# NEW COMPANIES ACT

Executive Summary

සංවාද
SANVADA
சம்வாதம்

Publication 05

## Introduction

The Companies Act No. 7 of 2007 [hereinafter the "Act"] marks a significant milestone in the development of the company law in Sri Lanka for many reasons. Firstly, it results in a significant paradigm change in the foundation of company law by moving away from its traditional affiliation to the company law in England and aligning itself to a legal system based on a model that exists in Canada and New Zealand. Secondly, it introduced several crucial changes by eliminating some fundamental concepts that had formed the essence of our company law, and substituting other concepts in their place. Thirdly, it results in modernizing company law in Sri Lanka, and at least theoretically, placing it ahead of its counterpart laws in the rest of South Asia. Though there are positive aspects to the law, it is not without defects. The Act has been widely criticized, not only for its content, but also the manner in which it was formulated and adopted. These factors necessitate a critical examination of the substance of the Act and the process by which it was adopted.

Company law in Sri Lanka has traditionally been based on the law of England. In 1982, Sri Lanka adopted the Companies Act No. 17 of 1982. This law was, however, based on the English Companies Act of 1948, thus resulting in the adoption of a law which was outdated by at least four decades, even at birth. In the late 1980's and the early 1990's there was a marked increase in the commercial and economic activity in the country, resulting in intense pressure being made on the resurrection of its dormant capital and financial markets. Although the Government took several measures to improve the operational and regulatory infrastructure to facilitate such development by means of encouraging the restructuring of the Colombo Stock Exchange, the establishment of the Securities and Exchange Commission and other complementary bodies such as the Sri Lankan Accounting and Auditing Standards Board, and the implementation of an aggressive privatization program, no corresponding developments were made in respect of company law. This often led to problems for the private sector i.e., the "engine of growth". Though forced to compete for financing on commercial terms, the private sector was required to be innovative in formulating modern financing techniques. Additionally, the law was also required to provide adequate comfort to the investors that their interests would be preserved. However, the law often proved to be lacking in these respects. Eventually, in or around 1993, the government was compelled to address this problem by commissioning the formulation of a new Companies Act.

One of the initial issues that had to be confronted in formulating the new law was the selection of a model on which it could be based on. Although the natural and popular inclination was to base it on English Law, there were several factors that decided otherwise, and the Act was finally based on a model which was closely aligned to the 1993 Companies Act of New Zealand.

### Issues arising during the passage of the law

When the original consultation draft of the Act was released for public comment in 1995, it immediately ran into a storm of opposition. Apart from objections to various substantive provisions in the draft, vehement objections were also raised to the suggestion that our company law depart from its affiliation to English Law. The debate raged on for over twelve years. Consequently, it was only in May 2007 that the law was finally passed in Parliament. Although the law is now in operation, there remains a considerable amount of concern on the procedures that were followed in adopting the law; certain substantive provisions in the law; and the lack of preparation for the implementation of the law.

pathfinder Foundation

## Procedural concerns

One of the fundamental concerns that were highlighted during the process of formulating the law and its eventual enactment was the lack of inclusion, consultation and transparency. When the original drafts of the law were being formulated, there was a serious concern that 'stakeholders' opinions were excluded in determining the selection of a model for the new law. Though there was a justification for identifying New Zealand law as the eventual model, it was believed that due consideration should have been given to the fact that the "market" was accustomed to English Law. Had this fundamental issue been recognized and proper consultation been engaged in, much of the opposition to the law could have been avoided and more focus could have been placed upon its substantial issues.

Additionally, the failure of the authorities to effectively address public concerns on the law and to create sufficient awareness regarding the need for the law and its benefits also stood out during this process. The third facet to this process was the reaction of policy makers to criticism. Faced with intense criticism, the Company Law Advisory Commission, which had by then taken over the responsibility of ensuring the passage of the law, withdrew the drafts from circulation in what was widely perceived as an effort to prevent further criticism of the drafts. Withdrawal of the drafts at a crucial point prevented comprehensive discussion on the substantive provisions of the law prior to its enactment by Parliament. The law in itself was rushed through Parliament and made operative without sufficient lead time for the market, the industry, regulators and other stakeholders to implement necessary infrastructure to deal with and comply with the new requirements.

Additionally, there was no attempt whatsoever to adapt or harmonize other laws and regulations, such as the listing rules of the Colombo Stock Exchange, which were complementary to the Companies Act, prior to the operation of the Act. These failures resulted, and in many instances, continue to result in severe hardship and inconvenience to stakeholders and the market.

This experience clearly highlights several issues. These are: the need to create a sense of ownership where laws of this nature are formulated; the need to effectively create public awareness and the dissemination of necessary information to stakeholders so that the law itself is comprehensively discussed to address stakeholder concerns; the need for preparatory groundwork prior to such laws being made operational; and, the absolute need for public awareness and sufficient lead times for the successful implementation and adoption of such a law.

## Substantive issues

Briefly, the major changes introduced by the Act are:

- A shift of stakeholder rights from "contract" to "statute";
  The Act introduces a significant change in stakeholder relations by shifting their rights from contract to statute.

  The Act introduces a fundamental change to this model by introducing an element of "self help", by granting shareholders and directors the right to enforce the provisions of the Act through private prosecutions and private actions. This approach is pragmatic and realistic, considering that experience has clearly demonstrated that the external regulator, i.e., the Registrar of Companies, has proven to be ill equipped to effectively ensure compliance with the provisions of the law.

- The elimination of long existing concepts and principles which formed the bedrock of company law in Sri Lanka;
  The new law eliminates several concepts which existed under the previous law. These include, the elimination of: the requirement for a memorandum of association; the concept of authorized capital; the need for an objects clause and the application of the doctrine of *ultra vires*; and the concept of par value of shares. The law also abolishes the concept of "Peoples Companies" which existed under the previous law.

- The relaxation of restrictions that existed under the previous law and the provision for greater flexibility in the incorporation and management of companies;
  One of the main objectives of the new law is the simplification of procedures and the reduction of the costs of operating under the corporate structure. Consequently, the law simplifies the incorporation process by eliminating the need for a Memorandum of Association and by facilitating the incorporation process by making available simplified application forms online. The law also makes provision for single shareholder companies and for greater flexibility for the operations of private companies by permitting them to dispense with certain formalities specified in the Act, and the simplification of other operational procedures.

  The new law also removes many of the procedural formalities that existed under the previous regime as a part of this process of simplification. For instance, the reduction of stated capital and the repurchase of shares no longer require court approval.

- The introduction of new concepts relating to capital and distributions;

  The new law introduces several new concepts relating to the operation of companies. These primarily relate to the treatment of capital and distributions. For instance, the concept of issued share capital is now replaced with the concept of Stated Capital. Furthermore, the Capital Maintenance Doctrine is now replaced with the Solvency Test. The law also sets out comprehensive principles relating to distributions by making the process less cumbersome and by granting companies considerable scope in determining the best use of its resources.

- Codification of duties of directors and providing for greater transparency;
  The Act has sought to achieve simplification of the law by the

codification of several principles which had developed through case law. These include the definition of the term "directors"; their role; and their rights and duties. Apart from specifying these broad principles, the law also lays down strict disclosure requirements expected from directors. These include the disclosure of interests in transactions with the company, interests in shares and remuneration received. The law also introduces certain new duties on directors, especially in respect of action required where the company is faced with financial difficulty. Failure to comply with these responsibilities can lead to severe criminal sanctions, disqualification, and in certain cases, the obligation to provide restitution.

- The strengthening of stakeholder rights for the purpose of creating greater balance in the rights of stakeholders; and the introduction of shareholder rights, and remedies;
  One of the key features of the new law is the introduction of several new shareholder remedies. These include the right of shareholders to obtain restraining orders to prevent the company and its directors from contravening the provisions of the Act and the articles of the company, and to institute derivative actions. Apart from remedies that can be enforced through a court of law, the law also provides for "minority buy out rights" whereby minority shareholders could require the company to purchase their shares when they object to the company engaging in a "major transaction".
- The provision of alternative dispute resolution procedures;
  The Act takes cognizance of the high cost of litigation which deters shareholders from seeking to enforce the provisions of the law. Accordingly, it provides for a Companies Disputes Board which is vested with powers of mediation.

## General conclusions

The Companies Act No. 7 of 2007 marks a significant milestone in the development of the company law in Sri Lanka. Many of its features are improvements to what existed previously. This is particularly true in respect of what has been introduced in relation to the treatment of capital, directors duties and stakeholders rights. However, at the same time there are certain features in the law that could be cause for concern and therefore would deserve further examination. For instance:

The law has, by design or by inadvertence, failed to recognize some essential practices that had been previously adopted by companies. A sound example of this is the treatment given to the issuance of bonus shares. Even though it is clear that the intent of those drafting the law was not to exclude the possibility of issuing bonus shares, the inadvertent exclusion of a provision that exists in corresponding laws to empower and facilitate companies in issuing bonus shares has made it impossible to make such issues without exposure to legal risks.

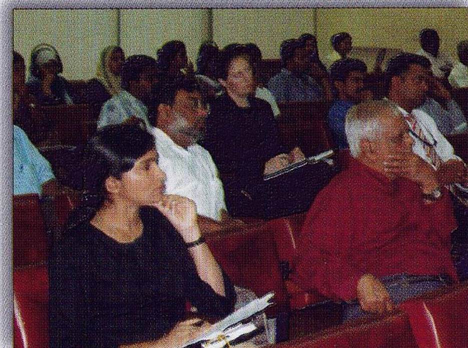
The Act has imposed several responsibilities on directors which appear onerous in the context of the economic climate of Sri Lanka. For instance, sections 219 and 220 of the Act require directors to resolve whether or not to liquidate companies when they are faced with solvency issues. Though these requirements are laudable in that they ensure good governance and protection of stakeholders, widespread concerns have been expressed that boards of a large number of companies in Sri Lanka may have to resolve to liquidate companies under the present circumstances. Had our law provided efficient restructuring processes, such a situation could have been beneficially managed.

However, the absence of such mechanisms, and the dearth of a pool of qualified persons to perform functions as directors appears to make this requirement unnecessarily burdensome on the corporate sector.

A further problem that will arise in the operation of the Act is that the Sinhala version of the Act, which takes precedence, has inconsistencies with the English version. This is a, practical issue and reportedly, several inconsistencies have already been detected. There is some uncertainty on how such inconsistencies will be handled in the event they come up for resolution before a judicial forum, and they could be a source of problems.

These issues will have to be recognized, acknowledged and addressed appropriately. Certain measures would necessarily have to be in the form of amendments to the Act. Additionally, several measures will be required to harmonize various regulations, such as the rules of the Stock Exchange and the Central Bank, with the provisions of the Act. Unless these measures are taken without delay, the full benefit of the Act will not be realized.

Mr. Arittha Wikramanayake, main speaker, addressing the gathering



View of the participants

The Panelists

Mr. Arittha Wikramanayake, Ms. Anushya Coomaraswamy,
Prof. H.M. Zafrullah, Mr. Kithsiri Gunawardena,

## About the Author ...

Mr. Arittha Wikramanayake was admitted to the Bar in Sri Lanka in 1980 and thereafter he joined the Attorney General's Department of Sri Lanka as a State Counsel in 1981. In 1993 he was appointed as the Director General of the Securities and Exchange Commission of Sri Lanka. Mr. Wikramanayake also held positions as a member of the Public Enterprises Reform Commission of Sri Lanka and the Sri Lanka Accounting and Auditing Standards Board. Presently Mr.Wikramanayake, the Precedent Partner of NITHYA PARTNERS handles Corporate Law, Securities Law and Trade Law aspects of the firm.

Mr. Wikramanayake holds Masters Degrees in Law from the Schools of Law, at the Vrije Universitiet, Brussels, Belgium (1985) and the University of Georgia, Athens, GA. USA (1987). In 1991 he obtained a degree in Master of Arts in Law and Diplomacy (MALD) from the Fletcher School of Law and Diplomacy, Tufts University, MA, USA.

# SANVADA...

This is the fifth in the series of Sanvada briefing notes.This briefing note analyses the New Companies Act No. 7 of 2007 which marks a significant milestone in the development of company law in Sri Lanka.This briefing note is based on an analytical paper prepared by Mr.Arittha Wikramanayake, Precedent Partner, Nithya Partners, which was presented on 18th of October 2007 at a community meeting.This analytical paper is available on line at www.sanvada.org.

The Sanvada (dialogue) Programme of the Pathfinder Foundation is aimed at critical analysis and debate on proposed or likely legislative initiatives impacting upon the economy and society of Sri Lanka, in order to enrich the legislative process in the Parliament and outside. The Mission of the Pathfinder Foundation, a non-profit and non-partisan institution, is to play a catalytic role in undertaking, promoting and facilitating research, dialogue and advocacy among the Parliamentarians, policy makers, civil society groups and the general public on issues relating to social-economic development in Sri Lanka.

The Sanvada Programme commissions briefing papers on impending legislation or existing legislation that are of critical importance to the well being of the masses. These briefing papers are written by experts on the subject matter, peer-reviewed and discussed extensively at community meetings. A final product emanates from the above process. A summarized and edited version of the final briefing paper is printed in the form of this newsletter (called Sanvada) for circulation among Parliamentarians, policy makers, journalists, trade unions, business chambers, academics, civil society organizations and concerned citizens.

The views and opinions expressed in this Sanvada are those of the author and do not necessarily reflect the views of the Pathfinder Foundation and its Board of Directors or the editor of the Sanvada.

We cordially invite you to participate in our Sanvada programmes and welcome constructive criticisms and suggestions towards the improvement of the programme and contents of our briefing note. Let us work together to upgrade the standard of public discussions and debates in and outside the Parliament, in order to effect positive changes to the process of economic policy making and corporate, social, economic and political governance in the country.


Pathfinder Foundation

Telephone No : 2596281
Facsimile No : 2595894
E-mail : info@pathfinderfoundation.org
website : www.sanvada.org



Editorial Assistance: Ms. Shamila Daluwatte, Project Manager