Chapter 1

Company Law Committee report - Key proposals

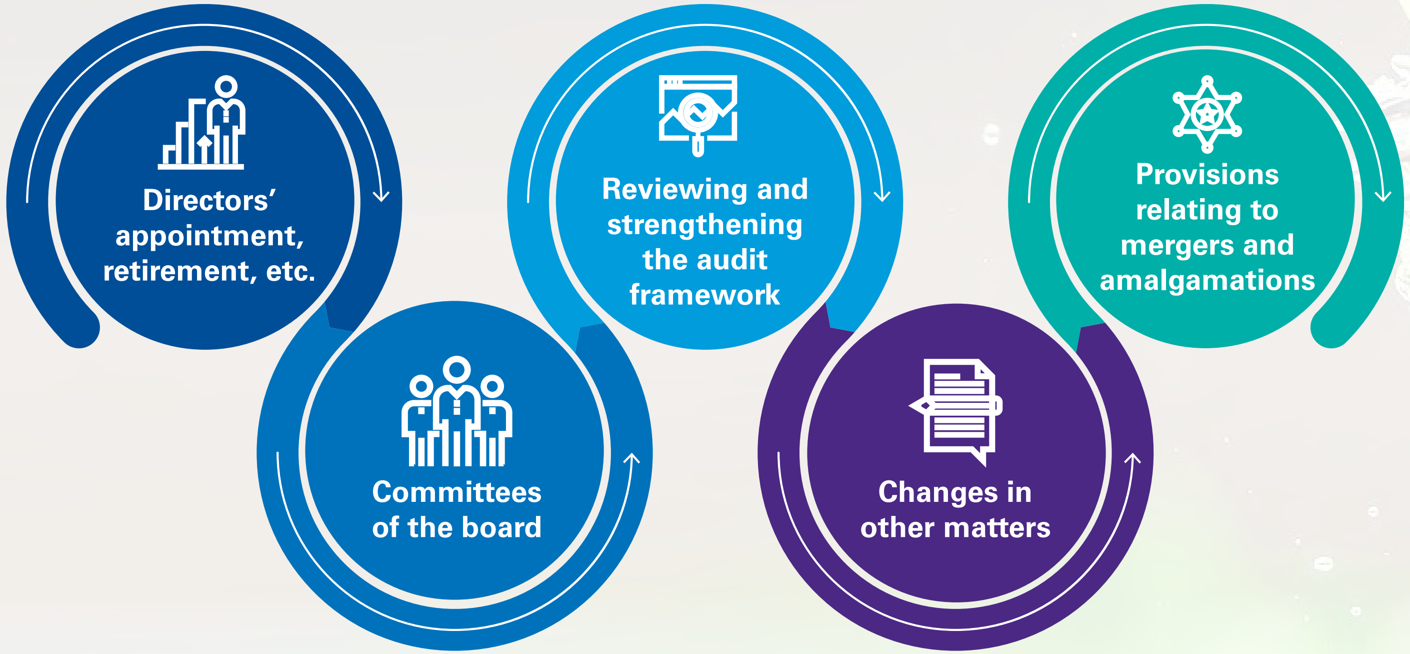
This article aims to:

Discuss key proposals in the committee's report

On 18 September 2019, the Ministry of Corporate Affairs (MCA) formed a Company Law Committee (the committee) to recommend changes to foster improved corporate governance and promote ease of doing business and ease of living to law abiding corporates.

The committee submitted its third report to the central government on 21 March 2022 and suggested changes to facilitate and promote greater ease of doing business in India. The report proposed various amendments to the provisions of the Companies Act, 2013 (2013 Act), the Limited Liability Partnership Act, 2008 (LLP Act) and the Rules made thereunder.

The recommendations relate to following key captions:



Overview of the recommendations

The following section discusses the key recommendations:

1. Revising provision relating to directors' appointment, retirement, etc.

A. Proposals relating to Independent Directors (IDs): Section 149 of the 2013 Act provides that an ID may hold office for a term not exceeding five consecutive years but would be eligible for re-appointment if the company passes a special resolution and such an appointment is disclosed in the Board's reports. Further, an ID should not be permitted to hold an office beyond two consecutive terms and will be eligible for re-appointment only after the expiry of the requisite cooling-off period of three years. The committee has issued following clarifications relating to an ID's tenure:

- The total tenure of an ID should not exceed the prescribed period of five years for a single term or 10 years for two consecutive terms, as the case may be, under any circumstances.
- The tenure of ID should be inclusive of any tenure held as an additional director. Therefore, the period during which the ID functioned as an additional director before regularisation should be included while computing the total tenure of ID.
- The tenure should be capped at a period of five years for a single term and period of ten years where the re-appointment of an ID is made after expiry of first term, irrespective of any resignation made before the expiry of the term of appointment. No individual can be appointed for more than two successive terms by any company under any circumstances.
- Section 149 of the 2013 Act provides that a person who is an employee, a proprietor or a partner of a legal or consulting firm, transacting with the company, could be appointed as an ID in such a company provided that such a transaction amounted to less than 10 per cent of the gross turnover of that firm. However, Section 149(11) further provides that during the three-year cooling-off period, the ID of a company should not be appointed in or associated with the company in any other capacity directly or indirectly.

The committee has recommended that Section 149(11) should be amended to allow the relevant legal or consulting firm to render the services as per the threshold limit provided under Section 149 of the 2013 Act. Further, the threshold limit of 10 per cent under Section 149 should be reduced to five per cent.

B. Revising provisions on disqualification and vacation of director's office

Section 164 and Section 167 of the 2013 Act lay down provisions relating to the disqualification and vacation of director's office, respectively. Section 164 identifies certain specific circumstances wherein a person shall not be eligible for appointment as a director of a company. The committee made following recommendations in relation to disqualification and vacation of a director's office:

- **Vacation of director's office as a result of disqualification under Section 164(2):** Section 167(1)(a) explicitly provides that vacancy shall arise if the director incurs any of the disqualifications specified in Section 164. In this regard, committee recommended that the vacation of office of directorship under Section 167(1)(a) should be limited only to disqualifications due to personal incapacity as per Section 164(1) and not on account of defaults made by a company under Section 164(2). However, the proposed amendment would be applicable prospectively and any vacation of office of directorship that has already arisen under Section 164(2)[1] would not be affected.
- **Relaxation relating to disqualification of new directors:** Proviso to Section 164(2) provides that after a company makes a default, any newly appointed director is exempt from disqualification for a period of six months from the date of appointment, to make good of the company's default. The committee proposes to extend the mentioned relaxation to two years instead of six months under Section 164(2).
- **Safeguarding rights of nominee directors:** Based on representations received from the Securities and Exchange Board of India (SEBI), the committee recommended that a new proviso be inserted in Section 164(2) of the 2013 Act to provide that the disqualification should not apply to the nominee directors appointed pursuant to nomination by the debenture trustees registered with SEBI.

C. Cooling off period for directors and auditors

- **Cooling off period before auditors become directors:** Section 149(6)(e)(ii) prohibits a person from being appointed as an ID of a company if he/she or any of his/her relative(s) has been an employee, proprietor or partner of a firm of auditors or company secretaries or cost auditors in such a company or group of companies, in any of the three financial years preceding the year in which employment is to take place.

  However, the 2013 Act does not contain any provision prohibiting an auditor from becoming a Non-Executive Director (NED), Managing Director (MD) or Whole-Time Director (WTD) in the same company or group of companies. Therefore, the committee recommends that there should be a mandatory one-year cooling-off period, from the date of cessation of office, after which an auditor of a company may be permitted to hold a position of a director in the same company or group of companies. In case an audit firm structured as a partnership/LLP, such a restriction should only operate concerning the partner that audited the company.
- **Cooling off period before an ID becomes managerial personnel:** Section 149(6)(e)(i) provides that a person shall not be appointed as an ID of a company if such a person currently holds or used to hold the position as a Key Managerial Personnel (KMP) or an employee in the same company or group of companies during any of the three financial years immediately preceding the financial year in which employment is to take place.

  Currently, the 2013 Act does not restrict appointment of an ID as a managerial person, i.e., an MD, a WTD or a manager, in the same company or group of companies after ceasing to be an ID of such company. Therefore, the committee recommends a mandatory one-year cooling-off period, from the date of cessation of office, after which an ID may be permitted to hold the position of an MD, a WTD, or a manager in the same company or group of companies.

1. Section 164(2) deals with the disqualification of directors on account of lapses made by a company in filing its annual returns and financial statements or default in repayment of deposits or debentures.

D. Clarifying resignation procedure of certain KMPs

Section 168 of the 2013 Act provides provisions relating to the resignation of directors. Section 168(1) allows a director to resign from their office by providing a notice to a company in writing. The 2013 Act empowers directors to directly file their resignation with the Registrar of Companies (ROC) since there is no requirement that a company should formally accept a director's resignation for it to become effective.

The committee recommended that the initial obligation to notify the ROC should be on the company about resignations tendered by KMPs, whose appointment intimation was filed with the ROC. In cases where the company fails to intimate the ROC within 30 days, the KMPs should be allowed to file their resignations directly with the ROC. The date on which resignation KMPs should come into effect should be harmonised with provision relating to resignation by directors.

2. Committees of board

Setting up Risk Management Committee (RMC): Section 134(3)(n) of the 2013 Act requires a board's report to contain a statement indicating the development and implementation of a risk management policy for the company, including the identification of risks that may pose a threat to the existence of a company. Additionally, Section 177(4)(vii) places an obligation on an audit committee to evaluate a company's internal financial controls and risk management systems. Further, Part II of Schedule IV requires IDs to bring an independent judgement to the board deliberations relating to risk management systems.

However, currently the 2013 Act does not contain any provisions relating to the formation of a RMC. Therefore, the committee has recommended to include new provisions in the 2013 Act, for constitution of a RMC for such class of companies, as central government may prescribe.

3. Reviewing and strengthening the audit framework

A. Amendments relating to NFRA

Section 132 of the 2013 Act, empowers the central government to constitute the National Financial Reporting Authority (NFRA) for matters relating to accounting and auditing standards for companies. The committee deliberated upon the autonomy of NFRA and its powers under the 2013 Act and recommended the following:

- **Empower NFRA to take appropriate action:** The NFRA should be empowered to take an appropriate action against individuals or a firm in case of non-compliance with the provisions under the 2013 Act in addition to its existing powers to take action against 'professional or other misconduct'. Further, it has been proposed to make specific provisions to enable NFRA to act in case its orders are neither complied with nor any appeal is made against such an order to National Company Law Appellate Tribunal (NCLAT).
- **Constitution of a NFRA fund:** The committee proposes amendments be made to the 2013 Act for the constitution of a NFRA Fund. The fund is expected to provide financial autonomy to NFRA and the amount in fund would be used to meet the expenses. Currently, NFRA receives its funding entirely from the central government.
- **Enabling NFRA to make regulations and granting supervisory powers to the NFRA chairperson:** The NFRA should be enabled to make regulations for specific matters such as
    - Form and manner of filing information with NFRA,
    - Place, timing, and procedure to be followed for NFRA meetings.

Additionally, chairperson of NFRA should be provided with the powers of general superintendence and direction within NFRA.

B. Reviewing and strengthening the audit framework and introducing mechanisms to ensure the independence of auditors

Sections 139 to 148 of the 2013 Act and the Companies (Audit and Auditors) Rules, 2014, govern the manner in which companies are audited under the 2013 Act. This includes provisions for auditors' appointment, removal and resignation, and eligibility of the auditors. The committee deliberated the mechanisms to strengthen audits under the 2013 Act and recommended following:

- **Non-audit services:** Section 144 of the 2013 Act provides an exhaustive list of services that an auditor is prohibited from rendering. The committee has recommended to enable the central government to prescribe a differential list of prohibitions on availing non-audit services or total prohibition on availing non-audit services for such class or classes of companies where public interest is inherent.
- **Punishment under Section 143:** It is recommended that Section 147 of the 2013 Act be amended to cover penal consequences for contravention of Section 143 regarding sub-sections other than sub-section (12).
- **Obligations of resigning auditor:** Section 140(2) of the 2013 Act states that the auditor who has resigned from a company is required to file a statement in a prescribed form within a period of 30 days to the company and the ROC from the date of resignation. The statement must indicate the 'reasons for resignation' and any 'other facts relevant with regard to resignation'.

  The committee recommended that an explicit obligation of a resigning auditor should also be introduced to make detailed disclosures before resignation and specific disclosure of reasons of such resignation such as non-cooperation from the company, fraud, severe non-compliance, or diversion of funds. However, if an auditor fails to make such disclosures in the resignation statement, then suitable action would be taken against such an auditor. Additionally, the auditor should be mandated to provide assurance about the company's accounts and independence of his/her decision to resign.
- **Mandatory joint audit for certain companies:** The 2013 Act should enable the central government to mandate joint audits for such class or classes of companies as it may deem necessary.
- **Auditor of holding company to comment on the true and fair view of each subsidiary company:** Section 143(1) provides an auditor of a holding company with a right of access to the records of all its subsidiaries and associate companies in so far as it relates to the consolidation of its financial statements with that of its subsidiaries and associate companies. However, there is no statutory obligation or liability on the auditor of the holding company to verify and confirm on the fairness and truthfulness of accounts of subsidiary companies.

  Therefore, the committee recommends to make suitable amendments in the provisions of the 2013 Act to ensure that an auditor of a holding company has been given assurance about the fairness of audit of each subsidiary company by respective auditors. In addition, the auditor of the holding company may be empowered to independently verify the accounts or part of accounts of any subsidiary company.
- **Forensic audit:** The 2013 Act should enable the central government to prescribe detailed rules relating to forensic audit through subordinate legislation.

C. Standardising qualification by auditors

Section 143(3)(f) and section 143(3)(h) of the 2013 Act require an auditor to provide observations and comments on financial statements of a company and to provide qualifications, reservations or any adverse remarks in relation to the maintenance of accounts of the company. However, currently auditors are not required to provide information on the impact of a qualification or an adverse remark on the economic health or functioning of the company.

Therefore, the committee has recommended an enabling provision under the 2013 Act to allow the central government to introduce a format for auditors to provide the impact of every qualification or adverse remark on the company's financial statements for circulation to the Board of a company before circulating to the shareholders of the company.

4. Changes in other matters

- **Allowing companies to realign their financial year in line with the 2013 Act requirements where they cease to be associated with a foreign entity**

  Section 2(41) of the 2013 Act provides that a company which is a holding company, or a subsidiary or an associate of a company incorporated outside India and is required to follow a different financial year for consolidation of its accounts outside India, may be allowed to follow such different financial year upon making an application to the central government.

  Currently, the 2013 Act does not contain any provision that allows such a company or a body corporate to revert to the financial year required to be followed under the provisions of the 2013 Act. Therefore, the committee recommended that such companies, which cease to be associated with a foreign entity, should be allowed to file a fresh application with the central government in a prescribed form to allow them to revert to the financial year followed under the 2013 Act.

- **Allowing companies to hold general meetings in virtual, physical or hybrid modes**

  The committee recommended that the 2013 Act should be amended to enable companies to hold general meetings, i.e., Annual General Meetings (AGMs) and Extraordinary General Meetings (EGMs) physically, virtually, and in hybrid mode. Further, it is proposed where the EGM is to be conducted entirely in electronic mode, then the notice period for those meetings should be reduced to such a period as may be prescribed by the central government.

- **Facilitating communication in an electronic form**

  Section 20 of the 2013 Act prescribes the mode by which documents can be served on a company, its officers or the ROC. The committee recommends amendment to Section 20 to introduce an overriding provision enabling the central government to prescribe rules for class or classes of companies mandatorily required to serve certain documents in an electronic mode only.

  However, if a member requests a company to provide physical documents also, then the company should deliver physical documents as an investor friendly measure to such members. Also, companies should be allowed to stipulate a fee for requesting such documents at any general meeting.

- **Maintaining statutory registers through an electronic form**

  The 2013 Act and rules thereunder require companies to maintain records in the form of registers. In this regard, the committee recommends that Section 120 should be amended to mandatorily require certain class or classes of companies to maintain their registers on an electronic platform in the manner laid down by the central government. For this purpose, the central government may set up an electronic facility. However, the central government may direct the company to share the information held on such statutory registers pursuant to certain enforcement-related functions.

- **Clarifying provision on buy back of securities – inclusion of free reserves**

  The committee has proposed that free reserves are to be included in the calculation of buy-back of equity shares even though the term has not been specifically stated in the provisions. Further, it is recommended that only shares on which the shareholders have exercised the stock option should be allowed to buy-back.

- **Issuance and holding of fractional shares, Restricted Stock Units (RSUs) and Stock Appreciation Rights (SARs)**

  A fractional share refers to a portion of a share less than one share unit. Fractional shares may arise as a consequence of corporate actions like mergers, issue of bonuses, or rights issues. Currently, the 2013 Act prohibits the holding of fractional shares.

  The committee recommended to enable issuance, holding, transfer of fractional shares, in a dematerialised form, for prescribed class or classes of companies in consultation with SEBI (for listed companies), as may be required. Further, RSUs and SARs should be recognised under the 2013 Act, and their issuance should be sufficiently encumbered.

- **Easing the requirement of raising capital in distressed companies**

  Currently, Section 53 of the 2013 Act prohibits a company to issue shares at a discount. The committee recommended distressed companies should be allowed to issue shares at a discount, notwithstanding the prohibition under Section 53. For this purpose, distressed companies may be categorised as such a class or classes of companies that have cash losses (other than those arising out of depreciation or revaluation) for previous three consecutive years or more and fulfil such terms and conditions and issue shares at a discount in such a manner as prescribed by the central government.

- **Recognising Special Purpose Acquisition Companies (SPAC) and allowing such companies, which are incorporated in India, to list on permitted exchanges**

  A SPAC is a type of a company that does not have an operating business and has been formed with a specific objective of acquiring a target company. This allows a shell company to issue an Initial Public Offering (IPO) without any commercial activity. After listing, the SPAC merges with or acquires a company, i.e., the target, thereby allowing the target company to benefit from such listing without going through the formalities of an IPO.

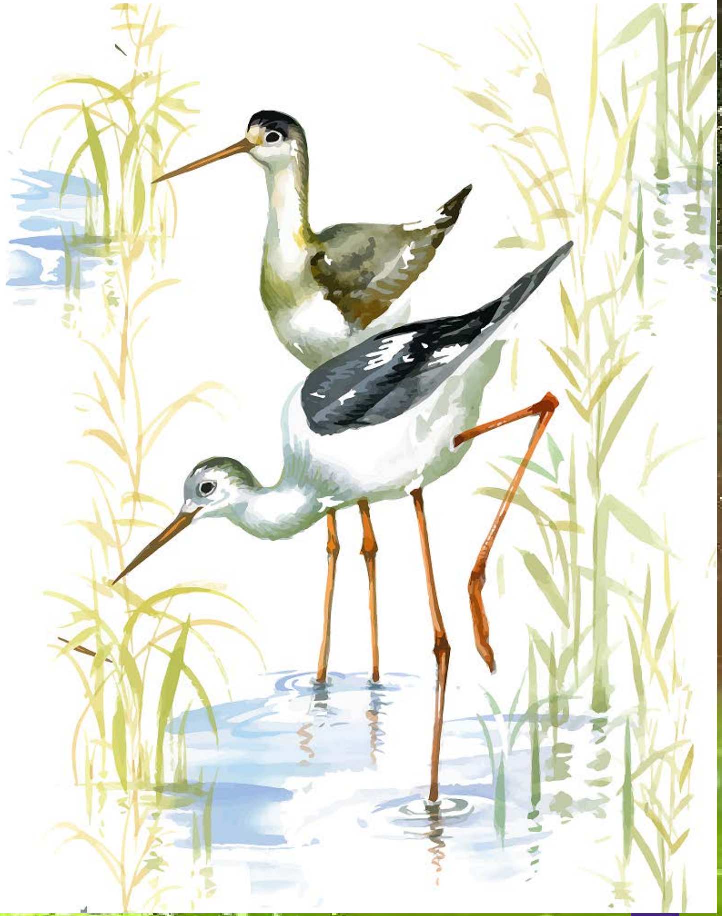
  The committee has recommended introducing an enabling provision to recognise SPACs under the 2013 Act and allow listing of a SPAC incorporated in India on domestic and global exchanges. The committee further recommended to relax the requirement to carry out businesses before being struck off and provide exit options to the dissenting shareholders of a SPAC if they disagree with the choice of the target company identified to be laid down in the 2013 Act.

- **Amendments relating to Investor Education and Protection Fund (IEPF)**

  - Section 124(5) provides that any money transferred to the Unpaid Dividend Account of a company that remains unpaid or unclaimed for seven years from the date of such transfer shall be transferred to the IEPF along with interest accrued, if any. Currently, the provisions do not cover the unclaimed dividend, not yet transferred to the unpaid dividend account, in respect of shares which have already been transferred to IEPF. Therefore, the committee recommends that any dividend which has not been paid or claimed in respect of shares transferred by the company to the IEPF fund shall also be transferred to the IEPF fund at the time of transfer of shares irrespective of the year they pertain to.
  - The committee proposes to include ‘redemption amount towards unpaid or unclaimed preference shares’ in the list of purposes for which the fund must be utilised.
  - The committee has proposed to include the money that remains unclaimed for seven years or more in respect of shares/securities that have either been bought back or cancelled should be allowed to be transferred to IEPF account.

- **Drafting and clarificatory changes to remove the inconsistency in various provisions within the 2013 Act**

  - **Amendment in Section 136(1) relating to shorter notice for AGM and other general meetings:** Section 136 of the 2013 Act provides a company’s members with the right to get copies of audited financial statements for all general meetings. The proviso to Section 136(1) provides that copies of audited financial statements may be sent to members in a shorter time than the prescribed 21 days before the date of the meeting, . However, it does not distinguish between AGMs and other general meetings. The committee recommends providing separate schemes when sending copies of audited financial statements for AGMs and any other general meetings.
  - **Penalty in relation to Section 188 (i.e. related party transactions) to be included as a ground for disqualification:** Section 164(1)(g) disqualifies a director who has been convicted of an offence dealing with related party transactions under Section 188. The committee recommended that penalty under Section 188 should be included as a ground for disqualification under Section 164(1)(g).
  - **Allowing Wholly Owned Subsidiary (WOS) to be the only member of the subsidiary:** Section 187 of the 2013 Act provides that a company’s investments shall be held in its own name. However, the proviso to Section 187(1) provides an exception in the case of shares held by nominees of holding company in the subsidiary company. The committee proposed that such an exception to be provided in the case of joint ventures also. Additionally, holding company should be allowed to be the only member in its WOS. Similar relaxations should also be permitted in the case of a WOS in which the entire shareholding is held by the holding company along with one or more of its WOSs.



5. Reviewing provisions relating to mergers and amalgamations

Section 232(3)(b) provides that a transferee company is not permitted to hold any shares in its own name or in the name of trust whether on its behalf or on behalf of any of its subsidiary or associate company and any such shares would be cancelled or extinguished. Following are the recommendations relating to mergers and amalgamations:

- **Treasury shares:** The committee recommends that company holding treasury stock would be required to report to the central government through a declaration in a prescribed form. Additionally, such a company should dispose of treasury stock within a period of three years. In case, the company fails to dispose of the treasury shares, then such shares would stand cancelled and share capital of the company would be reduced in prescribed manner and penal action can be initiated against such a company.

- **Fast-track merger:** The committee recommended to permit fast-track mergers between a holding company and its subsidiary company or companies other than wholly owned subsidiaries if such companies are not listed and meet prescribed conditions. The committee recommended twin test for fast-track mergers. A twin test requiring approval by
  i. Majority of persons present and voting at the meeting accounting for 75 per cent, in value, of the shareholding of persons present and voting; and
  ii. Representing more than 50 per cent, in value, of the total number of shares of the company, should be mandated for approval of fast-track mergers under Section 233 of the 2013 Act.

- **Constitution of benches of the NCLT:** The committee recommends including a provision under Section 419[2] to enable a competent authority to constitute the benches of the National Company Law Tribunal (NCLT) that may deal with matters of economic importance such as mergers, amalgamations, corporate restructuring and specialised IBC cases involving public interest.

Next steps

The recent committee's report has proposed various important amendments to the existing provisions of the 2013 Act. The objective of the proposals is to strengthen existing company law framework and an effort to address practical challenges being faced by the companies. The corporates in India should look out for further developments in this area.

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2. Section 419 requires constitution of the Benches of the NCLT and vests the power with the central government to constitute such number of Benches of the NCLT as may be specified by it by way of notification.