COMPANIES BILL

POLICY BRIEF

SAMRIDDHI FOUNDATION

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::::: Policy Brief :::::

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Companies Act is one of the important and over-arching pre-conditions for enabling corporate governance. It is the legislation that governs companies from their very incorporation to operation and exit. The Act encourages transparency and high standards of corporate governance as appropriate, given the significant role of companies within the social and economic life of the nation.

The Act attempts to enhance governance and bring about improved response from companies. However, since the Act is an extensive 200-page legislation, a potential entrepreneur might not fully comprehend the technicalities and compliances regarding the same. Therefore, it is an absolute necessity that the size of the Act be reviewed and reduced further by eliminating clauses that only add to non-compliance, in part of entrepreneurs.

Moreover, this piece of legislation has 65 instances of 'as prescribed (elsewhere)'; which is a common drafting practice for a legislation to generally prescribe for referral to other statutes taking convenience into consideration. However, having a plethora of such provisions in the same Act will only complicate its scope. Furthermore, when the Act specifies 'prescribed in the directive' given the directive has not been prepared, this may make the law subject to discretionary power of the administrators. These complex, opaque and subjective clauses reduce the sense of predictability and security about the

future policy discourse that is extremely crucial to an investor/ entrepreneur.

As complying businesses have raised concerns with the ambiguities regarding the Act, a modern, timely and locally tailored company Act in the view of growing private sector emergence is the need of the hour. This document aims to outline primary areas that require further discussion during the current review and amendment process. Following are some of the key issues that needs to be reviewed under the current Bill to amend the Companies Act, 2063.

1. Quasi-judicial role of Office of Company Registrar (OCR)

The Office of Company Registrar (OCR) is the executive authority that registers companies, maintains accurate and up-to-date records of companies, and ensures administration of companies and implementation of the Companies Act. However, pursuant to all above clauses, the OCR has been empowered with quasi-judicial powers and procedures resembling that of a court of law through which it is obliged to objectively determine facts and draw conclusions to provide the basis for an official action. Such actions may be to provide remedies to a situation or impose legal penalties that may affect the rights, duties or privileges of specific parties.

As the aforementioned clauses allow OCR officials to take up judicial functions and initiate court action, the act of resolving lawful matters, without legal expertise, may result in the malpractice of discretionary interpretation of the circumstance in a particular party's favor. This not only creates confusion in an impenetrable system, but also promotes rent seeking avenues and non-transparency among bureaucrats.

Hotel Jungle Camp v/s Office of Company Registrar is one such example where OCR exercised its judicial power and invalidated the general meeting of the shareholders by stepping on Section 178 of the Company Act. In the stated case, OCR quashed the decision of the extra-ordinary general meeting, where the Chairman and Managing Director were recalled from their respective positions for misappropriation of company's fund, after instructing the majority shareholders to call the meeting in the first place. In response to OCR's judgement, the majority shareholders filed a writ petition at the Supreme Court (SC) to

which it made a ruling that the shareholders possess the right to call the extra-ordinary general meeting and its legality cannot be questioned as long as the procedures have been followed to convene the meeting. The SC gave a verdict in favor of the majority shareholders and ultimately pronounced that OCR had no judicial authority to give jurisdiction on such disputes.

The above clauses are not only vague but also create cynicism among entrepreneurs. And with such vague clauses, the officers at the office of company registrar can misuse their power.

Recommendation

Therefore, the Company Act should, unequivocally repeal all the judicial functions that it practices at the moment. The Act must explicitly state that the commercial bench constituted within the High Court must have jurisdiction over the dispute on the company laws in order to establish appropriate perceptions of fairness and impartiality.

2. Unreasonable imposition of fines, punishments and appeals

Section 81, Subsection 1 and Subsection 2 have laid down the amount of penalty in response to a delay in the document submission. This penalty amount is calculated based on the company's paid-up capital. As this penalty amount is compounded in short penalty bands, an average entrepreneur ends up paying a large sum of money and suffers from injunctions, both of which are fatal to businesses.

Similarly, as per Section 160, the increased liability on part of the directors and the absence of any cushion impedes the ability to undertake strategic yet-risky decisions. Moreover, some qualified directors may find it difficult to seat in the Board.

Moreover, the inability to submit documents that are subject to penalty are concerned with a company's exclusive decision and in no way issue injury to public interest. And although it can be contested that these punitive provisions are levied purely for disciplinary purpose, it does not justify the hefty penalty that is placed under each heading. Therefore, it is irrational in part of the government to penalize companies for a delay in submitting their own judgements. In the FY 2074/75, 51,013 out of 1,92,164 companies failed to submit their returns, notice or replies pursuant to Section 81 of the Act. Certainly, it is not that these many companies have disregarded such legal provisions, but it is simply that these companies have not filed the required documents as they are unaware of such provisions due to which these requirements are unintentionally denounced, side-stepped and violated by many businesses.

Also, companies remain registered even after they cease

trading due to the fear of clearing the excessive penalty that has been amassed over the years. This ever-increasing exit expense thus, gives rise to 'zombie firms'- an uncompetitive company that is unable to grow or repay its debt principal and is functioning unwantedly. Thus, in most cases, such zombie firms find it difficult to exit the market. Amidst all this, what the government fails to recognize is that the tendency to unwantedly operate an uncompetitive business rather than to exit a market, because the latter is more expensive, lowers the average overall productivity of the economy. Also, these zombie firms are detrimental to the economy as they take up market share and lock up scare resources that could be available to more successful and dynamic companies.

Acknowledging the cumbersome exit scenario for businesses, the Government of Nepal (GoN), in 2016, introduced a special provision for defunct companies to cancel their registration by paying one percent of the paid-up capital or a prescribed fee (whichever is lower) within a year. During this two-year grace period, 546 companies alone deregistered themselves, which approximates to 23 percent of the total deregistered companies (2348) till date. This figure demonstrates that if only the amendment that cushions and not punishes failure is adopted, exit strategies can finally gain momentum in the corporate ecosystem and in all likelihood, ensure greater fluidity in terms of company exit.

As the underlying theme behind levying such hefty fines is to encourage more transparency and appropriate recovery measures, it seems that OCR is cashing on the collection of penalties. So, OCR should shift its focus in ensuring that its register is updated, rather than penalizing and prosecuting businesses.

Recommendation

Thus, the current regime of fines, punishments and appeals thus, needs to be altered to ease the cost of burden to the companies. Since, the entire penalty mechanism cannot be revoked, penalty bands can be widened or the amount of fine can be reduced.

Likewise, the Sub-clause (b) of Subsection 1 of Section 136 needs to be removed as companies may have their registration cancelled in case they are unaware of the provision.

Moreover, the special provision as per which defunct companies can deregister themselves needs to be extended or similar provision needs to be introduced. Furthermore, as companies and directors are separate entities, the Act should abide by the concept and not hold the directors responsible for non-compliance.

3. Duplication in the submission of documents

The companies registered in Nepal are subjected to repetitive filing and reporting requirements, where identical set of financial statements and audit reports have to be filed to the OCR and the Inland Revenue Department (IRD). As per the Income Tax Act, 2058 every company must file a tax return along with its audited accounts, which includes the presentation of financial statements, on an annual basis with the IRD. This clearly makes the submission of documents related to financial compliance to OCR both redundant and unnecessary as a company is already filing the same set of documents at IRD. Besides, this increases the cost and the time taken for entrepreneurs, both domestic and foreign, as they have to comply with the regulations of IRD and OCR equally.

Moreover, the provision wherein a company needs to comply by the numerous filing requirement is redundant. Failure to comply with the filing requirements attracts a hefty penalty for such companies given that the concerned authorities are adept in exercising a sledgehammer approach in imposing penalties.

Recommendation

As this duplication of reporting requirements and consequential liability of the company for non-compliance is likely to add to the time and cost of the entrepreneurs, it is imperative that documents are required to be filed only to the IRD and not to the OCR, thereby repealing Section 80 and 156 from the Company Act.

4. Compulsory Provision to appoint liquidator for Voluntary Liquidation

In these terms, compulsory provisions of having to hire a liquidator in voluntary liquidation proceedings adds to a company's burden of exit with regards to cost. Such companies may be of different sizes and the time as well as cost taken by them may vary accordingly. In most cases, micro-enterprises may not be able to afford the cost of hiring a liquidator. Though the definition of micro-enterprises varies from country to country with employee count ranging from five to ten in most Asian countries, these companies are usually characterized by limited capital, proprietorship and/or a small number of shareholders. The number of stakeholder and the size of its capital make it easy for small size companies to settle debt issues amongst themselves with the help of an auditor alone. So, if the company is to close, the micro-enterprise can easily distribute assets and capital in accordance with the auditor's reports without the help of a liquidator, who in such cases would only be increasing the cost of company exit for these small companies.

Likewise, when a company goes into liquidation, the cost of proceedings is paid out in assets. A large share of money is gone out to liquidators as part of their fees. In such a case, even though the time ceiling is defined, the liquidators can extend the time limit if the proceedings is incomplete for any reason. This makes the liquidators the real beneficiaries as they can manipulate the time ceiling and can, meanwhile, seek the fixed remuneration.

Recommendation

There is a need to replace a compulsory appointment of

liquidator with voluntary appointments for micro-enterprises. Moreover, there needs to be provisions as per which the liquidators cannot easily extend the time period for liquidation.

Thus, these legal provisions that allow small enterprises of certain size to exit at reasonable timeframe and affordable cost are not only necessary, but also essential to economic prosperity. So, it is imperative that the Company Act, which is committed to fostering entrepreneurship to promote economic growth, lays down clear and simple provisions for 'easy' entry and exit.

5. Ambiguity in IT related components

The Act provides a statutory basis for the recognition and implementation of the online filing of the documents with the OCR. However, in case of system failure, there exists no clarity as to how these documents are to be submitted. Pursuant to the aforementioned clause, the term 'as prescribed' steers lack of clarity and precision. It is beyond question that the alternative to the system failure will be the submission of physical copies. Consequently, the manual filing system will never be eliminated entirely. Even though the government is trying to come up with a contingency plan, this move is deemed to be regressive as the alternative to online submission will induce physical submission.

Recommendation

The government needs to repeal any statement or clause that exhibits regression in terms of the digitization of system. However, in case of system failure, the government can immediately introduce a notice or a circular that extends the time limit for online submission of the documents. This way, the government will not digress from its aim to embrace digitization.

6. Cumbersome preparation of MoA and AoA

The incorporation of a company involves drafting and submitting of fairly extensive number of documents. While incorporating a company, preparation of Memorandum of Association (MoA) and Articles of Association (AoA) are deemed to incur significant time and cost for an individual. As per the World Bank, it requires NPR 10,000 and takes 5 days for the preparation of these documents, which comes out to be a huge percentage of the total time and cost involved for an average entrepreneur.

Although professional verification or certification prior to submission to the OCR is no longer mandatory, entrepreneurs continue to use the service of professional lawyers or legal practitioners for verifying and drafting the MoA and AoA in practice. This is mainly done so as to avoid mistakes since the standard format availed by the government cannot be comprehended easily by an ordinary person. As these documents involve substantial legal jargons, entrepreneurs are compelled to seek support from legal professionals. Even though these jargons are defined in Section 2 of the Company Act, it is highly unlikely for a potential entrepreneur to read a 200 pager Act prior to or in the process of starting a company. Moreover, the preparation of MoA is redundant as the major headings - company name, its registered address, its objectives, matters related to share and shareholders- are also incorporated in the AoA. Therefore, preparation of two documents that require the same information only adds to the compliance cost for an average entrepreneur.

Recommendation

The government must introduce an AoA with an addendum form that explains and defines the legal terms. This deed will allow potential investors to fill basic information themselves that will further eliminate the need for professional help altogether.

Similarly, the MoA and AoA need to be substituted by a single document i.e. AoA. These actions will result in a speedier and a less costlier incorporation process.

7. Registration of foreign businesses

The prevailing provision requires foreign businesses to have a branch office in Nepal in order to be legally able to conclude any transaction. This provision is a product of Nepal's tax regime which requires any business to be present physically in order to tax them. Thus, imposing the requirement wherein a foreign business needs to have a branch office in Nepal to conduct any transaction.

Interestingly, the Act has failed to keep up with the recent leaps in technology. Emergence of online businesses, have led to several remarkable feats, the most prominent being the ability to conduct businesses over the internet without ever needing to be physically present. Cross border transactions and commerce have flourished owing to this model, but since Nepal government cannot tax an entity that is physically not present, it requires companies' especially foreign companies to be registered via a branch office in Nepal. This puts an unnecessary burden on foreign companies to establish a branch office which subsequently increases their costs and perhaps to a certain extent even disincentivizes said companies to enter the Nepalese market.

While government as dictated in the Budget speech aims at providing for an environment where innovative businesses and ideas can prosper Nepal's own stringent and archaic laws prevent it from doing so.

Recommendation

A much better approach as suggested by the European Commission is to Tax on the basis of interaction with consumers rather than on the basis of physical presence. In

an era where Online businesses are flourishing and even as one might argue increasing consumer welfare, our very own laws must incorporate provisions that businesses of the said category to grow. Taxation based on consumer interaction is the best way forward considering the current environment.

8. Issuance of shares at a premium

Issuance of shares at value higher than the face value is a means to acquire much needed capital which may be used for different purposes including but not limited to expansion of businesses. Issuance of shares at a premium is predominantly a result of the fact that over a period of time, the company has established its goodwill, reputation, brand or other intangible benefits that are not reflected in the financials of the Company. Moreover, subscription of premium shares by investors is a result of a strong belief that the company is a profitable venture reflected through its reputation and standing in the market. Essentially, subscription on part of the investors is an informed decision.

Nepal's own legal regime concerning company regulation allows issuance of premium shares but such issuance is subject to two conditions as per Section 29 of the current Companies Act. While the condition requiring approval of shareholders through a general meeting is understandable and perhaps even necessary to ensure that decisions taken by the Board of Directors are in the best interest of the shareholders, the prerequisite of having to make profits for three consecutive years is somewhat unnecessary. Subscription of shares by investors is not only a result of profitability of the business but also a sign of goodwill and reasonable belief of the investors that the company is worthy of being invested in. This belief is a result of number of factors which include the company's standing in the market that is reflected through its market share, competence of the management, years for which the company has operated, its future plans etc.

By requiring a company to make profits for three consecutive years and distribute dividends, the Companies Act has

restricted businesses to capitalize on other factors which create a reasonable belief of profitability on part of the investors. India's Company Act of 2013 provides no such criteria for issuance of shares at a premium. The responsibility of setting criteria is given to the Securities Board of India which is more competent in relation to setting of criteria for issuance of Shares. Companies Act is simply substantive law that deals with the regulation of a company. Issuance of shares is primarily a functional aspect of the company, an aspect that is better governed through guidelines from competent authority as is done in India by the Securities Board of India. Moreover, regulation such as issuance of primary shares are reflective of the investment climate of any economy, as such they require periodic and timely review and constant amendments. It is due to this reason that the issue of share premium is governed through directives and not through primary legislation.

Recommendation

Instead of setting out a criterion for issuance of shares at a premium in the Companies Act itself, a much better approach would be to give Securities board of Nepal - the regulatory as well as competent body in relation to issuance of shares - the power to frame guidelines.

9. Inconsistency between interrelated laws

A company has to abide by myriad of laws; these laws are related to taxation, company registration, labor laws, laws relating to foreign investment and industry. As such a necessity for consistency between all these laws is necessary in order to maintain a uniform standard and decrease the cost of compliance in such a manner that fosters entrepreneurship. The proposed amendment to the Companies Act is one that is not devoid of such inconsistency.

As per section the aforementioned amendments, companies that do not have a yearly transaction of more than NRs 2,500,000 are not required to appoint an auditor and submit their audit report respectively. While it may sound as a relief to many small-sized companies that have to pay large sums of money to hire auditors and prepare audit reports, it is not the case. While the audit report need not be submitted to the Office of the Company Registrar, preparation of audit report is still to be done owing to requirements present under the prevailing Income Tax Act, 2058. Eventually, making these small companies to appoint an auditor. So, the relief is only limited to non-requirement of submission of audit report and not to non-preparation of audit report. This inconsistency may give companies the wrong idea that audit report need not be prepared thereby resulting in payment of large sums of fines to the Inland Revenue Department. While the provision is a commendable one its inconsistency with other prevailing and interrelated acts of Nepal makes it rather moot.

Recommendation
In order to reduce the compliance for small businesses, the Act needs to be in coherence with the Income Tax Act as well.

Samriddhi, The Prosperity Foundation is an independent policy institute based in Kathmandu, Nepal. It works with a vision of creating a free and prosperous Nepal.

Initiated in 2007, it formally started its operations in 2008. The specific areas on which the organization works are:

i. Entrepreneurship development
ii. Improving business environment
iii. Economic policy reform
iv. Promoting discourse on democratic values

Centered on these four core areas, Samriddhi works with a three- pronged approach—Research and Publication, Educational and Training, Advocacy and Public Outreach.

Samriddhi conducts several educational programs on public policy and entrepreneurship. It is dedicated to researching Nepal's economic realities and publishing alternative ideas to resolve Nepal's economic problems. Samriddhi is also known for creating a discourse on contemporary political economic issues through discussions, interaction programs, and several advocacy and outreach activities. With successful programs like "Last Thursdays with an entrepreneur" and "Policy Talkies", it also holds regular interaction programs bringing together entrepreneurs, politicians, business people, bureaucrats, experts, journalists, and other groups and individuals making an impact in the policy discourse. It also hosts the secretariat of the 'Campaign for a Livable Nepal', popularly known as Gari Khana Deu.
(more information at www.samriddhi.org)