

Simplified Exit Scheme For Defunct Companies



Companies are promoted under the Companies Act, 1956 (the Act) with certain objectives, generally for carrying on commercial activities. However, due to various reasons, many of the companies subsequently become defunct and inoperative. Either they have never commenced business or have commenced business and later discontinued it due to adverse developments.



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Such defunct companies become a burden both on the Directors and shareholders on one hand and the Government on the other hand.

As far as Directors and shareholders are concerned, such a company is a burden for many reasons. Firstly, although the company is not operating, the Company is required to file a return of income under section 139(1) of the Income-tax Act, 1961. Failure to file the return, although there is no income, attracts penalty of Rs.5000/- under

section 271F. Secondly, such non-operative companies are also required to comply with several requirements under the Act. Such requirements include need to maintain various registers and minutes books on regular basis, hold meetings of

Board of Directors as well as Members within prescribed time frame, get the accounts audited by a Chartered Accountant every year, file Annual Return as well as certified copies of the audited accounts, etc.

There are substantial costs associated with these compliances, in terms of filing fees, professional fees and time involved. Additional costs and troubles are associated with non-compliances, in terms of penalties and prosecution. Also in case of non-compliance, the Directors of the companies attract disqualification under the provisions of section 274(1)(g) of the Act. Also many companies have not complied with the requirements

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of section 3 of the Act relating to prescribed minimum amount of the share capital.

It is apparently in the interest of the directors and shareholders to put an end to the life of a company, which has become defunct so as to obviate the need for various compliances.

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them to put an end to the life of a defunct company and thereby relieve themselves of the costs of compliance with the regulatory requirements.

Normal exit route

Part VII of the Act contains provisions for winding up of a company. The provisions for winding up are generally costly and time consuming.

However, the last section 560 in the said Part contains provisions empowering the Registrar to strike off, *suo moto*, and without long drawn procedures and costs, the name of a defunct company and dissolve it. Technically, the name may be struck off without any effort by the Directors and shareholders. The Registrar of Companies can issue letter inquiring whether the company is carrying on business or is in operation. In case no reply is received by the Registrar within one month after he writes to the company, the name of the company may be struck off.

However, these powers are generally not exercised by the Registrar for want of adequate guidelines and instructions. One of the reasons is that if such powers are exercised without due care and proper guidelines, it is possible that names of companies having substantial liabilities are struck off, to the prejudice of its creditors.

Earlier guidelines/schemes

The Government had earlier issued guidelines/introduced schemes providing exit route to defunct companies in the years 1987, 1991, 2000 and 2003. Several companies availed the benefits of these guidelines and schemes. However, these were not wholly effective and successful for various reasons. Following may be considered to be



some of these reasons:

- ✓ The schemes were not given adequate publicity in appropriate media in appropriate manner.
- ✓ The Government and the concerned officials did not promote them very actively and wholeheartedly.
- ✓ They prescribed requirements, which were cumbersome/costly/vague, and some of them were not really necessary.
- ✓ Initially they gave short time and people lost interest considering it difficult to comply with the requirements within prescribed time.
- ✓ The scheme required filing of audited accounts for earlier years and also until short period before the date of availing the benefits of the scheme. Many defunct companies found this requirement difficult to comply with, as there were no satisfactory accounts for number of years.
- ✓ Some were hesitant because of cost on account of fees and cost of professional help necessary for preparation and filing of the papers.
- ✓ Various issues relating to the scheme were not clarified and people were unsure and wary of costs and consequences.

The New Scheme

The new Scheme takes care of some of the shortcomings of the earlier schemes.

The highlights of the Scheme are as under:

- (i) The Scheme is called Simplified Exit Scheme, 2005 (SES 2005 or The 'Scheme'). It is introduced in terms of directions in General Circular No.02/2005 dated 28-01-2005 (No.17/78/2001-CL-V) issued by the Ministry of Company Affairs. The Scheme is to operationalise the provisions of section 560 of the Act. It supercedes all earlier circulars and schemes.
- (ii) The Scheme comes into operation on 1-2-05 and will continue until 31-7-05.
- (iii) The Scheme covers both public and private companies. However, the following are not covered:
 - † Companies registered under section 25 of the Companies Act, 1956 (generally charitable companies).
 - † Non Banking Financial Companies and Collective Investment Management Companies, which have carried on operations without being registered with RBI/SEBI.
 - † Cases in which prosecution for non compoundable offence is pending against the company.
- (iv) Non Banking Financial Companies and Collective Investment Management Companies, which are registered with RBI/SEBI respectively need No Objection letter from RBI/SEBI. Government companies need to file approval letter from concerned administrative ministry.

(v) For being eligible, a company is not expected to have any asset or liability. Generally defunct companies have liabilities in the form of unsecured loans from directors or shareholders, taken to meet small expenses on filing fees, audit fees etc. Such a company may consider seeking waiver of such liability or discharging the same so as to be eligible under the scheme.

(vi) For availing the benefits of the Scheme, application is to be made to the concerned Registrar of Companies in the Form given in Annexure A of the Circular. This is a simple form of approximately one page. Application is to be made by two Directors including Managing/Wholetime Director if any. Their photographs are to be affixed. It would appear to be in order if more than two directors sign the application in case there is disagreement amongst directors as to which two of them should sign it.

(vii) The scheme contemplates two categories of companies, one covering companies which have never carried out any business and the other covering companies that carried out business at some point of time, but later discontinued it. Some of the provisions differ as regards the two categories.

(viii) Apart from No Objection letter/approval, if applicable as above, the enclosures required are as per following details:

> Copy of Board resolution

The Simplified Exit Scheme, 2005 came in operation on 1-2-05 and will continue until 31-7-05. It covers both public and private companies. But one of the problems with such schemes is that they require a lot of unnecessary paperwork with accompanying costs and inconveniences.

- > Affidavits
- > Indemnity Bonds
- > Financial statements
- > Fees

The observations relating to these enclosures are as under:

Copy of Board Resolution:

Copy of Board Resolution authorizing the application, if validly constituted Board is in existence is to be filed.

The scheme does not contain exhaustive provisions relating to cases in which such a Board is not in existence. The normal provisions of the Act and the Articles of Association may be used for constituting such a Board. The scheme provides that if adequate directors are not there to constitute the quorum, the continuing Director/s may act in accordance with the Act/Articles of Association for increasing the Directors so as to constitute the quorum.

Annexure A (Para 2(vi)) contemplates 'other document showing authorization given to applicants for filing the application' in lieu of the Board Resolution. However, it is not clear what can be such other document. Further, Para 9 of the Affidavit does not give option to file such 'other document' but requires Board Resolution only.

The Board Resolution may also

cover the making and filing of affidavits and indemnity bonds.

Affidavits

Affidavit as per Annexure B is to be filed. This is to be made individually by each applicant.

The affidavit needs to state that the deponent is Director of the company concerned, giving its name, date of incorporation, address of Registered Office and Permanent Account

No. It should also state either Passport No. Or Permanent Account No. of the Deponent. In case such number is not obtained, it would appear to be in order to state 'Not applicable'. Copy of passport/P.A. No. attested by Gazetted Officer is to be enclosed.

The Draft affidavit requires filing of copy of Board Resolution. Copy of such resolution is also required to be enclosed with the application as per *Annexure A* and in my opinion that copy should suffice and it is not necessary to attach copy of same document again with the affidavit of each applicant.

The affidavit also contains undertaking to indemnify all valid claims or losses to any person, even after the name is struck off. This appears to be unnecessary repetition of similar undertaking in the Indemnity Bond as per *Annexure C*.

The Draft of the Affidavit contains averments regarding the following:

- ✓ Date since which the applicant is director and his Residential and Permanent address (Copy of evidence attested by Gazetted Officer or affidavit sworn before Magistrate to be enclosed). These evidences are again required along with the Indemnity Bond to be filed as per draft given in *Annexure C*.

However, it would appear that when these evidences are attached to the affidavit, they need not be attached again with the Indemnity Bond.

- ✓ Date of incorporation and object. In my opinion, this does not require reproduction of 'objects' clause of the Memorandum of Association, but brief description of the business contemplated at the time of incorporation.
- ✓ Fact of maintaining or not maintaining bank account on the date of application. This appears unnecessary as the company is not expected to have any asset including bank account. Further, while the Scheme requires affidavit to the effect that the company has no assets at all (Para 6), and the draft of the Indemnity Bond (Para 1-b) states that such affidavit is made, the draft affidavit as per *Annexure B* does not contain averment to that effect and contains averment only as regards asset in the form of bank account. Applicants may consider adding a sentence in the affidavit to the effect that the company has no assets or liabilities.
- ✓ Whether the company is non-operative since inception or became non-operative after commencing activities. In later case, number of years since which it is non-operative and reasons for being non-operative are to be stated. It would appear that the reasons need not be in very great details and need not be supported by any evidence. The company may state reasons like 'Adverse market forces' or 'competition' or 'lack of funds' etc. Such reasons may not be subject to examination as to genuineness or sufficiency.
- ✓ That as on date of application,

there is no due towards Income-tax/Sales-tax/Central Excise/Banks and Financial Institutions/Government Departments/Authorities or Local Authorities. While the Scheme requires affidavit to the effect that the company has no liabilities at all (Para 6), and the draft of Indemnity Bond as per Annexure C states that such affidavit is made, the draft affidavit as per Annexure B does not contain averment to that effect and contains averment only as regards specified dues towards taxes, etc.

- ✓ Details of pending litigation against or involving the company. In case of litigation under the Act pertaining to compoundable offence, compounding application is to be filed first and copy to be enclosed. While the Scheme does not bar cases of pending litigation, it would generally not appear to be in order to strike off the names of companies in such cases.

The affidavit is to be sworn before Magistrate/Notary/Oath Commissioner and in case of Foreign Nationals and Non resident Indians, before Court/person authorized to take and receive affidavit or before Indian Consul/Vice Consul.

Indemnity Bonds

Indemnity Bonds as per *Annexure C* to be filed. This is to be made individually by each applicant.

This again requires details of the name of the company, its date of incorporation, address of Registered Office and P.A. No., as also statement as to whether the company is non-operative since inception or became non-operative after commencing activities (in later case, number of years since which it is non-operative), which details are already contained in the draft of

Affidavit. It also again requires date since which the person is Director, attested copy of his Passport/P.A. No. and his residential and permanent address with evidences.

The Indemnity Bond is to the effect that even after the name is struck off, the person undertakes and indemnifies to pay all lawful claims and liabilities either existing or arising in future after the name is struck off and also indemnify any person for losses that may arise in pursuance of striking off the name of the company.

Financial statements

There are different requirements relating to financial statements for the two categories of companies.

- ✓ Regarding first category covering companies, which have not carried out any operations since incorporation, and have no financial information to furnish, audited financial statements are not required. Declaration in the affidavit to the effect that the company has no assets or liabilities is sufficient. Such a Declaration being not there in the Draft form of Affidavit as per *Annexure B* will have to be added in that form. This may be considered a great benefit. In case of company which has not filed audited accounts for a number of years, this provision will obviate the need for getting accounts audited for all these earlier years. However, if such a company has been filing regular financial statements, it should file financial statement for latest year prepared up to a period, which ended one month preceding the date of application. The Scheme does not state that such statement should be audited but the Form of Application in *Annexure A*

contemplates only audited financial statements.

- ✓ As regards the other category covering companies, which have carried out some operations and later discontinued operations, they are further divided into two sub-categories. The first category covers companies, which have carried out business for one accounting year or more. Company falling in such category has to file Audited financial statements for the period up to which business is carried on. For subsequent period, it has to file a Statement of Account in the form given in *Annexure D* for the latest year prepared up to period ending one month preceding the date of application. Such a statement is not required to be audited. If a company is non-operative for a number of years, it appears that statement is to be given only for latest year.

Option is given to file regular audited financial statements in lieu of such Statement of Account. Many companies may opt for filing regular audited financial statements, as these would be normally available while opting for statement of account as per *Annexure D* will require preparation of financial statements on odd date.

Taking example of a case in which business is carried on from 1st July, 2001 to 30th September, 2002, there may be two views as to whether it can be considered to have carried on business for one accounting year or more as it has not carried on business during the whole of any accounting year but carried on business for more than period of a year).

The various details required in the statement of accounts as per *Annexure D* regarding assets and liabilities appear unnecessary as the scheme applies only to cases hav-

ing no assets and liabilities.

Also in cases in which there are no assets or liabilities as on 31st March 2005 as per financial statements regularly filed, there does not appear to be justification for again requiring audited financial statements/statement of account up to a period ending one month preceding date of application. In such a case, statement in the application to the

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effect that the company has no assets or liabilities as on the date of the application should be enough.

In case of second category, i.e. cases in which business is carried on for less than one accounting year, statement of account in prescribed form (*Annexure D*) is stated to suffice. This appears to indicate that if audited accounts are filed, they would be more than sufficient, and there would be no need to file a statement of account.

The applicant is also to give a declaration that the 'Statement of account' gives true and fair view of the company's financial position. It appears that such a declaration can be either added in application as per *Annexure A* or added in Declaration as per *Annexure D* or given on separate paper.

Applicant filing statement of account and not audited financial statements is to give reasons for non-submission of audited financial statements. The scheme does not contemplate examination of genuineness or sufficiency of such reasons and examples of such reason may be 'non-availability of employ-

ees' or 'absence of business' etc.

Fees

Fees to be paid by Demand Draft/Pay Order/Banker's Cheque for Rs.3000/-

- vii) Penal action is not to be initiated from the date of filing of application. This also appears to be a great benefit as companies,

which have not filed audited accounts and annual return for a number of years will be saved of the filing fees, additional fees and penal consequences.

The text of the Scheme is available on the website 'www.dca.nic.in'

Suggestions

Considering the totality of the circumstances, the suggestions to the Government are as under:

- i) One of the problems with such schemes is that they require a lot of unnecessary paperwork with accompanying costs and inconveniences.

For example, regarding the present scheme, apart from application form as per Annexure A, it also requires Affidavit and Indemnity separately from each Director. This requires execution of 4 different documents, each to be stamped, drafted, printed, executed and attested/sworn involving cost and efforts at different stages. Further, these documents in turn require attested copies of

Passport Permanent Account No./evidence of address, again requiring cost and efforts.

Also some documents require attestation by Gazetted Officer, some require swearing before Magistrate, some are required to be notarized while some require swearing before either notary or magistrate. Also a company will need to involve a Chartered Accountant for audited accounts and if the Chartered Accountant does not desire to attend the office of the Registrar of Companies, also a company secretary. Thus, a defunct company needs to approach so many persons to make a company, which is already in-operative in practice, in-operative also in law.

Author's suggestion is that the law and scheme should be so designed that a single document contains all the necessary declarations, averments and undertakings, and these should become binding and effective by virtue of the provisions of law rather than on account of their being attested or sworn. In author's opinion, attestation by and swearing before Gazetted Officer/Magistrate/Notary can be avoided as these processes are generally not deterrent for a wrongdoer.

- (ii) Regarding the audited financial statements, the suggestion is that the statements up to 31st March, 2005 should suffice. The requirement for submitting such statements up to period ending one month preceding the date of application, will require separate statements shortly after normal statements which are generally prepared as on 31st

March, 2005.

- (iii) Considering the nature and purpose of the scheme, the Government should not charge any fees. Such fees are like charging a person for dying and generally fall on shoulders of persons who have lost money in promoting the company. Further, the Scheme also benefits the Government. However, in the event of false declaration, penalty may be recovered.
- (iv) While the scheme provides that no penal action will be initiated after the application is filed, as an incentive, the Government should consider withdrawing penal action already initiated in cases of technical defaults. For example, in case of a small private company promoted by a family, which is inoperative since last, say, 5 years, penal action may have been initiated for failure to file accounts or Annual Return. Such a failure has not hurt anybody and it would be logical to drop the penal action already initiated for such failure.
- (v) There should be adequate publicity of the Scheme, including by communication to individual companies explaining the benefits and procedures. The Government should designate knowledgeable and helpful officials in each of the Offices of the Registrars of Companies to facilitate all applications and names and telephone numbers of such officials should be informed/advertised. They should deal expeditiously with all applications, ignoring minor defects and pointing out other defects immediately or within short period of say 15 days. It should be possible to file the papers by post or courier and get feedback of the status of the application.
- (vi) Applications and their validity should be acknowledged immediately, the names should be struck off within reasonable time and this fact should be immediately communicated to the applicants. It may be noted that in case of earlier schemes, the author understands that the follow up actions of issue of advertisement, striking off the name and publishing the fact in Official Gazette are not taken expeditiously and many of the applicants have no knowledge whether the name of the company is struck off and whether the company legally exists. In such cases, the Income-tax Department can hold them responsible for non-compliance with the provisions of Income-tax Act requiring filing of the return.
- (vii) It is also suggested that while companies having some liabilities may not be considered eligible, companies having only share capital and some assets, (generally in the form of bank balance) and having no business plans, should be provided exit route.

Conclusion

In spite of some shortcomings in the Scheme and its working, and some problems, efforts and costs involved, it would appear that on the whole, the Directors and Shareholders of defunct companies would be well advised to avail the benefits of the Scheme so as to earn peace and avoid the need and cost of compliance with various regulatory requirements on recurring basis in the following years. ■