Legislative Brief

The Companies Bill, 2009

The Bill was introduced in the Lok Sabha on 3rd August, 2009.

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Highlights of the Bill

- The Bill shifts the onus of regulation and oversight over management away from the government and towards shareholders. It provides for stricter standards of approval by shareholders over some types of management decisions.
- The Bill allows for certain types of companies to be subject to a less stringent regulatory framework.
- It seeks to strengthen corporate governance by including new provisions related to independent directors and auditors.
- It gives greater powers to creditors to supervise a rescue plan and restrict the powers of management in the rehabilitation of a sick company.
- The Bill establishes a National Company Law Tribunal to administer provisions with respect to company law. It increases penalties and provides for special courts to try offences under the Act.
- Shareholders and creditors can file class action suits against the company for breaching provisions of any Act.

Key Issues and Analysis

- The composition and powers of the National Company Law Tribunal are similar to those introduced by a 2002 amendment to the Companies Act. The constitutional validity of that amendment is being examined by the Supreme Court.
- The Bill permits certain financial relationships between independent directors and the company, which can lead to conflicts of interest.
- Some provisions in the Bill, such as those covering independent directors and the delisting of companies, conflict with provisions under the SEBI Act and its regulations.
- The Bill provides for a number of issues currently specified in the Act, to be specified by the government in the rules. The government has not issued draft rules to the Bill so the impact of any possible change cannot be estimated.
- Fines have been increased and the range of offences which are punishable by imprisonment has been widened. The Bill does not require proof of intent to commit an offence as a condition for criminal prosecution. This differs from the recommendation of the Irani Committee.

PART A: HIGHLIGHTS OF THE BILL[1]

Context

The Companies Act, 1956 provides the legal framework within which companies function. It defines the relationship between the management of a company, the shareholders who own the company, other stakeholders, and the government.

The Act has been amended 24 times since 1956. Bills which attempted a comprehensive revision of company law were introduced in 1993 and 1997 but these lapsed. Some sections of the Companies (Second Amendment) Act, 2002 are yet to be notified. Another amendment Bill, proposing significant changes to the law, was introduced in the Rajya Sabha in 2003. In 2004, the Ministry of Corporate Affairs issued a concept paper on a new company law and constituted an Expert Committee under the Chairmanship of Dr. J.J. Irani to suggest a framework for such a law to replace the existing Act.[2] The Committee submitted its report in May, 2005. The 2003 amendment Bill was withdrawn in October, 2008 and a new Bill was introduced. However that Bill lapsed with the dissolution of the 14th Lok Sabha. It was reintroduced without significant changes in the August, 2009. This brief is based on the 2008 Bill.

Three committees chaired by Justice V.B. Eradi (2001), Shri Naresh Chandra (2002) and Dr. J.J. Irani (2005) have recommended changes to different aspects of company law and corporate governance.[3] The proposed Bill incorporates some of these recommendations.

Key Features

The Bill replaces the 1956 Act and consolidates a number of its provisions. It allows for a number of issues, currently specified in the Act, or its schedules, to be specified in the rules. On a range of issues, it shifts the onus of regulation and oversight over management away from the government and towards shareholders. On some issues, the Bill provides for tighter control by shareholders over management decisions by requiring 75% majority of shareholder approval rather than a simple majority. In cases where companies in financial distress have to be rehabilitated, the Bill gives much greater powers to creditors to supervise a rescue plan and restrict the powers of company management. It seeks to strengthen corporate governance by introducing new provisions related to independent directors and auditors. The Bill increases penalties and establishes special courts to try offences.

Types of Companies

- The Bill specifies the minimum criteria for the formation of different types of companies (see Table 1). The Bill does not specify a minimum limit for paid-up capital.
- The Bill defines an 'associate' company as one in which another company controls between 26% and 50% of voting power, and does not control its board of directors.
- One person companies, dormant companies and small companies are subject to a less stringent regulatory framework.

Table 1: Types of Companies

Company	Criteria for formation
Public Company	At least seven shareholders.
Private Company	Between two and fifty shareholders.
One Person Company	One shareholder.
Small Companies	Non-public companies with a paid up capital of less than Rs 5 crore or turnover less than Rs 20 crore. Cannot be a holding or subsidiary company, charitable company, or that registered under any special Act.
Charitable Company	At least one person; only for specified objectives. Dividends cannot be paid.
Dormant Companies	Those formed for future projects/ to hold assets or intellectual property, and which have no significant accounting transactions; or Companies which do not carry on any business or operation for 2 years or have not filed financial statements in that time.

Sources: The Companies Bill, 2009, PRS

Adjudication Mechanism

- The Bill establishes the National Company Law Tribunal (NCLT) to administer various provisions of company law and adjudicate disputes between companies and their stakeholders. It also establishes an Appellate Tribunal to hear appeals against orders made by the NCLT. The Bill provides for special courts to try offences.
- The NCLT may ask the government to investigate a company on an application made by 100 or more shareholders of the company, or those who hold 10% or more of voting power.
- The Bill introduces the concept of class action lawsuits by shareholders or creditors.

Incorporation of Companies

- The Bill introduces a new concept – entrenchment. This provision allows for articles of association of the company to include highly restrictive conditions for some amendments to some specified articles.
- At the time of incorporation of the company, the Bill requires that the directors disclose their interest in other companies. Persons convicted of any offence in connection with the incorporation or management of a company may not be able to incorporate a company.

Raising of Funds by a Company

- False statements made in a prospectus issued for raising capital are punishable. The Bill extends this liability to experts (such as merchant bankers or lawyers) who make misleading statements in the prospectus.
- The Bill prohibits the issue of irredeemable preference shares. All preference shares, except those used to finance specified infrastructure projects, must mature within 20 years.
- The Bill allows only management or employees to be offered shares at a discount. Such sweat equity shareholders enjoy the same rights as other equity shareholders.
- A company may issue debentures (bonds) which can be converted to equity. Only specified types of companies will be allowed to issue secured debentures, which are backed by the assets of the company.
- Companies are barred from taking public deposits, except from shareholders.

Administration of the Company

- The Bill provides that at least one of the directors of a company should be resident in India for at least 182 days in a calendar year. Independent directors shall comprise at least one third of the boards of listed companies with a paid up capital above a prescribed limit. The Bill defines the duties of directors.
- The Bill introduces the concept of key managerial personnel (CEO, CFO, MD and Company Secretary). Companies with share capital above prescribed limits should have whole time key managerial personnel. The Bill prohibits directors and key managerial personnel from insider trading.

Accounting and Audit

- The Bill establishes the National Advisory Committee on Accounting and Auditing Standards. The committee will submit recommendations to the government on the formulation of accounting standards, after consulting the Institute of Chartered Accountants of India.
- Creditors, debtors, shareholders, guarantors, or those in other business relationships with the company, or their relatives or partners, cannot be appointed as auditors. The approval of 75% of shareholders of the company is needed to remove an auditor before the completion of his term.
- Auditors cannot provide certain services to companies they audit. These include accounting and book keeping services, internal audit, and management services.

Mergers, Compromises and Arrangements

- A company, its shareholders, or its creditors can propose a compromise or arrangement by applying to the NCLT, which shall order a meeting of the company. Such compromises or arrangements may include a share-split, debt restructuring, mergers or takeovers, or a reduction in share capital, but cannot include a buyback of securities.
- For issues directly related to shareholders, objections can only be made by those who together hold 10% or more of shares. In the case of creditors, only those who hold 5% or more of debt can object. The arrangement must be approved by a 75% vote of shareholders, or creditors, as the case may be. All arrangements must be sanctioned by the NCLT.
- Where assets and liabilities of a listed company are being acquired by an unlisted company, the latter shall continue to remain unlisted.
- A merger between two small companies or between a holding company and its subsidiary must be approved by a special resolution at a general meeting and by 75% of creditors by value of both companies.

PART B: KEY ISSUES AND ANALYSIS

We analyze the main features of this Bill under five broad themes:

Constitutional Validity: The Bill provides for adjudication of company matters by the National Company Law Tribunal set up by the Act. However, a similar body set up under a under a 2002 amendment to the Companies Act currently faces a legal challenge in the Supreme Court.

Corporate Governance: The Bill requires companies above a certain size to appoint independent directors to their boards. While such directors are not supposed to have significant financial relationships with the company, the criteria proposed in the Bill for the appointment of directors are such that conflicts of interest are possible.

Conflict with other laws: Some provisions in the Bill conflict with provisions in the SEBI Act and its rules.

Implementation: The Bill provides for a number of issues, such as the format of financial statements, which are currently specified in the Act itself, to be specified by the government in the rules. The government has not issued draft rules to the Bill, so it is not known whether there would be significant changes from the prevailing system.

Corporate Restructuring: The Bill makes changes to the law on mergers and the rehabilitation of sick companies.

Constitutional Validity

Chapter XXVI

The Bill establishes a National Company Law Tribunal and an Appellate Tribunal. The composition and powers of the tribunal under the Bill are similar to those of the NCLT as established by the 2002 amendment to the Companies Act. Appeals from the Appellate Tribunal lie with the Supreme Court (and not High Courts).

The constitutional validity of the relevant amendment faces a challenge on the issue of barring appeals to the High Court. A three-judge bench of the Supreme Court said in May 2007 that the question to be determined was "whether such 'wholesale transfer of powers' as contemplated by the Companies (Second Amendment) Act, 2002 would offend the constitutional scheme of separation of powers and independence of judiciary, so as to aggrandize one branch over the other."[4] The matter is pending before a constitutional bench of the Supreme Court.

Corporate Governance

Independent Directors

Chapter XI

The Bill requires public listed companies above a prescribed size to reserve a third of all seats on the board for independent directors. It requires that independent directors (or their relatives) not do business with the company which amounts to more than 10% of the turnover of the company in the past two years. Permitting financial transactions with the company up to this point creates a potential conflict of interest. The listing agreement under the SEBI Act prohibits independent directors from a material financial relationship with company but does not define the term 'material'.

Statement of Objects and Reasons

Unlike the 1956 Act, the Bill limits the number of directors on the board of a company to twelve, excluding the nominees of lending institutions. Specifying a cap goes against the stated objective to "provide a framework for responsible self-regulation" by allowing decisions to be left to shareholders.

Related Party Transactions

The 1956 Act restricts transactions between a company and its directors, and certain other entities, on the grounds of possible conflict of interest. Government approval is required in most cases. The Bill restricts such transactions only for public companies but broadens the definition of a related party to include managers of the company. The approval of shareholders, rather than the government is now required (see Table 2).

Table 2: Comparison between Companies Act, 1956 and the Bill with respect to Related Party Transactions

	Subject	Companies Act, 1956	Companies Bill, 2008
Clause 166	Companies covered	All companies.	Only public companies.
Clause 2 (1) (zzy)	Definition of related parties	Definition covers directors and their relatives and firms and private companies in which they are involved.	Also includes (a) managers and relatives and those accustomed to Act according to the advice of the director or manager. (b) public companies in which the director/ manager, along with their relatives, hold more than 2% of capital. (c) subsidiary/associate/holding company or a company which shares a common holding company.
Clause 166	Approval	Central government approval in most cases.	Board approval; 75% shareholder approval for companies above a prescribed size.

Sources: Companies Act, 1956; Companies Bill, 2009; PRS

Audit and Inspection of Companies

Clause 127

The Bill prohibits auditors from providing certain services, such as accounting and financial services, to companies they audit in order to prevent conflict of interest. While prohibiting the same range of services as specified in the Bill, the 2003 Amendment Bill (now withdrawn) also allowed the government to add to the list of prohibited services. The 2008 Bill does not give the government the flexibility to notify other prohibited services.

The Bill does not require that the partners of a firm which audit the company be rotated on a periodic basis. The Naresh Chandra Committee had recommended compulsory rotation of audit partners of a company every five years.[5] The Irani Committee, however, had suggested that such decisions be left to shareholders of the company.[6]

Conflict with Existing Laws and Regulations

Insider Trading

Clause 173

The SEBI Act, 1992 prohibits insider trading in the securities of a listed company. It does not define the term 'insider'. It prescribes a penalty of Rs 25 crore or three times the profits made from such trading, whichever is higher, for those insiders found guilty of the offence.[7]

The Bill bans only directors or key managerial personnel from insider trading. It prescribes a penalty of Rs 5 lakh to Rs 1 crore or imprisonment up to five years, or both, for those found guilty of the offence.

Independent Directors

Chapter XI

The Bill requires all listed companies above a prescribed size to reserve a third of all seats on the board for independent directors. Clause 49 of the listing agreement under the SEBI Act, which companies sign with stock exchanges, require those companies with a non-executive chairman to reserve one third of all seats on the board for independent directors. Those companies with an executive chairman must reserve half of all seats on the board for independent directors.[8]

Delisting of Companies

Clauses 201 (3)-(6) and 203(3)(h)

Companies whose shares trade on stock exchanges are subject to stricter standards of oversight and governance. Companies can move to 'delist' themselves from an exchange only if they meet certain criteria specified under the SEBI Act.[9] Only companies listed for three years can delist themselves. Existing shareholders must approve the delisting. The price to be paid to such shareholders for their shares must be determined through a process specified by SEBI.

The Bill does not restrict the types of companies which can delist themselves. The approval mechanism, as well as the price to be paid to existing shareholders is also to be determined by a method different from that specified by SEBI.

Implementation

The Bill provides for a number of issues to be specified in the rules. These include disclosures made in the prospectus, the form of financial statements, the matters to be included in an auditor's report and the minimum size of those listed companies who are required to appoint independent directors.

Any substantial changes made in the rules may require auditors, accountants, company secretaries and stakeholders to modify their systems. The government has not released draft rules so it is not possible to estimate financial implications.

Corporate Restructuring

Mergers and Amalgamations

Clauses 203-205

Under the Companies Act, mergers between companies have to be approved by the relevant High Court. Amendments introduced in 2002 to the Act brought such mergers under the jurisdiction of the NCLT. However some of the relevant amendments have yet to be notified. The constitutional validity of the NCLT has also been challenged (see section on Constitutional Validity on page 4).

The Bill maintains the changes introduced by the 2002 amendment. As compared to the 1956 Act, the Bill restricts the conditions under which shareholders or creditors can object to a merger. It allows for a faster merger process for certain types of companies. However, the Bill does not implement the recommendation of the Irani Committee that approval for a merger be given within a certain time frame.

Revival and Rehabilitation of Companies

Chapter XIX

The Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) defines a sick or insolvent company and attempts to put in place a process by which such companies can be revived.[10] The Eradi Committee pointed to endemic delays in the restructuring process, often caused by company promoters themselves, and called for the repeal of SICA.[11] An Act to repeal SICA was passed in 2003 but has not yet been notified.[12]

The government also enacted the Companies (Second Amendment) Act, 2002, based on the recommendations of the Eradi committee report and which was intended to provide for the revival of industrial companies under the supervision of the NCLT. However the relevant amendments have not yet been notified.

The Bill redefines a 'sick' company and also gives much greater control over the assets of a sick company to creditors, who have a greater say in approving a revival plan. The company is barred from selling its assets during the revival process. The NCLT has to approve a revival plan within a fixed period of time.

Other Issues

Penalties and Offences

The Bill widens the range of offences which are punishable by imprisonment. The Irani Committee had recommended that officers in default should be criminally liable only when they authorise, actively participate in, and knowingly permit or fail to take active steps to prevent the default.[13] The Bill does not require proof of intent to commit an offence as a condition for criminal prosecution.

The Naresh Chandra Committee had recommended that penalties should be related to the sums involved in the offence. It proposed that fees (especially late fees) should be related to the size of the company in terms of its paid up capital and free reserves, or turnover.[14] The Bill increases the amount of the fine but does not link the amount of the fine with the size of the company.

Miscellaneous Provisions

Table 3: Further comparisons between the Companies Act, 1956, Irani Committee report and the Bill

	Subject	Companies Act, 1956	Irani Committee	Companies Bill, 2009
Clause 37	Shares with differential rights	Allowed.	No change. Provide clarity where needed in the rules.	Shares with different rights as to dividend/voting not allowed.
Clauses 175, 2(1)(zm)	Remuneration to Management	Total remuneration paid to directors / managers of a public company cannot exceed 11% of net profits. Govt approval needed for remuneration if company not making profits. Employee stock options can be issued to directors/officers/employees of company.	Amount of remuneration to be left to shareholders. Definition of what comprises remuneration to be prescribed in rules.	As recommended by Irani Committee. Employee stock options can also be issued to directors/officers/employees of holding company or subsidiary.
	Recognition of joint ventures	No provision; such agreements are covered by contract law.	Recognise such agreements so as to avoid possible conflict between company law and contract law.	Not implemented.

Sources: The Companies Bill, 2009; Irani Committee Report; Companies Act, 1956; PRS

Notes

1. This Brief has been written on the basis of the Companies Bill, 2009, which was introduced in the Lok Sabha on August 3, 2009.
2. Concept Paper on Company Law, Ministry of Corporate Affairs, www.mca.gov.in/MinistryWebsite/dca/common/conceptpaper.pdf.
3. Committee on Law Relating to Insolvency of Companies (Chairman: Justice V. Balakrishna Eradi), 2001; High Level Committee. on Corporate Governance (Chairman: Naresh Chandra), 2002; Committee on Company Law (Chairman: J. J. Irani), 2005.
4. Union of India vs. R. Gandhi, Civil Appeal No. 3067 of 2004. Judgement delivered on 18th May, 2007.
5. See Naresh Chandra Committee Report, Recommendation 2.4.
6. See Irani Committee Report, Chapter IX, paragraph 25.
7. The Securities and Exchange Board of India Act, 1992, Section 15G.
8. Clause 49 of the Listing Agreement. See SEBI Circular No. SEBI/CFD/DIL/CG/1/2004/12/10 dated October 29, 2004.
9. Securities and Exchange Board of India (Delisting of Securities)Guidelines 2003, http://www.sebi.gov.in/guide/guide2003.pdf.
10. Sick Industrial Companies (Special Provisions) Act, 1985.
11. See Eradi Committee Report, Chapter 5, paragraph 9.
12. The Sick Industrial Companies (Special Provisions) Repeal Act, 2003.
13. See Irani Committee Report, Chapter XII, paragraph 12.
14. See Naresh Chandra Committee Report, Recommendation 5.4.