



COMPANIES ACT NO. 7 OF 2007 THE BANKERS' PERSPECTIVE

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Introduction

The new Companies Act No. 7 of 2007, which came into effect on the 03rd of May 2007, repeals the earlier Companies Act No. 17 of 1982 and The Companies (Special Provisions) Law No. 19 of 1974, which contained certain provisions relating to the registration of liaison offices.

Some of the more important features of this Act are that it seeks to simplify incorporation procedures, imposes new rules on capitalizations, minimize the intervention of Court with respect to recapitalizations and amalgamations, grants more responsibilities to Directors and hold them more responsible for their actions and provides minority shareholders with distinct rights in the event of there being disagreements with majority shareholders.

Incorporation and Registration of Companies

The Act provides for simplified procedures for incorporation and the promoters could incorporate a Company by filling up particular forms which can be obtained from the Registry web site and submit them in the Registrar of Companies ("Registrar"). Upon the issue of the Certificate of Incorporation a Company with a set of model articles would be deemed to have been incorporated. The printing of the Articles would therefore be an independent exercise and it would not be a document which has been approved as such by the Registrar. Similarly even if the Company does not wish to adopt the model Articles, the Registrar would not be involved in approving the draft Articles as was the practice under the Companies Act No 17 of 1982, ("previous Act").

Existing companies are deemed to be incorporated under the new Act under Section 485. However, Section 487 of the Act requires an existing company to apply to the Registrar and obtain a new number within 12 months from the coming into operation of the Act. In the event of the Company not having obtained the new number within 12 months from the coming into operation of the Act, the Registrar shall cause to be published in the daily newspaper the name of such Companies who are in default. Within a period of 6 month from such publication a Director of the Company, a Shareholder of the Company or person who has registered a charge (i.e. a person who is a secured creditor) or a person who has instituted action against the Company either in Court or in arbitration proceedings could apply for the new number for and on behalf of the Company.



In the event of the Company not having obtained a number by the expiry of the 6 month period referred to above, the Company's name shall be struck off the register and all its properties and rights shall vest in and be at the disposal of the State.

The new Act does not provide for a constitutional document called the Memorandum of Association. There is only an Articles of Association. In the case of existing companies, the Memorandum would be deemed to form part of the Articles with effect from 03rd May 2007. Such Companies would therefore have Articles which contain the Primary Objects of the Company, the Ancillary Powers and even an Authorized Capital even though the Act does not have such a concept of capital.

The Companies Act No 17 of 1982 read together with the Companies (Special Provisions) Law No 19 of 1974 provided for companies which were incorporated outside Sri Lanka to register themselves in Sri Lanka either as branch offices or as liaison offices. The distinction between the two were that it was only a branch office which could carry on business in Sri Lanka. The New Act only has provision for the registration of one category named overseas companies and accordingly the distinction between a branch and a liaison office would no longer be applicable.

General Business Purpose Companies

The Act permits the incorporation of general business purpose companies with no specific objects. In the event of a person incorporating a Company, based on the model articles which are provided for in Schedule 1 of the Act, such person would end up with a general business purpose company with no specific objects. Such a Company would have no restriction on the types of business which it could carry out.

The Act does not prevent the incorporation of companies with specific objects. The effect of having objects in the Articles of Association would be that in the event of the company seeking to act outside those objects, a dissenting Director or a Shareholder could take steps to prevent the Company from acting outside those objects. Section 17 provides that restrictive objects however do not affect a third party acting in good faith with the Company and such a party would have a perfectly valid and binding contract with the Company, notwithstanding the fact that the Company has acted outside its objects. There is however a distinction between acting outside ones objects and a person who is not duly authorized entering into a transaction on behalf of the Company. In the latter event a third party may not get a valid contract with the Company.

If a Company which has objects changes its objects and the proposed alteration imposes or removes a restriction on the business or activities in which a company may engage in a minority shareholders is entitled to invoke his minority buy out rights and the Company would be required to purchase his shares at an agreed price, failing which a price considered fair and reasonable by the Auditors or failing which a price determined by Court.



Notwithstanding the removal of the rule of *ultra vires* and the additional protection which it gives to third parties the requirement that a major transaction requires to be approved by a special resolution of the shareholders has created new challenges for third parties. In start up situations almost every transaction could be a major transaction and the consequences for third parties in the event a Company not complying with the same is not specifically mentioned in the Act.

Names of Companies and Contracts

A Private Limited Company could in addition to the current '(Private) Limited' use the abbreviated form of '(Pvt) Ltd.'. Similarly, a Public Company could use the term 'Ltd.' instead of the current 'Limited' at the end of its name. In the case of a Public Quoted Company, the name should end with either the words 'Public Limited Company' or 'PLC.'.

It is a mandatory under Section 12 that in addition to the name of the Company that the company number be used on all business letters of the Company, all notices and other official publications of the Company, bills of exchange, promissory notes, cheques, orders for goods, invoices, receipts and letters of credit and any other document which creates or evidences a legal obligation of the Company.

In terms of the Act there is no compulsion for the Company to have a company seal. Section 19 provides that a notarially attested instrument needs to be signed by either two Directors, a Power of Attorney holder or some person specifically authorized by the Articles. A normal contractual document could be signed by any person acting under the company's expressed or implied authority.

Section 24 of the Act provides for pre incorporation contracts, which are entered into by the promoters of the Company to be valid and binding on the Company if ratified by the Company after incorporation. The ratification should take place within the times specified in the contract and if no time is specified within a reasonable time after the incorporation of the company.

Capitalization of Companies

The Act has several new features with respect to the capitalization of Companies. These aspects have resulted in several controversies and there are several areas such as bonus issues, share splits, repurchase of shares and reduction of stated capital where there are either gaps or inconsistencies in the Act. The interpretations given by the Registrar as well as those given by the Colombo Stock Exchange have not been conclusive and various stakeholders are still groping in the dark with respect to these matters.

Section 49(4) of the Act specifies that no share in a Company shall have a nominal or par value. This does not result in any change to the concept of a share as understood in Company Law and the only major significance of not having a par value is that the connection between the number of shares in issue and the issued share capital account (referred to as stated capital in the Act) is no longer a multiplication of the number of shares by the par value.



Section 52 of the Act provides that before issuing any shares the Board should decide the consideration for the issue and resolve that in its opinion the consideration is fair and reasonable to the Company and to all existing Shareholders. Section 58 provides that the term 'Stated Capital' in relation to a Company means the total amounts received or due and payable to the Company in relation to issue of shares or in respect of calls on shares. Consideration for the issue of shares includes not only cash, property and services, but also 'future services'. At present the view seems to be that the value of the unperformed service for which the shares have been issued should be shown as a current asset/ long term asset and be written off to the profit and loss account as and when rendered.

The new Act provides for a much more liberal regime of returning capital back to its shareholders, than what was available under the Companies Act No. 17 of 1982. A Company can repurchase its shares in terms of Section 64 of the Act, if the Board resolves that the acquisition is in the interest of the Company, the terms of the offer are in the opinion of the Company's Auditors' a fair value and the Board is not aware of any facts which would be material to the value of the share which is not known to the Shareholders accepting the offer. A Shareholder is not compelled to give up his shares on a repurchase. In the event of there being an offer to repurchase to some but not all to the Shareholders, the Board must also resolve that the making of the offer to only some person is not unfair to those to whom the offer is not made. The accounting treatment for a share repurchase in most jurisdictions would involve a debit to the stated capital account either for the entirety of the consideration paid out on the repurchase or at least partly with the balance being debited against reserves. This however has raised a further issue whether Section 64 can be worked out on its own independently of Section 59 since any repurchase would result in a decrease of the stated capital. The latter section requires a special resolution by shareholders and 60 days public notice for any reduction of the stated capital. Since the accounting treatment for redemption of shares is identical a similar issue arises with regard to redemptions as well.

A Company can also reduce its stated capital in terms of Section 59 of the Act to such amounts as it thinks appropriate by way of a Special Resolution. Public notice of not less than 60 days must be given of the proposed reduction prior to the resolution being passed. This regime for reducing the stated capital is much more liberal than what was contained in the Companies Act No. 17 of 1982, which required Court confirmation of any capital reduction scheme. However the Company can enter into a written agreement with any creditor not to reduce its stated capital and any reduction in contravention of such agreement would be invalid and of no effect.

Redeemable Shares under the Act are not confined to Preference Shares and accordingly Redeemable Ordinary Shares could now be issued as well. The Act draws a distinction between shares which are redeemable at the option of the Company and shares which are redeemable at the option of the holder or on a date specified in the Articles. In the former case, the redeemable shares are treated more like equity and in the latter cases they are treated more like debt. In the event of Section 59 being applicable to redemptions the principle of treating the latter cases as debt also becomes impractical in view of shareholder approval having to be obtained to make the payment.



Distributions to Shareholders and Solvency Test

'Distribution' is defined as the direct or indirect transfer of money or property, other than the shares of a Company to or for the benefit of a shareholder or the incurring of a debt to or for the benefit of a shareholder. Accordingly, any payment of a dividend or redemption of a share or a repurchase of a share would fall within the definition of a distribution.

In the event of there being a distribution, there is a requirement for the solvency test to be satisfied. A Company shall be deemed to have satisfied the solvency test if it is able to pay its debts as they become due in the normal course of business and the value of the Company's assets is greater than the value of its liabilities and its stated capital. The Board should take into account the most recent audited financial statements and any circumstances which they know or ought to know which affects the value of the Company's assets and liabilities. Furthermore, they may take into account a fair valuation or other method of assessing the value of assets and liabilities. This grants the Board a discretion with respect to principles of fair value accounting or other method of assessing value in determining whether the solvency test has been satisfied or not. The members of the Board who vote in favour of the distribution would have to sign a certificate that in their opinion the Company will satisfy the solvency test immediately after the distribution is made and the Auditors too would need to issue a certificate of solvency for the distribution to be made.

The term 'able to pay its debts as they fall due in the normal course of business' seems to be very wide in its application. However based on similar terminology used in other jurisdictions in a legal sense it may not mean much more than an assertion that the going concern assumption is not in doubt immediately after the distribution is made.

In the event of a distribution having being made without the solvency test being satisfied, the Company could recover the distribution from the shareholders, failing which every Director who authorizes the distribution could be personally liable for such distribution.

The regime for the payment of dividends is more strict than other distributions since it has not only to satisfy the solvency test, but it must also satisfy the requirement that the dividend could only be distributed out of the profits of the Company.

The Act as well as current thinking on principles of accountancy either disregard or downplay the differences between capital reserves and revenue reserves and it is likely that both such categories would henceforth be referred to as reserves.

Financial Assistance for the purchase of Shares

The Companies Act No. 17 of 1982 contained a general prohibition on the grant of financial assistance for the purchase of shares. The only exceptions permitted were the loans granted to employees for the purpose of such purchase, employee share ownership schemes and loans



granted by companies if its normal business included the granting of such loans. The new Act contains the same general prohibition but it provides a much more liberal regime for companies to grant financial assistance. Accordingly, financial assistance could be given if the Board has resolved that giving such assistance is in the interest of the Company, the terms and conditions in which assistance is given is fair and reasonable to the Company and to any shareholders not receiving such assistance and the Company which satisfy the solvency test. The exceptions contained in the previous Act are also applicable.

Amalgamations

The new Companies Act has much more liberal provisions with regard to amalgamations and no Court approval is required, unlike in the case of the previous Act. Two or more companies may amalgamate, provided that the shareholders of each of the companies have passed a Special Resolution to that effect and the amalgamated company will after the amalgamation satisfy the solvency test. The Board of each Company is required to prepare an amalgamation proposal setting out the matters specified in Section 240 of the Act and public notice should be given of such amalgamation at least 20 days before the amalgamation takes effect. The amalgamation proposal must be made available to every secured creditor of the Company and should be available for inspection by any shareholder, creditor or any person to whom the amalgamated company owes an obligation. Such a person can request for such proposal and is entitled to be supplied free of charge any such proposal.

A shareholder who is against the amalgamation is entitled to invoke his minority buy out rights and the Company would be required to purchase his shares at an agreed price, failing which a price considered fair and reasonable by the Auditors or failing which a price determined by Court.

If a creditor is of the view that an amalgamation proposal would be unfairly prejudicial to it, it could seek an Order from Court that the proposal should not be carried through.

Potential Insolvency and Serious Loss of Capital

Section 219 of the Companies Act requires a Director of the Company who believes that the Company is unable to pay its debts as they fall due, to forthwith call a meeting of the Board to decide whether the Company should continue or be wound up. If the Company is continued and is subsequently liquidated, all Directors other than those who voted in favour of the winding up would be liable for the loss suffered by creditors. This Section has very serious consequences for Directors *vis a vis* creditors and it is imperative that the procedural requirements as well as the assessment of its ability to pay debts is done correctly by the Directors in a timely manner. It is arguable that the term 'unable to pay its debts as they fall due' in this section should be given a more long term perspective than the term 'able to pay its debts as they become due in the normal course of business' which is provided for in the solvency test in Section 56 since the latter is dealing with a more short term issue than the former.



Section 220 of the Companies Act provides that if it appears to a Director that the net assets of the Company are less than half its stated capital, the Board should convene an Extraordinary General Meeting of the Shareholders. The notice calling the meeting should be accompanied by a report which advises the shareholders of the nature and extent of losses, the cause of the losses and the steps being taken by the Board to prevent such losses. The shareholders should be given a full opportunity of discussing the matters contained in such report. It should be noted that this section is entirely a shareholder issue and a breach thereof is not a matter which would by itself create any obligations to creditors.

Major Transactions

Section 186 of the Act provides that the Company shall not enter into a major transaction unless approval has been obtained by way of Special Resolution for such transaction or the transaction is subject to such approval or the transaction is expressly provided for in the Articles.

A 'major transaction' has been defined as an acquisition or disposal involving more than half the value of the assets of the Company or the acquisition of rights or obligations amounting to more than half the value of its assets or transactions which have the purpose or effect of substantially altering the nature of the business carried on by the Company. In the event of there being a major transaction, a minority shareholder is entitled to invoke his minority buy out rights and the Company would be required to purchase his shares at an agreed price, failing which a price considered fair and reasonable by the Auditors or failing which a price determined by Court.

Ranking of Claims

The position with regard to the secured creditor and its priority in respect of the secured asset has been clarified in the Act. Under the previous Act there was considerable uncertainty as to whether the claims of the secured creditor in respect of the proceeds from the secured assets were to rank in priority to preferential payments which were specified in the Act. This position has now been clarified and the priority of the secured creditor is established subject however that that employees' provident fund dues, employees' trust fund dues and gratuity dues which have become due prior to the creation of the security, fines for the commission of an offence, monetary penalties payable to the Government and costs in court proceedings would rank in priority to the claim of the secured creditor.



Private Company Dispensations

The Second Schedule to the Act contains a list of sections which would not be applicable to private companies if there is unanimous consent of its shareholders to that effect.

This list includes the following

- Consideration for the issue of shares
- Distributions
- Purchase of own shares
- Restrictions on giving financial assistance
- Major transactions
- Restrictions on loans to Directors

The reference to distributions above only exempts such a company from following the procedural formalities relating to the distribution but the liabilities attaching to the shareholders and the Directors from an improper distribution remain.

Conclusion

The new Companies Act have several provisions which are challenging to the banking community such as the more liberal provisions relating to distributions. It also provides many new opportunities with respect to recapitalizations such as repurchases of shares and financial assistance for the purchase of shares which could open up new lines of business and funding opportunities in a relatively low interest rate environment. The entire focus of the Act of permitting the Directors to carry out the affairs of the Company more freely whilst holding them more responsible is also likely to lead to better corporate governance practices within Companies which could be beneficial to creditors at large. Going forward the analysis of a company is likely to be a much more complex proposition for the banking community and more safeguards would need to be built in banking documentation so that it is not surprised by transactions which could be carried out by Companies which were hitherto not permitted under the previous Act.

References

1. Companies Act No. 7 of 2007
2. Companies Act No. 17 of 1982
3. Morrison's Company and Securities Law (Butterworths, Wellington, 2001)