Irani Committee Report - An Analysis of Corporate Law Reform In India: Are We Keeping Pace With The World?

Vinod Kothari

The author is the Member of the Institute.

Samik Mukherjee

The author is an advocate.

Company law reform is today a global hot pursuit. The reasons are multifold – corporates are becoming larger sources of power than ever before and a major corporate bankruptcy causes jolts to the economies of several nations, thus making it essential that we keep these powerhouses tightly supervised, safe and healthy. Two, the earliest intentions of company law to enable and facilitate enterprise seem to have fallen through the creeks in over 100 years of corporate legislation.

Today's world of business needs organisational structures, which are flexible enough to suit the needs of enterprise. Most of the major economies of the world are currently engaged in comprehensive corporate law reforms. Britain, which is the fountainhead of company law in most countries, has been undergoing the process of reform and has recently produced a White Paper on Company Law Reform. The European Union had published a paper titled A Modern Regulatory Framework for Company Law in Europe some time back. Japan has proposed comprehensive rewriting of company law to be implemented by 2006. In addition, Italy, Ireland and Switzerland are also proposing thorough rewrite of their corporate laws.

The basic objectives of the reform exercise are to distinguish between companies which have major shareholder interest, and small companies. Small or entrepreneurial companies are to be given substantial liberty in carrying out their business in the corporate form – with the cloak of corporate personality being seen as merely a facilitation. Companies with wide public interest, on the other hand, are to be tightly regulated. Historical provisions of corporate laws were modeled for larger companies whereas the reality of the world is that the largest number of companies are small – for example, in UK, 90% of the companies have 5 or less shareholders. These companies are nothing but corporatised proprietorships, and therefore, working on the traditional notion of shareholder-director separation and concepts of trusteeship is quite a myth. The UK white paper says: "Wherever possible, the Government wants the new law to recognize smaller private companies not as the exception, but as the rule. We will therefore remove unnecessary burdens on small firms and present the provisions they use most often in a more accessible way."

In light of these global developments, the Concept Paper on Company Law, issued by the Department of Company Affairs, in July 2004 was highly disheartening. There was not much of a "concept" in the Concept Paper – the exercise was primarily aimed at reducing the size of the basic law by shifting most of the provisions to rule-making powers. A comprehensive review of the law was prominent in its absence. The Irani Committee's report of 31st May 2005 is most welcome – there has been an attempt at fundamental review of some of age-old concepts of company law. The report is generally in line with international developments in company law.

This article studies the main provisions of the recommendations of the committee.

Recommendation on the basic approach to company law

The Committee acknowledged the growing complexities of corporate laws and stressed the importance of a "single, comprehensive, centrally administrative framework" and the "harmonious operation of all Government and regulated agencies".

The Committee has recommended that "procedural and quantitative aspects..(should be) shifted to rules. This would enable the law to remain dynamic and to adapt to the changes in business environment". This was also the approach of the Concept Paper – the subordinate legislation, that is, the rules, were supposed to become more powerful than the main law itself. While under classical principles of jurisprudence, this would have been frowned upon – as the basic tenet of law is that we should be governed by the laws of the Parliament and not the laws of the executive – the reality of the present day world is that we are increasingly being governed by rules and not laws. SEBI's myriad rules against the backdrop of a 20-page law is a pointer to this.

The Committee has also addressed the concern about the issue of regulatory overlap. A school of thought developed in recent years has strongly advocated that the capital markets regulations should be laid down by a single regulator. However, the Committee observed the importance of both the bodies. The Committee stressed the importance of both the Ministry and the SEBI - it stated that while the former is supposed to look after the interests of the State; the latter is for regulating the capital market intermediaries. The Committee reasoned -

"Corporates have a function as economic persons within the Union of India in a manner that contributes to the social and economic well being of the country as a whole and as such must be subject to the laws pronounced by the Parliament for the welfare of citizens"

Recommendations on Classification and Registration of Companies

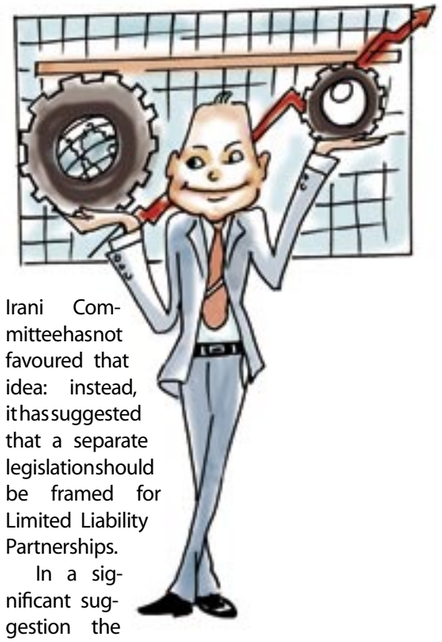
In line with international thinking, the Committee acknowledged that small companies should not be subjected to the same regulations as big companies. This is consistent with the "stake holder" approach; since there are limited number of stakeholders in the case of small companies, there is no justification to subject them to the same levels of corporate compliance standards as large corporations. However, the Committee recognized that defining the term "small company" would be difficult. The Committee suggested that small companies should be defined in terms of —

- "Fixed assets, current assets and investments not exceeding a particular limit as turnover
- Such company small neither be a holding or subsidiary of another company"

The Committee has advised that "One Person Companies" should be allowed to be established and provision for such an entity should be introduced in the Companies Act. In several European jurisdictions, single-shareholder companies are already a reality. The Committee has recommended that the salient features of such a body could be-

- Such companies must be registered as a private company with one member, but must have another person as director,
- Adequate safeguards should be provided that the business of the company does not get discontinued when the single member dies,
- The acronym OPC should be suffixed to their names to distinguish between them and other companies.

The Naresh Chandra Committee has suggested a separate law dealing with private companies or small companies The Irani Committee has not favoured that idea: instead, it has suggested that a separate legislation should be framed for Limited Liability Partnerships.



In a significant suggestion the Committee observed that-

"the procedure for a company seeking exit from the Register of Companies needs to be simplified…. The law should enable the Registrar of companies to strike off the names of companies from the Register of Companies on application for the purpose by the company directors or majority of them."

On receipt of such application, the Committee recommends, the Registrar must issue a public notice stating that such an application has been received by him. The order of the registrar striking off the name of the company should also be done through a public notice.

Board of Directors

The Committee has suggested that the law should only provide for a minimum number of directors and the maximum number of directors should be decided as per the Articles of Association of the concerned com-

pany. The limit on maximum number of directors is an archaic provision and it is only sensible to have it scrapped.

An issue that corporate law reformers elsewhere in the World have recommended, and some countries already permit the same, is that of corporate directors. Traditional notions suggest that directors should be individuals – however, modern company law permits corporate directors as well. The Irani Committee does not seem to have got into this point at all. This would be particularly important for the one-man companies, as the "one man" in question might be a company.

The issue of independent directors is quite a sensitive issue and controversy about the samehas been raging ever since the Narayan Murthy Committee recommended a substantial number of independent directors on corporate boards. The Irani Committee found a safe shelter by virtually skipping this issue and stating that there cannot be a singular prescription on this issue and that different percentages may be laid down for different companies by the rules.

There is a huge amount of international discussion on the issue of board structures and the Irani Committee has only been concerned with the peripheries or archaic provisions of existing law. For example, one issue of international debate is whether corporates should be governed by dual board structures where the Board will have two tiers – a "supervisory board" and a "management board". The former, being supervisory, will consist of non-executive directors, while the latter, concerned with day to day management, may consist of executives. The other key issue is whether the chairman of the board should be a non-executive director – general consensus in the interest of board objectivity is that the chief executive officer of the company and the chairman of the board should be two distinct persons.

OECD has recently formulated Principles of Corporate Governance . With regard to the objectivity of the Board, these principles state: "The variety of board structures, ownership patterns and practices in different countries will thus require different approaches to the issue of board objectivity. In many instances objectivity requires that a sufficient number of board members not be employed by the company or its affiliates and not be closely related to the company or its management through significant economic, family or other ties. This does not prevent shareholders from being board members. In others, independence from controlling shareholders or another controlling body will need to be emphasised, in particular if the exante rights of minority shareholders are weak and opportunities to obtain redress are limited."

Related Party Transactions

The Committee has made two significant recommendations with respect to related party transactions. They are:

- The approval of the shareholders should be required in case the transaction size in which the director is interested is above a stipulated limit; and
- The requirement of central government approval should be done away with.

Both the recommendations are in concert with the basic objective of increasing transparency and simultaneously reducing government control over corporates. It is hoped that these would be included in the Act soon.

Minority Interests

The Committee has recommended two important changes to be included in this respect, these are —

- The Committee has suggested that the terms "minority" and "minority interest" should be introduced in the Act. The word minority can be defined as a persons holding 10% of shares in a company holding share capital and 20% of shares in case of other companies.
- It should be mandatory for each company by modifying Section 265 which merely makes it optional for a company to provide a minority director.

The issue of minority interest is an important premise of company law – while these provisions are laudable in case of companies with larger public interest, they are often used as arm-twisting devices in case of smaller companies. The OECD document on Principles of Corporate Governance states that a significant tool of corporate governance is to define directors' loyalty not to the majority but to the company and the shareholders in general. In addition, pre-emptive voting rights, appointment of directors by system of cumulative voting, class right actions and derivative law suits have also been effectively used as minority protection systems.

Access to Capital

The Committee has suggested that the agencies involved in the access to capital should "interact with each other more comprehensively in operational matters". This is clearly a very general statement which raises more questions than it answers.

The Committee has proposed that the sections 372A (dealing with inter-corporate investments) should be amended and corporates should be prohibited from giving loans to broking firms and stock broking companies. Further, it has proposed that non-disclosure should be punished with penalties.

Mergers and Amalgamations

The Committee has suggested that valuation of shares by independent registered valuer should be made mandatory.

The Committee has suggested that the Act should specifically provide that de-listing by merging a listed company with an unlisted company should be specifically allowed by the companies Act. However, it has suggested that special "safety net/ exit option" should be provided for the public shareholders of the listed company.

Investigation

In a radical suggestion the Committee has proposed that the Central Government must be empowered to appoint private professionals as inspectors and investigators. The Committee has suggested that these private inspectors must not have any material interest in the company which they are appointed to investigate. Obviously, this is to protect the neutrality of the private investigation process. However, such a provision is subject to misuse. The institution of the "private investigators" could be misused by well-connected companies to harass small or not-so-well connected competitors. The proposal is liable to be abused and would do more harm than good. It is hoped that this proposal is not accepted by the Government.

Officer in default

Perhaps the most controversial suggestion of the Committee is its recommendation with respect of "officer in default" and the liability put on auditors, lawyers etc. The Committee has suggested:

"Equally important (as those of liability of CEOs/CFOs) would be the role of qualified professional such as the accountant, the auditor, lawyer, company secretary providing corporate advice. Such individuals should be held liable for wrongdoing if it can be established that they had specifically advised actions or behavior violative of the law.

The suggestion is liable to abuse as it is impossible to conclude whether an advice of the lawyer is "violative" of law. Perhaps the Committee had forgotten that as per the law, in cases of gross professional misconduct, a person can approach professional bodies (for example in case of lawyers the matter would lie before the Bar Council) and get the license of the concerned person cancelled or suspended. Subjecting them to company law obligations is unnecessary.

Restructuring and Liquidation

The Committee has made certain significant recommendations in this regard.

First, the Committee has suggested that the insolvency proceedings must be time bound. It has stated: "a period of one year should be adequate for rehabilitation process from the commencement of the process till sanction of the plan". Considering the present backlog of cases it is difficult, if not impossible.

Secondly, the Committee has suggested that the test of insolvency should be "liquidity test", i.e., the "test should prescribe default in payment of matured debt on demand (liquidity test) within a prescribed period". One is surprised as to how the Committee missed the very important Sections 433(e) and 434 which has already incorporated this test.

Thirdly, the Committee has suggested that the law should be amended to look into the interests of the unsecured creditors and special provisions should be incorporated into the Act. It has suggested that a committee of the unsecured creditors should be formed and such committee should be empowered with "limited right to represent and hearing without right to vote on the plan and other decisions".

Conclusion

While some suggestions of the Committee like those relating to "One Person Companies", delimiting the number of Directors, protection of minority interests are impressive and should be incorporated into the Act without delay, some like those of private professional investigators, expanding the definition of the term "officer in default" deserve further discussions.

"The devil lies in the detail" - goes an old adage. The Irani Committee has laid only the broad framework for the corporate law; however, it is the wording of individual sections that would matter. ❐