorporation.

A major transaction is defined as – (a) an acquisition of an asset of a value which is greater than 50% of the value of the assets for the Company before such acquisition, (b) the disposition of more than 50% of the value of the assets of the Company, (c) acquiring rights or interests or incurring obligations or liabilities of a value which is greater than 50% of the value of the assets of the Company before such event, (d) transaction/s which have the effect of substantially altering the nature of the business of the Company.

However, this does not preclude the Company from giving a floating charge over all or any part of the property of the Company, and excludes transactions entered into by a receiver, administrator or liquidator of a Company.

## **Stated Capital**

As per Section 49, different classes of Shares, with different rights could be issued, and any alterations of such rights are subject to provisions in Section 99. However, no Share shall have a nominal or par value. Shares may be issued at a consideration, either in cash or otherwise, as may be determined by the Board.

For instance, Shares may be issued at a particular price by the Company at its commencement, and thereafter, at a higher price i.e. at a 'premium' in present terms. However, the totality of the monies received or due and payable to the Company, as per Section 58 would be the 'Stated Capital' of the Company.

Accounting for 'premiums' on the issue of Shares, as 'Share Premium Account' has been done away with; the 'premium' being the equalising factor among the Shareholders, at different entry points.

Even now, the value of a Share would be reckoned in terms of the 'net assets value' or the 'earnings potential value' or the 'market value', with hardly any cognisance taken of the nominal or par value.

Keeping the 'Stated Capital' fixed, Shares may be 'split', giving additional Shares to Shareholders, akin to the present practice of sub-division of a Share, to have a larger volume and greater mobility of the Shares in the market.

Though even at present the Companies Act No. 17 of 1982 does not specify and draw a distinction between Authorised Share Capital and Issued Share Capital, the practice has developed by convention, with such specification in the Memorandum and provisions in that regard in the Articles. Similarly, if it is so desired, the Articles under the new Act could provide for such distinction and for the changes thereto.

## **Solvency Test**

In terms of the new regime, the Board of a Company is required to always be mindful and conscious of the 'solvency' of the Company, consistently conforming to the 'Solvency Test', as defined in Section 57 to consist of 2 conditions, namely - (i) to be able to pay its debts as they become due in the normal course of business, and (ii) that the value of the Company's assets is greater than the total value of its liabilities and its 'Stated Capital', i.e. the difference being the 'reserves' of a Company.

In computing the value of assets and liabilities, a fair valuation or assessment could be taken into reckoning.

The Board is required to determine whether a Company satisfies the 'Solvency Test', taking into account the most recent financial statements prepared in accordance with Section 151, whilst Section 150 stipulates that such financial statements are to be in compliance with the requirements of the Act.

Hence, when the Companies Act No. 7 of 2007 comes into operation in the financial year commencing April 1, 2007, the reference in Section 57 to the most recent financial statements prepared in accordance with Section 151, would be the financial statements for the year ended March 31, 2007.

However, in computing the 'Solvency Test' for the purpose of Section 98, where application is made to Court by a Company seeking an order exempting the Company from an obligation to purchase its own Shares, the 'Stated Capital' of a Company shall not be taken into account in determining, whether the Company will fail to satisfy the 'Solvency Test', after the purchase of its own Shares.

## **Dividends**

As per prevalent practice, in terms of Section 60, Dividends could be distributed out of the profits of a Company, subject however to applicable Accounting Standards. Such distribution of Dividends could be in cash, or in some instances as a 'scrip dividend', where Shares held by a Company in another Company are distributed to the Shareholders as 'Dividends'.

Where a Company requires to retain its profits without distributing in cash as Dividends to Shareholders, it could 'capitalise' such profits, adding such profits to the 'Stated Capital', and issuing additional Shares to the Shareholders, commonly referred to as 'Bonus Shares', but in actual fact, there is no 'free gift', since the Shareholders' right and entitlement to the profits or profits retained as reserves, are 're-invested' as 'Stated Capital' in the Company, affording the Shareholders additional Share Certificates, which if a Shareholder so desires, could be sold to another, realising cash.

The 'consideration' for such additional Shares issued, referred to as 'Bonus Shares', in lieu of distributing profits in cash as Dividends, would be the 'value' of such profits being retained in the Company, and being added on to the 'Stated Capital', without being distributed as cash to the Shareholders, divided by the number of additional Shares so issued, would be deemed to be the 'consideration' per such Share, in relation to Section 52.

Section 52 stipulates that the 'consideration' should be 'fair and reasonable' to the Company and to all its existing Shareholders. The quantum of profits or reserves to be capitalised divided by the number of 'Bonus Shares' to be given equitably to the all the existing Shareholders would be the 'consideration' for purpose of Section 52, in the absence of the regime of a 'nominal value' of a Share, which has been done away with.

Even at present, 'Bonus Shares' are issued at a nominal or par value, which is unrelated to and regardless of the actual value of such Share, whether the 'net assets value', 'earnings value' or 'market value', since the existing Shareholders themselves are receiving such additional Shares in proportion to their respective Shareholdings.

This concept is akin to the profits being 'deemed' to be distributed in cash as 'Dividends' to the Shareholders, on the condition that they are required to re-invest such 'distributed cash profits', in the 'Stated Capital' of the Company, for which the Shareholders are issued additional Shares; This is the 'effect' of the transfer of the quantum of reserves to 'Stated Capital', referred to as 'capitalisation'.

The above could also include 'Bonus Shares' issued to Shareholders from 'unrealised profits' arising from a re-valuation of fixed assets, where such re-valuation reserves, would be likewise added to the 'Stated Capital', issuing additional Share Certificates to the Shareholders, which similarly, if so desired by a Shareholder, could be sold to another, realising cash.

Though as per Accounting Standards this practice was prevalent, without specific provision therefor in the Companies Act No. 17 of 1982, such practice would now come under the ambit of 'distributions' in the Companies Act No. 7 of 2007, which enables distribution to Shareholders, in cash or kind, surplus reserves.

## **Distributions**

This new concept of 'Distributions to Shareholders' provided for in Section 56, read with Sections 57 and 61, should not be mixed-up with the distribution of Dividends out of profits, as per Section 60. 'Distribution to Shareholders' must be authorised by the Board, and unless the Company's Articles provide otherwise, must be approved by the Shareholders by Ordinary Resolution.

'Distribution to Shareholders' is in instances, where there is excess solvency in a Company, in the form of either liquid funds or property, which accordingly would be represented by 'Reserves', which could be distributed, subject to satisfying the 'Solvency Test', after such distribution is made. This could also be in the form an issue of 'Bonus Shares', where the Company wishes to retain for internal application its cash resources.

Section 529 interprets 'Distribution', as the 'transfer' of the money or property, of a Company, other than Shares of a Company, for the benefit of a Shareholder, 'including the payment of Dividends'.

Intrinsic in the term 'transfer' of Shares, is that it refers to Shares already issued and registered, and that they therefore could not be transferred to Shareholders, which would tantamount to a 'reduction' of 'Stated Capital', for which there is separate procedure provided in Section 59.

However, prior to making a 'Distribution', the Board has to be satisfied that the Company immediately after the proposed 'Distribution' will satisfy the 'Solvency Test', (including debts of fixed preferential returns on Shares ranking ahead of those in respect of which a 'Distribution' is made), obtaining a 'Certificate of Solvency' from the Auditors, and the Directors, who vote in favour of the 'Distribution', signing a Certificate that in their opinion, the Company will satisfy the 'Solvency Test' immediately after such 'Distribution' is made.

### **Recovery of Distributions**

As per Section 61, if a 'Distribution' is made, and immediately thereafter a Company does not satisfy the 'Solvency Test', then such 'Distribution' may be recovered by the Company from the Shareholders, unless the Shareholder received the 'Distribution' in good faith and without knowledge of the Company's failure to satisfy the 'Solvency Test', has altered his position in relying on the validity of the 'Distribution', and it would be unreasonable in the circumstances to require re-payment.

The failure on the part of a Director to have taken reasonable steps to ensure that the procedure was followed to satisfy the 'Solvency Test', or where he has signed the Certificate, he shall be personally liable to re-pay to the Company the extent of the 'Distribution', the Company is not able to recover from the Shareholders.

Since, Section 529 defines 'Distribution' to include the payment of 'Dividends', the 'Solvency Test' and provisions of Section 61 would apply to the payment of 'Dividends' as well. This patently exposes the fallacy of the unrealistic theoretical concept of 'deemed Dividends' !

### **Bonus Shares**

A baseless and unfounded 'controversy' was created on the matter of issue of 'bonus shares', leading it to be quite an 'issue' in the media, who cannot be faulted for reporting, what some persons had 'propounded', that no 'bonus shares' could be issued !

There is a concept and scheme laid down in the Companies Act No. 7 of 2007 for the management of funds of a company, and it would be clear to anyone, who understands such concept and scheme, that 'bonus shares' could be issued. In fact, the Companies Act No. 7 of 2007 permitted the issue of 'bonus shares' by introducing the concept of 'distributions', which would be out of 'reserves'.

Companies Act No. 7 of 2007, in fact, has specifically stipulated as Section 72 (3) (b) that – “ an allotment of fully paid shares in the company may be validly made by way of capitalization of reserves of the company”. Thus the Board may issue fully paid shares of the Company by way of a 'bonus issue' by capitalising available reserves and/or profits of the Company.

Section 52 stipulates that the 'consideration' for issue of Shares, in the opinion of the Board, should be 'fair and reasonable' to the Company and to all its existing Shareholders. The Board shall decide, in their opinion, the value per share of such bonus issue, by taking into reckoning the amount of reserves, which are to be capitalised for the issue of such fully paid shares, as and by way of a distribution. Such value per share need not be the market value of such shares, or any other valuation of such shares, provided however, the company satisfies the solvency test, after the issue of such bonus shares.

Therefore, the quantum of profits / reserves to be 'capitalised' i.e. to be added on to Stated Capital, divided by the number of 'bonus shares' to be issued equitably on a *pro-rata* basis to all the existing Shareholders would be the 'consideration' in conformity with Section 52, since it would be fair and reasonable to the Company and to all existing Shareholders, in the absence of the regime of the 'nominal value' of a Share, which has been done away with; subject however, to not eroding the 'Solvency Test' of the Company.

Such feature was not provided for in the repealed Companies Act No. 17 of 1982, which provided for the issue of 'bonus shares', only from the 'share premium account' and the 'capital redemption reserve fund'. Therefore no other reserve, could have been utilised, to issue 'bonus shares', whereas in contravention of the repealed Companies Act No. 17 of 1982, 'bonus shares' were issued, even utilising other 'reserves', including 'revaluation reserves', which prevailed, curiously without any query or challenge !

Further confusions in regard to 'distributions' and the 'issue' of 'bonus shares' *vis-à-vis* the definition of 'distribution' in Section 529 was also baseless and unfounded, in that, it related to the 'transfer' of shares of a company, and not to the 'issue' of shares. In fact, Section 70 stipulates certain restrictions placed prohibiting a company from giving financial assistance to purchase shares of a company. However, in terms of Section 71, such restrictions in Section 70 do not apply in respect of 'distributions' and the 'issue of shares' by a company.

Section 72 (3) (b) in Section 72 *vis-à-vis* the prohibition for a subsidiary to acquire shares in a holding company, except to continue to hold shares acquired prior to becoming a subsidiary, but with no right to vote on such shares in the holding company states thus: "72 (3) (b). Where a body corporate is permitted to continue as a member of the holding company by virtue of paragraph (b) of sub-section (1) and paragraph (a) of this subsection, *an allotment of fully paid shares in the company may be validly made by way of capitalization of reserves of the company, which shares also will have no right to vote*"

No doubt, this would make the issue quite clear to those, who had found it difficult to comprehend the concept and scheme for the issue of 'bonus shares', but needed to see it in 'black and white' !

### **Reduction of Stated Capital**

Correctly as defined in Section 529, 'Distribution' excludes the 'transfer' of the Shares of a Company to Shareholders, as no part of the Shareholdings of a Company can be transferred or returned back to the Shareholders, since that would tantamount to a 'reduction of the Stated Capital', which is provided for, with special procedure therefor in Section 59.

A Company, subject to any agreement with a creditor that the 'Stated Capital' will not be reduced below a specified amount without the prior consent of the creditor, may by Special Resolution i.e. with a majority of 75% of those entitled to vote, reduce the 'Stated Capital' to an amount as it thinks appropriate, in accordance with the provisions of the Act.

Public notice of such proposed reduction of 'Stated Capital' has to be given not less than 60 days before the Resolution to reduce the 'Stated Capital' is passed, and within 10 working days of such reduction, notice thereof has to be given to the Registrar of Companies.

The above procedure moves away from the prevalent practice of obtaining a Court Order.

### **Re - Purchase & Redemption of Own Shares**

Sections 63, 64 and 67 empowers the Company to purchase or acquire its own Shares – (a) in terms of Section 64, if the Articles so provide, with the approval of the Board, (b) in terms of Section 67, in the exercise of an option to redeem a Share which is redeemable at the option of the Company, if the Board has resolved that the redemption is in the interest of the Company (c) if a private company, with the agreement of all Shareholders in terms of Section 31, or (d) in accordance with an Order made by Court.

As per Section 64, before the Board could resolve to purchase or otherwise acquire its own Shares, the Board should resolve that - (a) the acquisition is in the interests of the Company, (b) consideration to be paid for the Shares, in the opinion of the Auditors is a fair value, (c) is unaware of any information not disclosed to Shareholders, which is material to the assessment of value of the Shares, making the offer to purchase unfair.

Also in terms of Section 64, the Board should resolve that the offer or entry into an agreement to purchase Shares of the Company, is fair to those Shareholders to whom the offer is not made or with whom no agreement is entered into, leaving unaffected the relative voting and distribution rights of all Shareholders.

Section 65 provides for the enforcement against the Company of a contract to re-purchase its Shares, except to the extent, that the Company would after performing the contract, fail to satisfy the 'Solvency Test'.

Section 66 provides for the Redemption of Shares of a Company, if the Articles so provide - (a) in terms of Section 67, at the option of the Company, (b) in terms of Section 68, at the option of a Shareholder, or (c) in terms of Section 69, on a date specified in the Articles, for a consideration that is specified or calculated or fixed by an uninterested qualified person.

In terms of Section 65, where a Company has failed to purchase Shares as contracted, the party to the contract retains the status of a claimant and ranks subordinate to the rights of creditors, and in terms of Section 68, where a Company receives notice from a Shareholder exercising the option to redeem the Shares, and in terms of Section 69, where the redemption of Shares is on a specified date, in both such instances, the former Shareholder ranks as a unsecured creditor for the sum payable on redemption.

In terms of Section 59, where Shares are redeemed at the option of the Shareholder as per Section 68, or redeemable on a specified date as per Section 69, or a Company purchases a Share under Section 95 from a dissenting Shareholder, and if as a consequence of such redemption or purchase, the Board is satisfied that the Company fails to satisfy the 'Solvency Test', the Board after obtaining the Auditors Certificate of 'Solvency', shall resolve that the 'Stated Capital' be reduced by the amount that the Company would fail to satisfy the 'Solvency Test', without a Special Resolution, and notwithstanding any agreement with a creditor not to reduce the 'Stated Capital', but with public notice not less than 60 days, and consequent notification to the Registrar of Companies.

Redemption of Shares at the option of the Shareholder or on a fixed date, as per Sections 68 and 69, is not a Distribution for the purpose of Section 56, but is deemed as a Distribution for the purpose of Section 61 Sub-sections (1) and (3), which provide for the recovery by the Company of monies so distributed and/or action to be brought against the Directors or Shareholders, whereas redemption of Shares at the option of a Company, as per Section 67, is deemed to be an acquisition by the Company for purpose of Section 64 Sub-section (3) and a Distribution for the purpose of Section 56.

A Share that is acquired or redeemed by the Company shall be deemed to be cancelled immediately upon acquisition or redemption, giving immediate notice thereof to the Registrar of Companies.

### **Serious Loss of Capital**

As per Section 220, if it appears to a Director of a Company, that the 'net assets' of the Company are less than 50% its 'Stated Capital', then the Board, within 20 working days of such fact becoming known to the Director, shall call an Extra-ordinary General Meeting of the Shareholders to be held, not later than 40 working days from the date of calling of such Meeting.

The Notice calling such Meeting shall be accompanied by a Report prepared by the Board, which advises the Shareholders of – (a) the nature and extent of losses incurred, (b) the causes for the losses incurred, (c) steps, if any, being taken by the Board to prevent further losses or to recoup the losses incurred.

At the Meeting, this Report of the Directors and the financial position of the Company shall be discussed and the Shareholders given a reasonable opportunity to ask questions, discuss and comment on the Report and the management of the Company.

Such provisions compel the management of a Company to be always mindful and conscious of the solvency of the Company, and to take strategic steps to endeavour to arrest and reverse the erosion of the 'Stated Capital' of a Company.

As per Section 219, if a Director believes that a Company is unable to pay its debts as they fall due, he shall forthwith call a Meeting of the Board to consider whether the Board should apply to Court for the winding-up of the Company and the appointment of a liquidator or an administrator or carry on further the business of the Company.

If a Director in such circumstances fails to so act, and the Company is subsequently placed in liquidation, the Court may on the application of the liquidator or creditor, make Order that the Director shall be liable for the whole or any part of any loss suffered by the creditors, as a result of the Company continuing to carry on its business.

If at the Meeting called by the Director, the Board does not resolve to apply to Court for the winding-up of the Company and for the appointment of a liquidator or administrator, and at the time of such Meeting there were no reasonable grounds for believing that the Company was able to pay its debts as they fell due, and the Company is subsequently placed in liquidation:-

The Court may, on the application of a liquidator, or a creditor make order that the Directors, other than those Directors who attended the Meeting and voted in favour of applying to Court for winding-up of the Company, and the appointment of a liquidator or administrator, shall be liable for the whole or any part of any loss suffered by creditors, as a result of the Company continuing to carry on its business.

This places an onerous duty on the Directors of a Company to always ensure the adequacy of 'solvency' and not to continue to carry on business, when a Company is insolvent, exposing themselves to personal liability !

This also gives protection to unsecured creditors and bankers, who hitherto did not have such protection.

### **Priority for Statutory Payments to Employees**

As per Section 361, all Provident Fund dues, Employee Trust Fund dues and Gratuity payments due to employees, standing accrued as due to employees of a Company, prior to the securing of any assets of the Company, will be paid as a priority from the sale proceeds of such secured assets, before payment is made to the party, who had obtained such security over such assets, after such statutory dues to the employees had become due.

In addition, in the Ninth Schedule to the Act, the payment of all Provident Fund dues, Employee Trust Fund dues and Gratuity payments due to the employees, will rank in priority, even over statutory payments due by way of taxes to the Government, but after payments due to the liquidator.

### **Directors Duties**

As per Section 187, a Director of a Company shall act in good faith in what he believes to be in the interest of the Company, subject however in a fully owned subsidiary, if permitted by the Articles, he may act in what he believes to be the interest of a parent company, even though it may not be in the interest of the subsidiary of which he is a Director.

Section 188 prohibits a Director to act in a manner that contravenes the provisions of the Act or the Articles of the Company.

Section 189 prohibits a Director from acting in a manner, which is reckless or grossly negligent, and mandates him to exercise the degree of skill and care that may reasonably be expected of a person of his knowledge and experience.

Section 190 permits a Director to rely on reports, statements, financial data and other information prepared or supplied, and on professional or expert advice given by - (a) an employee of the Company, (b) a professional advisor or expert on matters he believes to be within such person's competence, (c) any other Director or Committee of Directors, within such Director's or Committee's authority, subject however, that a Director acts



in good faith, makes inquiry where the need for inquiry is indicated by circumstances, and has no knowledge that such reliance is unwarranted.

As per Section 147, a Director and a former Director is entitled to receive certified copies of the Minutes of all Meetings of the Board, held during the period he is / was a Director of the Company.

### **Directors Interests**

Section 191 defines the meaning of a Director being ‘interested’ in a transaction, i.e. if a Director – (a) is a party to or derives a material financial benefit from a transaction, (b) has a material financial interest in a party to a transaction, (c) is a Director, officer or trustee of a party deriving a material financial benefit from a transaction, excluding instances of a holding Company *vis-à-vis* a subsidiary company, (d) is a parent, child or spouse of a party deriving a material financial benefit from a transaction, (e) is otherwise directly or indirectly materially interested in a transaction.

Section 192 stipulates that a Director having such ‘interest’ shall enter the same in the ‘interests register’ and disclose the same to the Board.

Sections 193 and 194 provide for avoidance of a transaction in which a Director has had an interest, if the Company has not received ‘fair value’, whilst protecting the interests of a third party, if there has been ‘valuable consideration’ and such party had acted in good faith, without being aware of any circumstances for the ‘avoidance’ of the transaction.

Subject to the provisions in the Articles, Section 196 provides for a Director who has an ‘interest’ – (a) to vote *vis-à-vis* a transaction, (b) attend a Meeting of the Board where the transaction arises, (c) sign a document *vis-à-vis* the transaction on behalf of the Company, (d) do anything as a Director in relation to the transaction.

Section 196 prohibits a Director to disclose information except – (a) for the purpose of the Company, (b) as required by law, (c) as authorised by the Board, (d) as permitted by the Articles.

Similarly, Sections 198, 199 and 200 provide for a Director to disclose to the Board and enter in the ‘interest register’ any interest that he has in any Shares of the Company, directly and/or indirectly.

In terms of Section 157, a Director or a person who is a partner or employee of a Director, cannot be appointed as an Auditor of a Company for a period of 2 years, after such Director ceased to hold office, as a Director of the Company.

### **Minority Shareholder & Derivative Actions**

Sections 224 to 233 set out the remedies that can be sought by minority Shareholder/s, who hold/s not less than 5% Shareholding of a Company, by instituting legal action for the prevention of oppression, where the affairs of the Company are being conducted in a manner oppressive to any Shareholder/s and/or for the prevention of mismanagement, where the affairs of the Company are being conducted in a manner prejudicial to the interests of the Company or that a material change has taken place in the management or control of the Company, and thereby it is likely that the affairs of the Company may be conducted in a manner prejudicial to the interests of the Company.

Whilst under Section 233 restraining orders may be made by Court in a legal action brought to prevent oppression and mismanagement, there is further provision under Section 521 for the Court to make interim orders, pending the making of a final order, in any application or reference to Court made under the Act.

The right of a Shareholder to institute a legal action in the right and on behalf of a Company, in the interest of and for benefit of a Company, referred to as a ‘derivative action’ has now been enshrined in Section 234, as a statutory right, not only of a Shareholder of a Company, but also as that of a Director.

Such actions have been entertained by Court, where a Company has been / is being defrauded as a result of the Company being controlled by wrong-doers, or where rights and entitlements of minority Shareholders have been / are being expropriated, or where a Company is carrying on an illegal activity violating the law.

Section 234 provides for the proceeding with such 'derivative actions', only upon obtaining the grant of leave from Court, with notice having been served on the Company, which would prevent scurrilous actions.

Since a Shareholder may not have access to all relevant documents necessary for prosecution, in some countries, the Securities & Exchange Commission (SEC), which have the right to call for documents from a Company, has also been given the right to institute a 'derivative action' *vis-à-vis* any Company, since a SEC's primary objective is to protect the interests of Shareholders. Whether such a right could be exercisable by the SEC, as a Shareholder of a Company, is debatable !

Hence at the stage of granting leave, with notice having been served on the Company, the Company ought be required to provide all requisite documents and informations for consideration of the grant of leave by Court.

### **Minority Buy-out**

In terms of Section 93, where a Special Resolution is passed i.e. by a 75% majority as per Section 143, to (i) alter the Articles imposing or removing a restriction on the business or activities of a Company, (ii) approve a major transaction in terms of Section 185, or (iii) approve an amalgamation under Section 241, or as per Section 100 an interest group has approved taking of any action that effects the rights attached to Shares, a Shareholder voting against such Resolution, is entitled to require the Company to purchase his Shares, giving notice to the Company in terms of Section 94.

Upon receipt of such notice by a Shareholder requiring a Company to purchase his Shares, as per Section 94, the Board shall – (a) agree to purchase such Shares, (b) arrange some other person (which does not exclude an existing Shareholder) to agree to purchase such Shares, (c) apply to Court for an Order exempting the Company from its obligation to purchase such Shares, (d) arrange for such Resolution to be rescinded.

Where the Board agrees to purchase the Shares by the Company, the Board shall as per Section 95 nominate a fair and reasonable price, and give notice to the Shareholder, and the Shares are then deemed to be purchased by the Company, upon receipt by the Shareholder of such notice.

If the price nominated by the Board is not acceptable to the Shareholder, he shall give notice of objection to the Company, otherwise, the Company shall pay the price nominated, and the Shareholder shall deliver the Share Certificate to the Company.

If the Shareholder has objected, then the Company shall refer the question of determination of a fair and reasonable price to the Auditors, and pay the provisional price nominated by the Board, until the determination by the Auditors. Upon the payment of such provisional price, the Shareholder shall deliver the Share Certificate to the Company.

Upon the Auditors' determination of the price, any balance price shall be paid by the Company to the Shareholder, and if the provisional price paid had been excessive, the Shareholder shall refund such payment, with interest in both instances, as determined by the Auditors.

If the Company fails to refer to Auditors or the price determined by the Auditors is not acceptable, the Shareholder may obtain an Order of Court to appoint a person to determine such price.

In terms of Section 96, the above procedure set out in Section 95, will also apply, where the Board has arranged some other person (which does not exclude an existing Shareholder) to agree to purchase the Shares from the dissenting Shareholder.

As per Sections 97 and 98, the Company could on stipulated grounds, apply to Court for an Order exempting the Company from the obligation to purchase the Shares, whilst Court can make equitable Order granting redress to the dissenting Shareholder.

In terms of Section 246, a person, who has made an offer and acquired 90% of the voting rights of Shareholders of a Company, can within 3 months of such acquisition, give notice to the balance Shareholders with voting rights, of his desire to acquire such balance Shares.

Upon application made to Court by any Shareholder, within 14 days of receipt of such notice, unless the Court thinks fit to Order otherwise, the person who has acquired 90% voting rights, will be entitled to acquire the balance Shares with voting rights on the same terms made for the acquisition of the 90%.

### **Private Companies**

Whilst most of the self regulation concepts referred to above apply to ‘public companies’, where monies of public Shareholders are being managed by Board of Directors, however, in the case of ‘private companies’ in terms of Section 31 (1), read with the Second Schedule, the following provisions do not apply to ‘private companies’ acting with unanimous approval of the Shareholders.

- Consideration for issue of Shares (Section 52)
- Pre-emptive rights to new issues (Section 53)
- Distributions (Section 56)
- Dividends (Section 60)
- Recovery of Distributions (Section 61)
- Purchase of own Shares (Section 64)
- Restrictions on giving Financial Assistance (Section 70)
- Exercise of powers reserved to Shareholders (Section 90)
- Powers exercised by Special Resolutions (Section 92(1) (b))
- Alteration of Shareholder Rights (Section 99)
- Major Transactions (Section 185)
- Disclosure of Interest (Section 192)
- Avoidance of Transactions (Section 193)
- Remuneration and other benefits (Section 216)
- Restrictions of loans to Directors (Section 217)
- Indemnity and Insurance (Section 218)

However, provisions of Section 220 ‘Duty of Directors on serious loss of capital’ and Section 219 ‘Duty of Directors on insolvency’, exposing the Directors to personal liability, do apply to ‘private companies’; including also the qualification for and disqualification of Directors, as per Section 202, 213 and 214.

### **Accounting Records & Financial Statements**

As per Section 148, a Company has to keep records to correctly record and explain its transactions.

The accounting records should enable – (a) the financial position of a Company to be determined with reasonable accuracy, (b) Directors to prepare financial statements in terms of the Act, (c) Company’s financial statements to be readily and properly audited.

Without any limitation to the above, the accounting records should contain – (a) monies received and paid each day, stipulating why money was paid, (b) assets and liabilities, (c) where applicable, goods bought and sold, and stock at end of financial year, with records of any stock takings during the year, (d) services provided and invoices.

A Company has to keep its accounting records in Sri Lanka. Exceptionally, in terms of Section 149, where the Registrar of Companies considers it 'not prejudicial to the national economy or to the interests of Shareholders', he could permit a Company to keep the accounting records outside Sri Lanka.

Where accounting records are kept outside Sri Lanka, a Company should ensure that accounts and returns of the operations disclose with reasonable accuracy the financial position every 6 months, and they will enable the preparation of the financial statements in conformity with the Act. Notice of the place where accounting records are kept, and the accounts and returns of the operations have to be given to the Registrar of Companies.

As per Section 150, a Company has to prepare within 6 months of the Balance Sheet date, financial statements in compliance with Section 151, and they have to be certified by the person responsible for their preparation that they are in compliance with the requirements of the Act, and dated and signed on behalf of the Board by 2 Directors, or by the only Director, where applicable.

In terms of Section 151, the financial statements of a Company should give a true and fair view of – (a) the state of affairs of the Company as at the Balance Sheet date; and (b) the profit or loss, or the income and expenditure, for the accounting period ending on the Balance Sheet date. As per Section 529 'financial statements' are defined, to include any notes or documents giving information in relation thereto.

Also as per Section 529, 'Balance Sheet date' has been defined to mean 31<sup>st</sup> March of each year, or such other date the board has adopted and notified to the Registrar of Companies

Without any limitation to the above, financial statements should comply with – (a) regulations made under the Act; and (b) requirements which apply to a Company's financial statements under any other law.

Thus, preparation of financial statements, where applicable, must comply with the Accounting Standards of the Institute of Chartered Accountants of Sri Lanka, and should ensure that they could be audited in accordance with the Auditing Standards of the Institute of Chartered Accountants of Sri Lanka, in terms of the Sri Lanka Accounting & Auditing Standards Act No. 15 of 1995.

Similarly, specific requirements in terms of other laws for the preparation of financial statements, such as of Public Listed Companies in terms of the Securities & Exchange Commission Act, and such as in the case of Banks, Finance Companies, Insurance Companies, etc. will apply, including any incidence under Exchange Control Act, etc.

In terms of Sections 152 and 153, group financial statements on the above lines have to be prepared by a Company, which has one or more subsidiaries, except where a Company is a wholly owned subsidiary of another Company.

A Company which is not a Private Company, has to deliver within 20 working days, copies of the financial statements and the auditors report to the Registrar of Companies, who may require a Private Company to deliver the same as per Section 170.

### **Appointment & Duties of Auditors**

In terms of Section 162, an Auditor of a Company, in carrying out the duties under the Act, has to ensure that his judgment is not impaired by reason of any relationship with or interests in the Company or any subsidiary.

Auditor of a Public Company has to be a Member of the Institute of Chartered Accountants of Sri Lanka, whilst the Auditor of a Private Company or a Company Limited by Guarantee, could also be a registered Auditor, as per Section 157.

Also, a Director or Employee of a Company, a Partner or an Employee of a Director or of an Employee of a Company, a Liquidator or Administrator or Receiver, a body corporate, cannot be appointed as Auditor of a Company or a related Company; and such person cannot be appointed as a Auditor for a period of two years, after such person has ceased to hold such office.

A Partnership, where all Partners are qualified, could be appointed as Auditors, and all Partners, from time to time, are deemed to be Auditors of the Company, as per Section 156.

In terms of Section 159, the first Auditor of a Company could be appointed by the Board to hold office until the conclusion of the first Annual General Meeting, and as per Section 154, a Company at an Annual General Meeting has to appoint an Auditor to hold office, from the conclusion of that Meeting, until the conclusion of the next Annual General Meeting.

The Board can fill a casual vacancy of an Auditor, or where no Auditor is appointed or re-appointed by Resolution at an Annual General Meeting, and where a casual vacancy is not filled within one month, the Registrar of Companies could appoint an Auditor.

An Auditor, other than the first Auditor, shall be deemed to be re-appointed at an Annual General Meeting, unless - (a) he not qualified, (b) another Auditor is appointed by Resolution, (c) the Auditor does not wish to be re-appointed, as per Section 158.

In terms of Section 155, the fees and expenses of an Auditor or the manner of fixing the same, would be decided at an Annual General Meeting, and would be fixed by the Directors or the Registrar of Companies, where they appoint an Auditor.

As per Section 160, a Company cannot appoint a new Auditor, unless 20 working days notice is given to the present Auditor, and the Auditor has been given a reasonable opportunity to make representations, in writing or orally, to the Shareholders, on the appointment of another Auditor, and the Auditor is entitled to reasonable fees and expenses for making such representations.

If an Auditor resigns, the Auditor has to deliver to the Company a Statement of any circumstances connected with his resignation, where he considers it should be brought to the attention of the Shareholders and Creditors, or a Statement that there are no such circumstances, in terms of Section 161.

Such Statement by an Auditor has to be delivered to a Company, if he resigns with notice, or he gives notice not wishing to be re-appointed, or ceases to hold office for any other reason.

Where an Auditor has stated circumstances, which ought to be brought to the attention of Shareholders and Creditors, a Company has to send a copy of the Auditor's Statement to the Shareholders and to the Registrar of Companies. A Company could refrain from sending such Statement, with an Order of Court.

In addition to the Auditor's duties and responsibilities, in respect of the audit of financial statements of a Company, the Auditor is conferred with further duties and responsibilities,

- in terms of several provisions of the Act for Certification of Solvency of a Company, which would involve (a) an assessment of the ability of a Company to pay its debts as they become due, and (b) the reckoning of the value of a Company's assets *vis-à-vis* its Liabilities and Stated Capital.
- the Auditor is also required to provide fair and reasonable price for the Shares of a Company, as per Section 95 for the purchase of a Shareholder's Shares by a Company or a person arranged by a Company.
- Stated Capital of an amalgamated Company is the sum certified by the Auditor as per Section 245.

## **Auditor's Report**

As per Section 164, the Board shall ensure that an Auditor has access at all times to the accounting records and documents of a Company.

An Auditor is entitled to require from a Director or Employee of a Company information and explanations which are necessary for the performance of his duties.

In terms of Section 151, financial statements should comply with requirements, which apply to a Company's financial statements under any other law, and hence where applicable, financial statements must comply with the Accounting Standards of the Institute of Chartered Accountants of Sri Lanka and be subject to audit in accordance with the Auditing Standards of the Institute of Chartered Accountants of Sri Lanka, in terms of the Sri Lanka Accounting & Auditing Standards Act No. 15 of 1995.

Accordingly, financial statements, such as of Public Listed Companies in terms of the Securities & Exchange Commission Act, and such as in the case of Banks, Finance Companies, Insurance Companies, etc. will be subject to audit, to be in compliance with the respective applicable laws.

As per Section 165, an Auditor is permitted to attend Shareholders' Meetings, and to receive Notices and communications to Shareholders, and an Auditor may be heard at a Meeting of Shareholders on business, which concerns the Auditor.

In terms of Section 163, the Auditor is mandated to make a Report to Shareholders on the financial statements audited, stating in his Report – (a) basis of opinion, (b) scope and limitations, (c) whether all informations and explanations required were obtained, (d) whether proper accounting records had been kept, (e) whether the financial statements give a true and fair view, and if they do not, the respects in which they fail to do so, (f) whether the financial statements comply with requirements of Section 151 or 153 of the Act, and if they do not, the respects in which they fail to do so.

Together with the Auditor's Report, the Auditor has to deliver to the Company, a Statement of – (a) any relationship or any interests the Auditor has with or in the Company or any subsidiary, and (b) amounts payable as audit fees and expenses, and as a separate item, any fees and expenses for other services provided by the Auditor.

## **Annual Report to Shareholders**

A Company, within 6 months after the Balance Sheet date, has to prepare an Annual Report on the affairs of the Company, during the accounting period ending on the Balance Sheet date, and send a copy of the Annual Report to Shareholders, 15 days before the Annual General Meeting, in terms of Sections 166 and 167.

Section 168 stipulates the contents of the Annual Report thus –

- (a) description of what is material for the Shareholders to have an appreciation of the state of the Company's affairs, and will not be harmful to the business of the Company or its subsidiaries, including any change in the nature of business of the Company or its subsidiaries, or classes of business the Company has an interest in, whether as a Shareholder of another Company or otherwise.
- (b) financial statements in compliance with Sections 151 and 152
- (c) auditor's report on the financial statements
- (d) description of any changes in accounting policies during the accounting period
- (e) particulars of entries in the interests register made during the accounting period
- (f) remuneration and other benefits of Directors during the accounting period
- (g) total amount of donations made during the accounting period
- (h) names of Directors at the end of the accounting period and Directors who ceased to hold office during the accounting period.

- (i) amounts payable to the Auditors, as Audit Fees, and separately, Fees payable for other services provided by the Auditors.
- (j) particulars of any relationship or any interest the Auditors have with or in the Company or any of its subsidiaries.
- (k) signature of 2 Directors on behalf of the Board or of 1 Director and Secretary.

Information referred to at (b) to (j) above, have to be included in respect of subsidiaries. The Annual Report need not comply with (a), (d) to (j) above, if all Shareholders agree in writing that it need not do so, with such agreement noted in the Annual Report.

### **Annual Return to Registrar of Companies**

As per Section 131, a Company has to deliver every year to the Registrar of Companies, an 'Annual Return', as set out in the Fifth Schedule to the Act.

As per the Fifth Schedule, matters to be included in the 'Annual Return' are as follows:

- (i) List of Shareholders and those who ceased to be Shareholders, since the previous Annual Return
- (ii) Names and addresses of the Shareholders and the number of Shares held by each of them, specifying the Shares transferred, since the previous Annual Return
- (iii) Date of incorporation and any change of name of the Company
- (iv) Address of the Registered Office
- (v) Total number of Shares issued by the Company
- (vi) Stated Capital of the Company
- (vii) Total number of Shares forfeited
- (viii) Particulars of Directors & Secretary, as per the Register of Directors & Secretary
- (ix) Total amount of indebtedness of the Company in respect of all mortgages and charges, which are required to be registered with the Registrar of Companies, under the Act
- (x) Name and address of the Auditor

\* Note: Reference to Share Warrants in the Fifth Schedule is in error, since the Act does not provide for Share Warrants

The Annual Return, signed by a Director and the Secretary, has to be delivered to the Registrar of Companies within 30 working days of the Annual General Meeting.

As per Section 132, a Private Company has to send with the Annual Return,

- (a) declaration signed by the Directors that to the best of their knowledge and belief, all things required to be done under the Act, have been done
- (b) Certificate signed by a Director and the Secretary
  - i) that the Company has not issued any invitation to the public to subscribe to any Shares or Debentures of the Company
  - ii) where the number of Shareholders exceeds 50 that the excess consists of employees of the Company or former employees, who were Shareholders, while being employed

### **Overseas Companies**

Section 488 defines an 'overseas company' to mean a Company, which has an established place of business within Sri Lanka.

Section 489 requires every 'overseas company' to deliver specified documents, disclosing relevant informations, including names and addresses of one or more persons resident in Sri Lanka authorised to accept service of documents on behalf of the Company, to be registered with the Registrar of Companies, and for the Registrar of Companies to register such a Company, as an 'overseas company' and issue a Certificate of Registration.

Section 493 precludes a registered 'overseas company' from using a name prohibited in terms of Section 7 of the Act.

Section 489 also stipulates that a Company incorporated outside Sri Lanka, shall not establish a place of business within Sri Lanka or be registered as an 'overseas company', where the business carried on by that Company does not conform to the stipulations made under the Exchange Control Act.

Section 490 empowers a registered 'overseas company' to hold lands in Sri Lanka, as if it were a Company incorporated under the Act.

Sections 491, 492, 495 and 496 mandates registered 'overseas company' to deliver to the Registrar of Companies any changes in documents and informations submitted at the time of registration, and to submit financial statements in every calendar year.

The procedure for a registered 'overseas company' or a company incorporated outside Sri Lanka to issue any Prospectus offering for subscription any Shares in or Debentures of a Company, is set out in Sections 494, 500 to 505, respectively.

### **Companies Dispute Board**

Another new feature of the Act is the establishment of a 'Companies Dispute Board' (CDB) in terms of Section 507, consisting of not less than 3 and not more than 5 Members, appointed by the Minister, with substantial experience in relation law relating to and administration of Companies, with one Member being appointed as the President of the Board.

Section 508 provides for parties to a dispute - (a) arising in giving effect to the provisions of the Act, or (b) which relates to the affairs and management of the Company, to refer such dispute, with the approval of the President of the CDB, for mediation before a Member of the CDB.

A Court may refer any proceeding pending, for mediation before a Member of the CDB, with the consent of all parties, and the proceedings stayed until a successful settlement is reached, or proceedings resumed thereafter.

Any settlement reached at the mediation before a Member of the CDB shall be recorded in writing and signed by the parties and the Member of the CDB, and a certified copy of such Settlement Agreement shall be filed in Court, and shall have effect, as if it were a judgment of Court.

Costs of such mediation are to be borne by the parties.

### **Conclusion**

In giving effect to the new Companies Act No. 7 of 2007, there is bound to be 'teething problems' and the 'pangs of change', with a complete new set of Forms, in conformity with the provisions of the Act, having also been developed to be adhered to.

Though the Commission has made much effort, interacting with professional institutes, trade chambers, stakeholders and political parties, ever since the Companies Bill was gazetted on May 19, 2006, as far back as 10-Months, there still could be incongruities and issues, which may require future amendments.



Nevertheless, the new Companies law is what has been adapted from evolved well established and accepted international law currently prevailing, with some modifications to address local concerns, and has been passed by Parliament unanimously.

Even the Companies Act No. 17 of 1982 still uses the Forms specified in the Companies Ordinance of 1938 and copies of the Subsidiary Legislation unavailable ! These Forms are outdated and do not relate to the provisions of Companies Act No. 17 of 1982 ! Even the provisions of the Conversion Act of 1987, converting government corporations into public companies has several material contradictions with the Companies Act No. 17 of 1982, such as, the single shareholder public companies, the requirement to issue a Certificate to Commence Business, under the Companies Act No. 17 of 1982 ! All these have been condoned over the years, without any demur, whatsoever !

Directors of Companies are not necessarily the owners and stakeholders of Companies; the owners being the Shareholders, and stakeholders, the providers of funds, such as Banks, and also the employees. Directors of Companies have a fiduciary duty, trust and responsibility to manage these resources of interest groups, without permitting corporate failures that are being witnessed today, due to corporate mismanagement and frauds deliberately and intentionally perpetrated.

Inasmuch as those who hold public office are bounden in law to protect the resources of the people, the same onus falls on those who hold office as Directors of Companies, to protect the resources of the Shareholders and stakeholders, and therefore, Directors holding office cannot avoid accountability and responsibility.

Companies Act No. 7 of 2007 is a major step in the right direction to provide a much warranted corporate culture and environment, to build a private sector, developing therein the confidence of the constituency of the people ! The Act was enacted with unanimous support and endorsement by all political parties, representing the people in Parliament !