9. Corporate Law

9.1. Legal status of a company and Registration of a company

A company is a body corporate and a juristic person. It has a distinct legal personality separate from its shareholders. [Section 2(1)] In the case of Salomon v A Salomon & Co [1897] AC 22, a proprietor of a business converted the business into a limited liability company in which he, his wife and children became members. The company then went into liquidation without sufficient assets to discharge outstanding debentures. In an action brought against the proprietor for the purpose of recovering amounts owed to unsecured creditors, the Court of Appeal held that the conversion of the business into a limited liability company was a "sham" and that the company was an alias, agent, trustee or nominee for the former proprietor who remained the proprietor of the real business and that he was therefore liable to indemnify the company against its trading debts. This decision was however unanimously reversed by the House of Lords. In the words of Lord Macnaughten, "……the company is at law a different person altogether from the subscribers……; and though it may be that after incorporation the business is precisely the same as it was before and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustees for them. Nor are the subscribers, as members liable in any shape of form except to the extent and in the manner provided by the Act."

Subject to the restrictions it may have imposed on itself under the articles, a company has the capacity to carry out or undertake any business or activity and to undertake or engage in, or enter into, any transaction within or outside Sri Lanka. It also has the rights, powers and privileges that may be necessary for that purpose, subject to written law. [Section 2(2)] A company may sue or be sued in its own name.

The legal status of a company offers distinct economic advantages. The concept of limited liability ensures that the liability of shareholders is limited to the issue price of the company's shares. Hence, the personal estates of shareholders are not at risk even in the event of the company's insolvency. This facilitates entrepreneurship by encouraging persons to engage in business without the fear that a failure of the business could lead to personal bankruptcy. Another advantage is that a company continues its existence even if there is a change in shareholders. A company's shares therefore can be sold or transferred to third parties without having to reconstitute the entity, unlike a partnership. These features facilitate the pooling of resources for business activity and increase the ability to raise large amounts of capital.

Registration of a company

Any person may apply to the Registrar to incorporate a company. The application must be accompanied by;

- A declaration by the applicant that to the best of his knowledge the proposed name of the company is not identical or similar to an existing company
- The articles of the company signed by the initial shareholders
- Consent from the directors and secretary to act in such capacities. [Section 4 (2)]

Number of shareholders

The Companies Act No. 7 of 2007 allows a company to have even a single shareholder. The single shareholder can be an individual, a body corporate or secretary to the treasury holding shares on behalf of the Government of Sri Lanka.

Certificate of Incorporation

Once the application is accepted, the Registrar must assign a number to the company and issue a certificate of incorporation. The certificate will specify the name and number of the company, the date of incorporation and its legal status.

Company Names

Public notice of incorporation must be given by companies within thirty days of their incorporation. The notice must specify the company name, company number and reisgtered address.

Every company must indicate its legal status in its name in full or in an abbreviated form. A limited company other than a public limited company must end its name with the word “Limited” or “Ltd”; a private company with the words “(Private) Limited” or “(Pvt) Ltd”; or a public limited company with the words “Public Limited Company” or “PLC”.

Articles of Association

The sole constitutional document of a company is its articles of association. Companies have a choice of either having its own articles or opting to adopt the model articles. If they elect for the former, the articles can provide for any matter not inconsistent with the Act, including objects, rights and obligations of the shareholders, management, and administration of the company.

9.2. Issue of shares and stated capital

As a general rule, the board of a company may issue shares to those is considered appropriate. If the terms of issue that are approved by the board are inconsistent with the articles, those terms will be invalid and of no effect to the extent of the inconsistency. Subject to these requirements, the terms of an issue are deemed to form part of the articles once they are approved by the board.

A share is deemed to be issued when the name of the holder is entered in the share register. Companies are required to issue initial shares immediately upon incorporation, or amalgamation, to those shareholders named in the application.

The registrar must be notified about the issue of shares within twenty days of issue and must be given details of the number of shares issued, the consideration received or the value and the company's stated capital following the issue.

Value and consideration for shares

The Companies Act provides that no share shall have a nominal or par value. Shares must be issued for consideration which the board of directors resolve is fair and reasonable to the company and to all existing shareholders. Consideration can be in any form including cash, promissory notes, future services, property of any kind or securities of the Company.

Calls on shares

Shares may be issued with future liabilities on the holder to meet calls or to perform obligations. Directors have to exercise their discretion in such instances on whether and when the call should be made, unless the articles carry a provision to the contrary. If the call is not met, the directors must use all reasonable means to enforce the obligation. When such a call is made, or when any other obligation attached to a share is performed by a shareholder, the company must give notice to the Registrar of the amount or value of the call and the stated capital thereafter.

Share splits

In a share split, the company increases the number of shares by dividing existing shares into a greater number. Share splits are essentially paper transactions and assets are neither received nor distributed by the company for the increased number of shares since they are created by a division of existing shares. The exercise therefore does nt have any impact on the stated capital of the company.

Stated Capital

The stated capital of a company is the total amount received by it, or due and payable to it, in respect of the issue of shares and calls on shares. If the shares are issued for consideration other than cash, the board must determine their cash value for the purpose of calculating stated capital. If a share has an obligation attached to it other than an obligation to pay calls, the board must determine the cash value of that performance and such performance shall be deemed to be a call paid on that share for computing stated capital.

9.3. Solvency test and its applicability

Under the Companies Act, the solvency test is deemed satisfied if the company is able to pay its debts as they become due in the normal course of business, and the value of the company's assets are greater than the value of its liabilities and the company's stated capital. The last requirement i.e., that the assets must be greater than the stated capital, is unique to our law and entrenches the capital maintenance rule in the solvency test.

Application of the Solvency Test

The Act provides guidance on how the solvency test must be applied. Boards must take into account the most recent financial statements prepared in accordance with section 151 of the Act. Boards must also take into consideration the circumstances that they know or ought to know affect the value of the company's assets and liabilities. When it assesses the value of assets and liabilities, a board may take into account a fair valuation or other methods of assessing the value of the company's assets and liabilities. When boards apply the solvency test for the purpose of distributions they must take another factor into account which is that when liabilities are computed, debts will include fixed preferential returns on shares ranking ahead of those on which the distribution is made, except where the fixed preferential return is subject to the board's power to authorize distributions.

Boards responsibility in making a distribution

Every distribution requires prior board authorization. Distribution also need to be approved by the shareholders by an ordinary resolution, unless the articles provide otherwise. A distribution of any amount may be made at any time that the board thinks appropriate, provided that it is satisfied that the company will satisfy the solvency test immediately after the distribution and it obtains a certificate of solvency from the auditors. The directors who vote in favour of a distribution must also sign a certificate confirming that the solvency test will be satisfied immediately after the distribution.

Shareholders are residual stakeholders of companies and their entitlement to payment is subject to the prior rights of creditors. Hence, a distribution that is made to a shareholder when the company did not satisfy the solvency test, may be recovered from him, unless the shareholder received it in good faith without knowledge of the company's failure to satisfy the solvency test, he had altered his position by relying on its validity, and the circumstances make it unreasonable to require repayment in full or in part.

If a distribution is made without compliance with the procedure specified in section 56 of the Act, or the directors sis not have reasonable grounds to believe that the company would satisfy the solvency test when they signed the certificate of solvency, every director who failed to take reasonable steps to ensure compliance with the procedures in section 56, or signed the certificate of solvency, would be personally liable to repay the company any amount that cannot be recovered from its shareholders.

Directors duties on insolvency

If a director believes that the company is unable to pay its debts as they fall due, he must immediately call a board meeting to consider whether the board should apply to the court to wind up the company and to appoint a liquidator or administrator, or whether the company should continue its business. If a director fails to do so and the company is subsequently places in liquidation, a court may, on the application of the liquidator or a creditor of the company, order that the directors be held liable for the whole of part of any loss suffered by the creditors as a result of the company continuing its business.

Dividends

A dividend is a distribution out of the profits of the company other than a company's acquisition or redemption of its own shares. They are the primary return that shareholders receive as consideration for the use of the money contributed by them to the company. If a distribution fits the description of a payment made to shareholders out of profits and other sums available for distribution, it will be determined to be a dividend. The board has discretion on the timing and amount of a dividend. The board is not obliged to declare dividend, and it can decide to set aside profits to meet the general needs of the company.

When a dividend is declared, shareholders of the same class are entitled to equality of treatment. The board cannot discriminate between them unless the reduction is in proportion to any liability attached to the share under the articles, or the shareholder agrees to it in writing.

Reduction of Stated Capital

A company may be special resolution reduce its stated capital to an amount it thinks appropriate in compliance with the provisions of the Act. The Act requires that public notice of the proposed reduction be given at least sixty days prior to the resolution being passed so that persons dealing with the company are aware of the proposed reduction.

Repurchase of Shares

A company may purchase or redeem its own shares in accordance with the provisions of section 63 of the Act. The section authorizes any company

- to purchase its own shares under section 64,
- exercise an option to redeem a redeemable share under section 67,
- if it is a private company, to purchase or acquire its own shares with the agreement or concurrence of all shareholders under section 31, or
- to purchase or redeem shares in accordance with an order made by a court under the Act.

When a company purchases its own shares, it must satisfy certain conditions and follow a prescribed procedure.

9.4. Serious loss of capital

Duty of Directors on serious loss of capital

If it appears to a director that the company's net assets are less than half its stated capital, the board must call an extraordinary general meeting within twenty working days of the directors becoming aware of the fact. The meeting must be held not later than forty working days from the date it is called. The notice of meeting must be accompanied by a report from the board advising shareholders of the nature and extent of losses incurred, cases for such losses, and the steps that the board has taken to prevent further assess or to recoup losses already incurred. The chairperson of the meeting must ensure that adequate opportunity is given to shareholders to ask questions in relation to, and to discuss and comment on, the report and the management of the company generally.

9.5. Provisions relating to accounts and audit

Duty to maintain Accounting records

Every company is required to maintain proper accounting records. The obligations of companies regarding the maintenance of accounts are contained in several statutes, including the Companies Act. These broadly fall into two areas. i.e. form and content, and procedures for dissemination to stakeholders.

Form of accounting records

Every company must keep accounting records that correctly record and explain the company's transactions. The accounting records must be in a form that will enable the company's financial position to be determined with reasonable accuracy at any time. They must also enable the directors to prepare the company's financial statements as required by the Act, and for the financial statements to be readily and properly audited.

Shareholders have no rights to accounting records in statute or common law. The accounting records shall include entries on money received and expended daily, and the purpose for which it was spent; the assets and liabilities of the company; records of goods bought and sold (except those sold for cash in the ordinary course of retail business); identifying the goods, buyers and sellers and relevant invoices for companies that deal in goods; the stock at the end of the financial year and stock takings; and, the provision of services, with invoices where the company is in the business of providing services. [Section 148 (2)]

Location of Accounting Records

Accounting records must be kept in Sri Lanka. The Registrar however may permit them to be kept outside Sri Lanka, if he considers that it is not prejudicial to the national economy and the interests of shareholders. When such permission is granted, the company must ensure that the accounts and returns of the operation of the company are sent to and kept in Sri Lanka. The records in Sri Lanka must disclose the financial position of the company with reasonable accuracy, at not less than six month intervals, and must enable the company to prepare the financial statements of the company and its group and any other documents required to be maintained under the Act. The company must also give the Registrar notice of where the accounts and returns are kept in Sri Lanka. Since the records must be accessed by the company's officers and other authorized persons, an accountant may not exercise a lien over them for unpaid fees.

Duty to prepare Financial Statements

The board is responsible for ensuring that financial statements of the company are completed within six months of the company's balance sheet date. They must be certified as being compliant with the requirements of the Act by the person preparing it. They must be dated and signed by two directors on behalf of the board, or, if the company has only one, by that director.

The financial statements must give a true and fair view of the state of affairs of the company as at the balance sheet date, and the profits or losses or income and expenditure of the company for the accounting period ending on the balance sheet date. Such financial statements must comply with any regulations that may be made under the Act with regard to form and content , and other requirements under any other law.

Subsidiary and group Financial Statements

If a company has subsidiaries, it shall prepare group financial statements which relate to that group on the balance sheet date. However, if the subsidiary is wholly owned this is not required.

Group accounts, where required, must be prepared in the same form and carry the same content as a company's accounts. [Section 153 (1) (2)]

If the subsidiary became a subsidiary during the course of the accounting period to which the financial statement relates to, the consolidated profit and loss statement shall relate to that part of the period that is was a subsidiary within the group. If the balance sheet date of the subsidiary is not the same as that of the parent company, the group financial statements must incorporate the last financial statements of the subsidiary if its balance sheet date preceded that of the company by three months, or, the interim financial statements of the subsidiary for the period that corresponds with the accounting period of the company. In any other case, the interim financial statements of the subsidiary that correspond with the period of the parent's financial statements shall be incorporated.

The Act specifies certain circumstances in which group financial statements need not incorporate financial statements of a subsidiary. Accordingly, they must be omitted where the board is of the opinion that it would be impracticable, or that no real value would result to shareholders because of the insignificance of the amount involved, or that it would involve expense or delay that is out of proportion to the value to shareholders. They may also be omitted when the board is of the opinion that it would be misleading or harmful to the business of the company or any of its subsidiaries, or that the businesses of the subsidiary and the parent are so different that they reasonably cannot be treated as a single undertaking. Omission of financial statements of a subsidiary on these grounds requires prior approval of the Registrar who may impose terms and conditions in such situations.

Accounting and Auditing standards

The content of accounting records is primarily governed by the Accounting and Auditing Standards Board Act. This law empowers the Institute of Chartered Accountants of Sri Lanka to adopt accounting and auditing standards.

9.6. Appointment of Directors and their responsibilities

The Act lays down certain criteria on the appointment and removal of directors. Apart from provisions in the Act, the articles of companies, other codes and rules and regulations of other statutory bodies also have some bearing on these issues.

Number and Qualifications

Every company must have at least one director, except for public companies, which must have at least two. A person must be at lease eighteen years of age to be a director. Only natural persons can be directors. Undischarged insolvents and those adjudged to be of unsound mind are disqualified. So are persons who are, or would be, prohibited from being a director of, or being concerned in taking part in the promotion, formation or management of, a company under the Companies Act. The company's articles may also prescribe additional qualifications for directors. When a disqualified person acts as a director, he will be treated as a director for the purpose of any provisions of the Act that impose a duty or obligation on a director of the company.

Composition of Boards of Public Limited Companies

Although there is no requirement in the Act that a board should consist of executive and non executive directors, the Listing rules of the Colombo Stock Exchange require the boards of public limited companies to have at least two non-executive directors or the equivalent of one third of the total number of directors, whichever is higher. Apart from the requirements of non executive directors, at least two of the non executive directors must be independent. The Listing Rules specify the criteria for independence and the board must require each non executive director to submit a signed and dated declaration annually confirming his independence or non-independence against that criteria specified by the Listing Rules.

Application of other laws

Certain companies that are governed by specific laws have to comply with additional requirements in the appointment of directors. The Banking Act is one such example, requiring a person who is appointed, elected or nominated as a director of a licensed commercial bank, to be fit and proper to hold such office.

Appointment procedures

Any person appointed as a director must consent to the appointment is a prescribed form and certify that he is not disqualified from being appointed. Those who are named as directors on an application for incorporation or in an amalgamation proposal shall hold office as director from the date of incorporation or the date on which the amalgamation proposal becomes effective, until he ceases to hold office as a director in accordance with the provisions of the Act. All other directors must be appointed by an ordinary resolution, unless the articles provide otherwise. Articles of companies generally authorize the board to fill casual vacancies. Boards also sometimes enter into agreements to appoint nominees of third parties to the board. However, they have no legal right to do so, unless the articles grant such authorization. If the articles recognize such a right, the courts will enforce it by way of an injunction, unless the nominee is unfit for appointment.

The Act prescribes the formalities that must be followed in the appointment of a director by a resolution. Unless the articles specifically provide to the contrary, shareholders of every company, other than a private company, may vote on a resolution to appoint a director only if it is for the appointment of one director. However, two or more persons may be appointed as directors by a single resolution, if the shareholders first pass a separate resolution that the appointment be voted in as a single resolution. A resolution that is moved in contravention of this requirement is void, even though it may not have been objected to at the time it was moved. However, such a resolution will not invalidate the director's acts. The passing of a resolution in contravention of these provisions does not activate provisions for the automatic reappointment of retiring directors in default of another appointment. There is nothing to prevent two or more directors being appointed by ballot or poll.

Removal Procedures

Subject to the articles, a director may be removed by ordinary resolution at a meeting called for the purpose, or purposes that include such removal. However there is no inherent power of removal if the articles provide for a fixed period. The notice calling for the meeting must specify that it is for the purpose of removal. Reasons for the removal are not however required. When notice is given of an intended resolution to remove a director, the director concerned has the right to make representations within fourteen days of the notice and to request the company to circulate it to all shareholders. If the company fails to circulate is, the director can require that the representations be read at the meeting. The company however, may obtain permission from the courts to refrain from circulating the representations or permitting the representations to be read out at the meeting, if it can satisfy the court that the procedure is being abused to secure unnecessary publicity for a defamatory matter.

The right to remove directors is the ultimate power that shareholders exercise over the directors. A court will rarely interfere with a decision of a general meeting to remove a director. If a director is removed in accordance with the grounds specified in the articles, he has no redress against the company for damages for wrongful dismissal. However, if the director has a service vontract, he can sue for damages that arise from wrongful dismissal. If the procedure followed has a curable irregularity, the courts will not intervene. However, a removal of a director may give a right to petition the courts for a winding up of the company on "just and equitable" grounds.

Powers of Directors

Generally, the business affairs of a company shall be conducted by the board subject to the control of the shareholders and provisions in the articles. The Act grants the board with all powers necessary for that purpose, subject to certain exceptions. Certain transactions that are classified as major transactions must be, contingent upon or approved by a special resolution; consented to in writing by all the shareholders, or expressly authorized by a provision in the articles which was included in the articles at the time of incorporation.

These major transactions are defined in the Act. They are the acquisition or disposal of assets, or agreement to acquire or dispose of assets (whether contingent or otherwise) that are greater than half the value of the company before the acquisition or disposal, transactions that cause, or are likely to cause, the company to acquire rights, or interests, or incur liabilities, exceeding half the value of its assets before the acquisition; or a transaction, or series of transactions, that have the purpose or effect of substantially altering the nature of the company's business.

Duties of Directors

Act in good faith

The Act requires that every person who exercises powers or performs duties as a director must act in good faith, in what he believes to be in the interests of the company. Unlike a shareholder, who can act or vote in his own interests even if a conflict exists, a director must act in the interests of the company. Directors must not use their powers for a collateral purpose. When there are mixed motives, courts will look at the primary purpose. The directors have a duty to act fairly if a decision will affect categories of shareholders differently.

Duties owed to the company

When a director sits on a board, his duties are to the company and not to the appointer. However, the Act specifies exceptions. A director of a wholly owned subsidiary may, if provided in the articles of that company, act in the interests of the holding company, even though it may not be in the interests of the subsidiary.

Directors owe duties to the company and not to individual shareholders. However, in certain instances, directors may undertake to act as an agent of shareholders, in which event, the directors would owe duties to the shareholders. In certain other situations, such as in the face of a takeover, the directors may owe duties to the shareholders to ensure that they get the best possible price.

Compliance with law and standard of care

A director must not act or agree to the company acting in a manner that contravenes the Act of the articles. Further, a director must not act recklessly or be grossly negligent in exercising power. A director must exercise the degree of skill and care reasonably expected of one with his knowledge and experience. This means that a director is not expected to be an expert, unless appointed as such. The standard required is the exercise of care and diligence of a reasonable person.