Companies Act: Stakeholders at Risk?

(Section 487 of the Companies Act No. 7 of 2007)

October 2009

Position Paper

The registration of companies is a key means to ensure accountability in the private sector. An accurate and updated registry enables the state to monitor companies' compliance with a country's laws and regulations. Sri Lanka's new Companies Act No.7 was passed by Parliament in October 2006 and became operative in May 2007. Its Section 487 aims at cleaning up the Companies Register by removing all non-operating companies.

This position paper discusses the shortcomings in Section 487. It argues that some provisions in the section provide room for abuse, and actually contravene the very essence of the Companies Act, i.e. to ensure the survival and continuity of a corporate entity as opposed to securing its demise. It also highlights low compliance with the Act, and provides recommendations for all stakeholders on how to overcome the loopholes in the Act.

Section 487 of the Companies Act No. 7 of 2007

487. Provisions relating to company numbers of existing companies &c.

1) *Subject to the provisions of subsection (2), the number which an existing company has been assigned by the Registrar for administrative purposes, shall be the company number for that company.*

2) *Within a period of twelve months from coming into operation of this act, all existing companies shall apply to the Registrar to assign a new number as its company number, in a form as may be prescribed by the Registrar. The new number so assigned shall be entered in the register and also on the fresh certificate of incorporation to be issued under the provisions of subsection (6) of section 485.*

3) *Where an existing company fails to comply with the requirements imposed under subsection (2) of this section within the times specified therein, the Registrar shall cause to be published the name of such company in a daily newspaper in the Sinhala, Tamil and English language, and where such company continues to fail to comply with those requirements thereafter, the Registrar shall, within six months of the publication of its name in the newspapers, strike off the name of such company from the register maintained by him under the provisions of section 473.*

4) *During the period of six months referred to in subsection (3), in addition to a Director of the company, a shareholder of such a company or a person who has registered a charge under section 102 or a person who has a money claim pending before a Court or in arbitration proceedings, shall also be entitled to apply to the Registrar to have a new number assigned to such company under subsection (2)*

5) *Where a company's is struck off from the Register under subsection (3), all property and rights whatsoever vested in or held on trust for the company immediately before the date on which the name is struck off (including leasehold property but not including property held by the company on trust for any other person), shall vest in and be at the disposal of the state.*

Background

Company Law in Sri Lanka has been governed mainly by the following four Acts introduced during the British rule and thereafter enacted by the Parliament of Sri Lanka;

1) Joint Stock Companies Ordinance No 4 of 1861
2) Companies Ordinance No 51 of 1938
3) Companies Act No 17 of 1982
4) Companies Act No 7 of 2007

The law was chiefly structured on the English model. England however, drastically amended its Company Law in 1985, 1989 and in the nineties. Lamentably, they were not accordingly adopted in Sri Lanka. Sri Lanka continued to have the English Law of 1948 in its statute books even in 2006. Sri Lanka was thus 58 years behind and the winding-up rules followed were based on the 1938 Ordinance.[i]

In the 1990's, Sri Lanka started a process of reforming its Company Law to keep in line with global developments and to meet the demands of the corporate sector and the Chambers of Commerce. In 1993 an Advisory Commission on Company Law in Sri Lanka was set up with the assistance of international donor agencies and guided by Mr David Goddard, a senior practitioner and scholar in New Zealand. Views of the public and corporate sectors were obtained and the draft law was modeled using the Company Law of New Zealand.[ii]

In this context, section 487 of the Companies Act No. 7 of 2007 was enacted for the express purpose of re-registering all companies in order to:

- eliminate all dormant and non operational entities from the Companies Register estimated at over ten thousand causing a major backlog in monitoring and inefficient operations of the department;
- rid the Register of ineffective filing processes which now inhibits effective public probing and ready access to information for better enforcement and improved efficiency;
- facilitate computerization of the entire system of registration and records management.

Current status of registrations

Companies are registered under the above mentioned enactments as below:

Governing Act	No. Of Companies Registered	Percentages (%)
Joint Stock Companies Ordinance No 4 of 1861	823	1.09
Companies Ordinance No 51 of 1938	10,470	13.88
Companies Act No 17 of 1982	55,203	73.17
Companies Act No 7 of 2007	8,951	11.86
Total	75,447	100
Total private companies	66,986	88.8
Total public companies	3,280	4.3
Total guarantee, foreign and offshore companies	5,181	6.9

Source: Registrar of Companies - data up to 1/6/2009

However, not all registered companies may be operational. Regrettably, information on the number of operational companies submitting Annual Returns in terms of the provisions of the Companies Act is not available at the Department of Registrar of Companies.

Since the Act was passed in October 2006, the Registrar has received 24,623 applications for re-registration, and has processed 22,300. Re-registration was completed and certificates issued for 14,900 companies. Out of these, the large majority was private companies (13,409), the balance were public companies (950), public quoted companies (208) and others (333).[iii]

Thus out of the 66,496 registered companies under the Acts enacted prior to the 2007 Act, only 37% have sought to re-register in terms of the provisions of Section 487. Furthermore only 208 quoted public companies have sought re-registration, whilst the Colombo Stock Exchange has 235 companies in its list of quoted companies.

These statistics prove that 63% of all companies entitled to re-register under section 487 have failed to do so. This may be due to lack of awareness, dormant and non-operational companies seeking a simple method of winding up, or wilful actions of directors and officers in avoiding re-registration.

Analysis of the Pitfalls of Section 487

The following analysis is based on 30 interviews conducted in June 2009 with leaders of Business, Lawyers, Bankers, and Journalists, members of Regulatory Authorities, Professionals, Chambers and Good Governance championing civil society leaders, as well as desk research. Pitfalls are found in the provisions of the Act itself as well as in the process of formulating the law, and in its implementation. This analysis reflects the questionable inclusion of Section 48 and is ample reason to suggest a hidden agenda behind this inclusion.

Striking companies off the registry

According to interviewees, the major loophole in Section 487 was its provision for the process of striking companies off the registry. When an entity is struck off the Companies Register in terms of section 487, it automatically extinguishes the legal status of the company. Consequently, Section 487 appears, prima facie, to be in conflict with the underlying principles of the Act, i.e. to ensure the survival and continuity of a corporate entity as opposed to securing

its demise. Thus, Section 487 which empowers the Registrar to strike off an existing company due to the possibility of an unintentional corporate administrative/procedural failure to re-register, may require, in principle, to be construed and implemented to be in accord with such overall legislative intent, and not contrary thereto. Section 487 also does not correspond to the provision in the previous Companies Act where the striking off of a Company required a prior legal process by the Registrar. It is noteworthy that the Discussion Draft Companies Act prepared with the assistance of Mr Goddard, which was reviewed extensively by professionals and business chambers, did not contain any reference to the intent to include a striking off provision as set out in section 487.

In view of the abovementioned likely detrimental effects of improper implementation of the Section, the Registrar of Companies needs to ensure that the striking off action requires being subject to concurrent investigative procedure into the operational and financial status of the entity in question.

Lack of awareness (on the provisions of the Act)

The level of awareness of the need to re-register appears to be low. Stakeholder interviews revealed that the process to be followed by stakeholders entitled to seek re-registration was not widely understood. The legal due process related to notices published by the Registrar of his intent to strike off companies in terms of Section 487 was seen as reader unfriendly and ineffective in communicating the potential impact on the stakeholders. From the perspective of stakeholders, the advertisements were not effective in drawing due attention to the consequences of striking off of a company. The notices are user unfriendly and there has been little prior awareness building amongst the stakeholders by the Registrar, Professional Groups and the Media. These bodies apparently have paid scant attention to their public duty.

It was evident that even professional law firms, banks and professional firms offering accountancy and secretarial services had, in the first instance, missed several of the notices published by the Registrar. In addition, the fiasco with the first set of notices including several companies which had already obtained re-registration made the credibility and public confidence in the process fail.

Low levels of stakeholder engagement (during law reform process)

Interviews also revealed low levels of stakeholder engagement in the law reform process. Review of the draft law was extremely low and was not supportive of safeguarding stakeholder interest. Although a number of seminars were held by professional associations and Chambers of Commerce during the reform process and after enactment, these were mainly targeted for knowledge enhancement of a select group of professionals and corporate executives, mainly resident in Colombo.

Lack of recourse for defrauded stakeholders

Many of the stakeholders likely to be impacted have no recourse through the Companies Act to prevent errant business persons and directors of companies from misusing the section to defraud. Nor are they able to take remedial measures if they have been unjustly defrauded.

However, a minority of those interviewed felt that this section was created with sufficient

safeguards in place under subsection (4) to prevent misuse. There was also significant mis-interpretation of subsection (4) within this group of persons. They felt that this safeguard enabled any creditor or regulator to call for re-registration. These persons also believed that the process of notifying in newspapers in all three languages was an adequate form of communication and was far superior to the alternative which was a gazette notice. They also felt that public should take an active role in protecting their interests and should not "sleep on their rights". Many of them used the philosophy that **"**Ignorance of the Law Is Not a Defence" to support their stance and felt that protection offered by alternative legislation such as those under civil and criminal law would deal effectively in eradicating any corrupt practices.

A leading constitutional lawyer put forward the poignant question of whether this section would have passed judicial scrutiny on its constitutionality had it been challenged at the opportune time on the grounds that the state was acquiring property from the victims without compensation and without following a transparent due process and would thus be a violation of their right to property.

Scope for abuse

Interviews also revealed that Section 487 leaves significant opportunities for errant directors and controlling shareholders to avoid and evade liabilities and penal sanctions, due to the fact that when a company is struck off the register it ceases to be a legal entity and therefore action cannot be brought against it thereafter. This contravenes the original idea of the Commission that the provision to vest assets of non-compliant companies in the state would prompt stakeholders to voluntarily seek re-registration. However, it appears that fraudulent entities can deliberately non-register in order to escape financial liabilities, legal obligations, potential investigation and consequential penal sanction.

At the same time, a company which is genuinely operating may also be struck off under this section due to the lack of awareness or disinterest on the part of directors and officers, to the detriment of its stakeholders. Fully operational entities can be unjustifiably struck off the register on account of mere oversight to register.

Interviews also pointed at the possibility that legal, tax and accountancy professionals may advise their clients on the opportunity to misuse this section. It is possible that some companies have in fact used this provision to their advantage by using it to cover up fraudulent activities and remove potential risks of investigation and consequential penal sanction.

The following are some hypothetical examples of opportunities for abuse:

- An unregistered deposit taking institution with a rural market focus could use this section to avoid liability to depositors.
- A company (engaged in teakwood plantations) with long term delivery commitment could use this section to avoid liability to customers.
- A company with a major contingent liability on account of tax consequent to the revocation of the tax amnesty related law may attempt to benefit from this section.
- A company with a significant potential customs/excise duty liability may not seek re-registration

- A company with significant overseas property and liquid assets may plan not to seek re-registration
- A company with issues relating to solvency and serious loss of capital in terms of the Companies Act may use this provision, if they fail to raise the required capital.
- Any company with potential risks of prosecution by authorities, such as the Financial Intelligence Unit, for money laundering may use this section to disappear into anonymity.
- Any company with potential risks of investigation or prosecution by law enforcement authorities (eg. having traded in narcotics or terrorism related activities) may use this provision to be struck off in order to prevent further probing.
- Any company with potential risks of fraud or mismanagement may wish to avoid a liquidator led probing and consequential action and use the striking off provision as a means of eliminating such risks.

How the State could be defrauded by the Misuse of Section 487

Governmental agencies

Tax, Customs, Excise and even Municipalities and other state institutions with pending claims or having the potential options for future claims will have no recourse if an entity to be so charged is found to be already struck off, especially in the context of the low intra unit networking, low awareness and non diligent follow up on advertisements by state agencies.

Law enforcement officers/regulatory action

The Regulators wishing to pursue action against errant and corrupt entities may find them to be nonexistent having been struck off in terms of the provisions under section 487. Violation of regulations and other illegal practices cannot, in these instances, be proceeded against.

Finally, discussions with stakeholders also revealed that some of the pitfalls identified in this paper had in fact been debated by the Advisory Commission. It is unfortunate that these problems have not been rectified at an earlier stage.

Victims of Potential Misuse

It is apparent that all stakeholders of a company may be potential victims of misuse of the Section and thus may stand to lose by deceitful actions of directors and officers who may leverage the opportunities available through this Section. Below are hypothetical scenarios that depict the potential for abuse with negative impacts on different stakeholders;

Lenders and depositors

- Where lenders and depositors are not aware or have no registered charges and are unable by themselves to seek re-registration, they are susceptible to lose significant value if the borrowing company takes advantage of Section 487.

Suppliers and creditors

- Where suppliers and creditors are not aware or have supplied goods and services without knowing the date of striking off by the Registrar and are unable by themselves seek re-registration they are susceptible to lose significantly.

Employees

- Employees who are unaware of the pending striking off of a company and have no pending arbitration or proceedings before a tribunal and are unable to enforce registration will stand with no contract and with no recourse after the company has been struck off.

Customers

- Customers with unfulfilled contracts including long-term contracts and those who have paid advances will lose and be without recourse. If a company is struck off the register without due notice customers with long term warranty and service commitments stand to lose out.

Shareholders

- Shareholders who believe a company is genuinely operating and have no part in management and are limited to only receiving dividends could suffer as a consequence of misuse of the Section. Where shareholders or directors have been overseas for a significant period of time and are unaware of Section 487, their assets could be taken away and be vested in the state.

Alternative Methods of Achieving the Aims of Section 487

1. The Registrar of Companies or any person or persons or a body corporate nominated by the Registrar of Companies could have been assigned the duties, responsibility and accountability of a liquidator / administrator in terms of the Act, of all companies identified for striking off in terms of Section 487. The Registrar is thus empowered to outsource the tasks of liquidation and this alternative does not become a constraint on his limited resource capacity.
   The drafters could have thus effectively entrusted the Registrar of Companies or his nominees with wide powers to look after the interests of shareholders and creditors, the government, employees and customers etc before striking off a company from the register. This would have given the option to the Registrar to strike off dormant companies by liquidation having followed a due process to assure that all stakeholders are treated fairly and also to proceed against any errant directors before vesting any residual assets in the state.
2. In the first instance, instead of striking off a company name from the register, the Registrar could have created a list of non operating companies and these companies could have been separately listed within the Register. This would have limited the resource needs for regular review of these entity related files. The relevant files could have been sent for external storage by an outsourced party. This would enable action to be brought against the company if such action was deemed necessary at any stage or a file opened for re-activation, liquidation and or striking off after a due process.
3. Due process for striking off of dormant and non operating companies could have been attempted in terms of section 394 of the Companies Act of 2007.

TISL recommendations

TISL believes that urgent action is needed to prevent misuse of Section 487. The State, the Registrar of Companies, regulatory bodies as well as the private sector and civil society should work together to reformulate the law and ensure proper law enforcement.

Registrar of Companies

1. The Registrar should do the following administrative steps to implement Section 487 effectively:
   - To write to directors requesting the submission of an affidavit stating that the company has no outstanding liabilities, nor contingent liabilities on account of potential claims from stakeholders, including Revenue Authorities, Regulatory Agencies and Law Enforcement Agencies. Any company able to provide such an affidavit may be deemed by the Registrar as being a company genuinely and transparently seeking to benefit from the provisions of Section 487. This process can be further supported by the submission of an affidavit or an extract of a special resolution passed by shareholders affirming that they have no objection to the company being struck off the register.
   - To inform the relevant Regulatory Authorities where a regulated entity has not applied for re-registration.
   - All Revenue Authorities to be notified by the Registrar of entities failing to seek re-registration
   - The present practice of the Registrar of writing 3 letters to the company, the company directors and the secretary in terms of Section 394 should be continued post the advertisement in the newspapers.
   - To call for a statement on the state of affairs and the assets and liabilities of the company as last audited by the declared auditor of the company.

2. The Registrar should expand the explanatory note in the newspaper notices in order to make the communication more easily understood by laymen.

3. The Registrar should take steps to gain information of registered assets of companies notified for striking off under Section 487 by making appropriate inquires with Banks, Land Registry, Registrar of Motor Vehicles, Registrar of Trademarks, Register of Charges (for assets mortgaged) and the CDS (for shares). Once he receives details of the registered assets, the Registrar can prima facie assess whether the non re-registration maybe mala fide and make inquires of the company, its directors and secretary. This will enable and support the process of the remaining assets being vested in the state.

4. The Registrar must review with experts (Advisory Commission appointed in terms of section 506) the issues and barriers likely to be encountered in appropriating assets held overseas of companies which have been struck off the register.

State

5. Assets vested in the state should be converted to money and such funds should be maintained in a pool dedicated to compensate those stakeholders who have genuine claims.

6. The state must provide legal aid for those persons who have been victims of misuse of Section 487, for recourse to be sought through alternative legislation, and civil and criminal action must be brought against those who defrauded them.

7. The state should consider the following amendments to Section 487:
   - Empower Regulatory Authorities (Central Bank, Securities & Exchange Commission, Insurance Board, etc) and Revenue Authorities (Inland Revenue, Customs, Excise,) to seek re-registration
   - Consider relevant sections from the New Zealand Companies Act for adaptation as appropriate in local context[iv]
   - Give the Registrar the right to reinstitute a company where revenue fraud or frauds on stakeholders are deemed to have taken place. This could be achieved by bringing back the proviso as stated in Section 394 (6) of the Companies Act No. 7 of 2007 within the ambit of Section 487
   - Give power under the Companies Act to deal with fraud by directors or officers done prior to striking off by enacting a provision similar to that of the provison in section 394 (5).
   - The Act should allow for class action as well as individual petitions in respect of section 487.
   - Section 528 holds that the Sinhala version of the Act will prevail as to any inconsistency. The intent behind Section 487 and other sections should be assessed in order to ascertain if it has been represented correctly in the Sinhala version of the Act. Corrections must be made to all three language versions of the Act to rectify any discrepancy.
8. The state should ensure that any new Act or changes to an Act which results in potential for misuse to the detriment of stakeholders, government revenue, regulatory control or effective law enforcement, be subject to greater public review and debate prior to enactment. For this purpose publication of white/green papers and awareness building seminars and debate with the active involvement of media, professional groups and civil society representatives should be arranged as a prerequisite.

Non-governmental organisations and Private Sector

9. The Legal Aid Commission and other voluntary organisations with similar objectives should support those wishing to obtain protection from misuse of Section 487 by establishing legal claims within the prescribed period.

10. Chambers and other professional bodies should increase awareness of stakeholders on the potential implications of Section 487:
    - Launch a media communications programme in all three languages, including question and answer type presentations.
    - Arrange Chambers including Regional Chambers, Professional Associations (OPA, Bar Association etc.), Accountancy / Secretarial and Tax Professionals, Rotary / Lions and other Social Clubs to build awareness, across the island, through meetings, seminars and member communications.
    - Promote Banks Association (SLBA) to alert all account holders of banks.
    - Develop examples of potential misuse situations for publicity through the awareness programmes, as well as for publication and distribution.

11. Professional Associations (Chambers, Directors, Attorneys, Auditors, Accountants and Tax Advisors etc) should promote their codes of ethics and conduct, and by a special directive require that members should not misuse the provisions of Section 487 (duly recognizing the limited application of the directive).

12. In the recent past, Public Interest Litigation (PIL) led by high profile judgements of the Supreme Court has extended the scope as well as the applicable prescriptive periods. It has also given a new meaning to 'locus standi'. In the context of these changes, the private sector and the chambers, should review its applicability of the legal maxim 'frauds unravel all" whereby risks of businesses, directors and officers may extend into the future if they have fraudulently made use of the loophole in the law enabled by Section 487.[v]

Regulatory authorities

13. The SEC, Insurance Board and Central Bank must suspend the operations of and give due publicity to any regulated entity which has failed to register, as soon as the period of re-registration expires and prior to newspaper advertisements.

14. Regulatory Authorities to notify relevant stakeholders where any regulated entity has not sought re-registration and give publicity of such notice.

15. Regulatory Authorities must vigorously pursue those who have wilfully defrauded the state and the full force of civil and criminal sanctions must be enforced against errant directors and officers.

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I. *Dr. Harsha Cabral PC: Companies Act No.7 of 2007 and the corporate law of Sri Lanka*

II. *The chronology of events in the reforms is as follows:*
    - *The Advisory Commission on Company Law - 1993*
    - *The Key Areas of Company Law Reform Discussed – 1994*
    - *The Consultation Draft of 4th September 1995*
    - *The Discussion Draft of 1997*

- *The Ten Position Papers*
- *The Draft Act – L.D 7/1999*
- *The Draft abandoned – 2002/2003*
- *The Advisory Commission on Company Law – 2004*
- *The Draft Act – 2005*
- *The Companies Bill – 2006 – L.D. – 0.44/2005 gazetted on 19th May 2006*
- *The Companies Act No.7 of 2007 passed by Parliament on 20th October 2006 and operative from 3rd May 2007*

III. *Registrar of Companies accessed on 1/6/ 20*

IV. *Extract from the* New Zealand Companies Act:

(2) A request that a company be removed from the New Zealand register under subsection (1)(d) of this section may be made on the grounds—
(a) That the company has ceased to carry on business, has discharged in full its liabilities to all its known creditors, and has distributed its surplus assets in accordance with its constitution and this Act; or
(b) That the company has no surplus assets after paying its debts in full or in part, and no creditor has applied to the Court under section 241 of this Act for an order putting the company into liquidation.
(3) A request that a company be removed from the New Zealand register under subsection (1)(d) of this section must be accompanied by a written notice from the Commissioner of Inland Revenue stating that the Commissioner has no objection to the company being removed from the New Zealand register. (Extended to included Customs, Excise, as well) and the relevant regulatory body in the case of regulated entities (Central Bank, Insurance Board, SEC, etc)

Objection to removal from register

(1)Where a notice is given of an intention to remove a company from the New Zealand register, any person may deliver to the Registrar, not later than the date specified in the notice, an objection to the removal on any one or more of the following grounds:
(a) That the company is still carrying on business or there is other reason for it to continue in existence; or
(b) That the company is a party to legal proceedings; or
(c) That the company is in receivership, or liquidation, or both; or
(d) That the person is a creditor, or a shareholder, or a person who has an undischarged claim against the company; or
(e) That the person believes that there exists, and intends to pursue, a right of action on behalf of the company under Part 9 of this Act; or
(f) That, for any other reason, it would not be just and equitable to remove the company from the New Zealand register.

V. *It reflects an old legal rule that fraud unravels all: fraus omnia corrumpit. Once fraud is proved, "it vitiates judgments, contracts and all transactions whatsoever": Lazarus Estates Ltd v Beasley [1956] 1 QB 702 at 712, per Denning LJ*

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