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An Examination of the Legal Framework of Sri Lanka under the Company Law Regime concerning Creditor Protection

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Abstract
The involvement of corporate creditors is a common presence in almost all business organizations, and in lieu of the investment they make, they generally hold a vested interest in the companies they lend money to. Protection of creditors is a crucial business, legal and social issue, especially after the incidents which occurred in Sri Lanka where some major companies went through economic failure, leaving the creditors in a desperate situation. A protective framework has been established to a certain extent by the Companies Act 2007 in order to vouch for their protection. However, the adequacy of the current corporate creditor regime is open to debate. Hence this paper attempts to ascertain the sufficiency of the existing system in providing the necessary level of protection to corporate creditors under company law during the company's life span before the institution and commencement of winding-up. For the above purpose, this paper examines the creditor protection mechanism established by the Companies Act 2007. The comparative stance adopted by the Companies Act 2006 of the United Kingdom has also been juxtaposed, which comprises of an approach involving the doctrine of 'Legal Capital Rule'. This comparative analysis provides for a more effective comprehension of the efficiency of the Sri Lankan corporate regime. Thus, the references to legal provisions and established precedent of relevant cases are instructive, and could be referred by policy-makers in order to further improve the existing legal regime.

Keywords: *corporate creditor protection, solvency test, capital reduction*

Introduction

The secured or unsecured corporate creditor is one of the many stakeholders of a company. Although the creditors are generally regarded as an outside source of the company, they form an indispensable and integral part of the company whilst also performing a vital role in the financial structure of the company. This observation stems from the fact that in the modern sphere of company law, apart from the shareholders who are primary stakeholders of a company, the creditors, employees, suppliers, customers, society and states too bear stakes in the affairs of a company[1]. The fact that companies consequently proceed to borrow money to perform their daily activities stand as proof that the existence of creditors' in any business operation is both undeniable and inevitable. The fact that most companies are unable to grow and expand their businesses without creditors is further proof that the contribution of creditor's to the capital of a company is important for the smooth functioning of the economy as a whole.

Hence, it is essential that the interests of the creditors are afforded exclusive protection and that the company law regime adequately provides safeguards for their rights. This is due to the fact that their interests are often at risk, given the complexity of a free and liberal economy which accepts that corporations are better off as private entities as opposed to being creatures of the state[2]. Creditors are considered to be a vulnerable segment in the corporate world, and hence they should be protected under company law in order to safeguard corporate entities from corporate collapse. In light of events such as Golden Key, Pramuka Savings and Development Bank Ltd, Touchwood Investment PLC. and Central Investment & Finance which seriously jeopardized the depositors and creditors in the Sri Lankan corporate field, this paper highlights that unless adequate protection is extended towards creditors, there lies the possibility that they may be exposed to acrimonious experiences which could even lead to a destabilized economy.

The rights of the creditors come into prominence upon the company winding up. However, the creditors are afforded inadequate protection in terms of the application of the concept of limited liability[3], which has transferred the burden of business failure from the shareholders to the creditors. There are also other loopholes, such as the concepts of legal personality of the company and the lifting of corporate veil, which could adversely affect the creditors. If the directors exploit a situation to the disadvantage of the creditors and the company, the creditors would be left with neither return nor compensation for their dues. Against such a backdrop, this article seeks to review as to why corporate creditors require protection, the nature and extent of creditor protection under the Companies Act of Sri Lanka No 7 of 2007 (hereinafter referred to as 'the Act') and whether Sri Lankan company law sufficiently addresses the issue of creditor protection[4].

The Scope of the Study

Creditor protection under the company law regime can be considered under three temporal instances: (i) during the life of the company; (ii) when the company is on the verge of collapse; and, (iii) at the stage of winding-up. In Sri Lanka, protection is afforded to the creditors when in distress under Chapters XIII and IX of the Act, and at the point of failure under the sections on winding up and they are considered after the preferential claims are settled

[1] S. Marsoof, "The Demise of Ultra Vires & the Protection of Stakeholders under the Companies Act of 2007", the BALJ, Colombo (2011) Vol. XVII, at p1 and 7.

[2] Kent Greenfield, 'Ultra Vires Lives! A stakeholder Analysis of Corporate Illegality' (2001) 87 Virginia Law Review 1279 at 1294.

[3] The introduction of limited liability meant that creditors' claims were limited to company assets and the shareholders of a company are not liable for its creditors. When a company fails, the creditors swallow the failure or the loss instead of shifting it to shareholders leaving the creditors of the company in an unsecured situation.

[4] Corporate creditors today, do not solely need to rely on the protections afforded by the company law regime, since the separate statutes and general law relating to debtor-creditor relations also offers protection to creditors.

under section 365 of the Act. Creditors' rights are disregarded during the life of the company as there is no direct statutory protection for them during such time period, although some proactive measures are addressed in the Act to protect the corporate creditors during the lifetime of the company. Creditors' rights at the point of winding up need to be considered at length under the liquidation process, and is hence beyond the scope of the subject of this article. The focus of this article is limited to avenues available to the creditors under company law during the company's life span before the institution and commencement of winding-up although there has been much debate as to the need to protect creditors during the life of the company rather than merely at the death of it.

To buttress the arguments of this article, comparisons are drawn between examples from Sri Lanka and the United Kingdom. In the above context, the position of the creditor in the Sri Lankan corporate arena will be analysed by taking into account the related Sri Lankan legal provisions. Furthermore, parallels will be drawn with the provisions associated with creditors in the UK Companies Act 2006 (UK Act) and legal principles that have been developed by the courts in order to evaluate the adequacy of the law in relation to creditor protection.

Methodology

This is a qualitative research; carried out by reference to secondary data. The study was conducted based on the collection of publications on the subject, including journals, law books, case reports, newspaper articles, and the worldwide web to assess the practical situations. The comparative analysis has been adopted in the light of the UK law.

Definition of a Creditor

In common parlance, a ‘corporate creditor’ refers to a person to whom a sum of money is due and payable by a corporate entity. In the present context, a creditor comes in many shapes and forms, and could either be a supplier of raw materials awaiting payment or a sophisticated bank who provides financial facilities to corporate entities. The types of creditors that a company comes across during its lifetime include secured or unsecured[5] debenture holders, institutional and individual lenders, trade creditors and deposit holders etc**.** In Sri Lanka, the act has failed to define the term "creditor", and the UK Act too has failed to lay down a statutory definition, despite making references to the term numerous times in the Act. According to the Oxford Dictionary, a creditor is a ‘person to whom a debt is owed. Black’s Law dictionary[6] which derives its basis from American case law, defines a creditor as a person to whom a debt is owed by another person, called the “debtor”. Hence a creditor is a lender to a company.

Parts IX and X of the Act (which govern compromises with creditors and approval of arrangements, amalgamations, and compromises by court), characterize the creditor as “a person who in a liquidation, would be entitled to claim in accordance with the provisions of section 357 of the Act, that a debt is owed to that person by the company”[7]. Section 357 refers to unsecured creditors and lays down the procedure by which claims could be made by unsecured creditors in the instance of winding up. Accordingly, it could be argued that this definition is only applicable to parts IX and X of the Act as the word “creditor” is not defined in section 529, which is the interpretation section of the Act which has a bearing upon the entirety of the Act.

The Sri Lankan definition has omitted the use of the term ‘secured creditor’, thereby raising the question as to whether secured creditors have been left out from the process of credit compromising. The plain reading of this definition suggests that it has only emphatically added the unsecured creditors within the scope of Part IX and X,

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[5] Creditor, secured or unsecured is determined according to the creation of security by them over the loan.
[6] Henry Campbell Black, *Black’s Law Dictionary* (2nd Edition) 297
[7] Sections 247 and 255 of the Act

and does not hinder any other class of creditors recognized under the Act from resorting to Part IX and X of the Act. This position is more evident from subsection 252(2) of the Act which implies that the process laid down in Part IX of the Act is available to secured creditors, in addition to the rights afforded by the Act to charge the property of the company.

Part 31 of the UK Act, which deals with dissolution and restoration to the register, defines a creditor to include "a contingent or prospective creditor"[8]. However, the definition is only applicable to that particular chapter of the UK Act. In conclusion, the term 'creditor' could be defined as widely as interpreted in the dictionaries, whereas where the interpretation of the term in the Act is concerned, the definition could either be narrowly construed or expanded beyond the ordinary limit. For example, the term 'creditor' does not encompass contingent creditors in some occasions. In the absence of a general interpretation for creditors, except for interpretations found in certain chapters[9] of the said Acts, the general meaning of the creditor as 'one to whom a debt is owed'[10] will be used in the context of this paper.

The Solvency Regime and Restricted Transactions

To guarantee creditor protection, share capital has been exclusively considered by law as the fund which is tied to the repayment of debts owed by the company to the creditors. It has been the conviction of some scholars that the rules pertaining to share capital is an attempt to ensure that creditors are protected[11]. Therefore, as long as the stated capital is maintained at an adequate level, the creditors have the assurance that there is a fund which is available for the repayment of their debts. In the Act, the principle known as the "Capital Maintenance Rule"[12] has been removed and the solvency test and stated capital have been introduced. The solvency test could be termed as one of the most significant innovations in the sector of corporate finance, as it monitors and helps capital maintenance[13]. It acts as a yardstick to measure whether a company is solvent and financially healthy at a given point of time, and thereby acts as an indicator of whether the creditors of a company are safe.

As the Company Law Advisory Commission opined, the concept of the solvency rule is that it is the 'golden thread that runs through the entire fabric of the Act on capital maintenance'[14]. The solvency test acts as a shield to protect the creditors[15], and this protection has been carved out in several provisions of the Act[16]. The solvency test is required to be assessed before many critical milestones of the company, which could diminish the assets available to meet the claims of the creditors such as distribution[17], redemption of shares[18], purchase of shares by the company[19] and the provision of any financial assistance[20]. In terms of section 57(1)(b)(ii) of the Act, the company

[8] Section 1011, UK Act

[9] Section 247, 255 of the Act; s.1011, UK Act

[10] Dictionary of Law 8th ed, Oxford University Press, 2015

[11] John Armour, '*Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law?*', (1999) ESRC Centre for Business Research, University of Cambridge Working Paper No. 148, 2 <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.167.5439&rep=rep1&type=pdf>

[12] This rule ensured that there was a specific amount of funds on which creditors could rely. However, there have been arguments for and against this approach in various jurisdictions.

[13] Section 57 of the Act.

[14] H. Cabral, 'Companies Act No. 7 of 2007 and the Corporate Law of Sri Lanka' (2007) p.67

[15] K.Kanag-Iswaran, D.Wijayawardana, 'Company Law' (2014), p.25

[16] s.31 –relating to private companies, s56 distributions, s.56 reductions of capital, s.61 recoveries of distributions, S. 65 enforceability of contracts to purchase shares, S. 70 restrictions on giving financial assistance, S. 98 dealing with minority buyout, S. 241 amalgamation.

[17] Section 56 of the Act

[18] Section 64 of the Act

[19] Sections 66-69 of the Act

[20] Section 70 of the Act

should be able to pay its debts as they become due in the normal course of business and the company's assets are greater than the value of its liabilities and stated capital.[21] This is a noteworthy framework which has been integrated in the solvency test. To manage the above operations, the company requires not only an earning surplus, but also assets in excess of its stated capital. Section 58 of the Act provides that the term 'stated capital' refers to the total amounts received or due and payable to the company in relation to the issue of shares or in respect of calls on shares. Consideration for the issue of shares includes not only cash, property and services, but also 'future services'.

The strict nature of the solvency test in the Act restricts cash moving out of the business, which provides long term protection for the creditors since the assets/liquidity is preserved within the company. The principle governing capital maintenance in the Act is also reflected in the solvency test, which aims to ensure that a company is financially healthy and its creditors are secure.

The solvency test prescribed in the Act[22] comprises of two limbs: the 'liquidity limb' and the 'balance sheet limb'[23]. The prior ascertains if the company is capable of paying its debts as and when they become due in the normal course of business. This aspect of the solvency test is deemed to be a 'check and balance' which the creditors can rely on in the course of business of a corporation. Nevertheless, the creditors are not guaranteed a deep insight into the creditworthiness of a corporation through the liquidity limb. The 'balance sheet limb' inquiries into whether a company's assets are greater than the value of its liabilities and stated capital. It has been observed that the aforesaid balance sheet limb 'entrenches the capital maintenance rule in the solvency test'.[24]

One particularity of the Sri Lankan solvency test is the inclusion of the stated capital in the balance sheet limb. It is contended that this imposes a greater sense of responsibility on the directors, as they now have to maintain the capital of the company at a satisfactory level. It can be concluded that the inclusion of stated capital into the definition of the solvency test is an attempt to assure greater protection for the creditors.

'Under the "cash flow" or "commercial insolvency" test, a company is insolvent if it is unable to pay its debts. For this purpose, the fact that its assets exceed its liabilities is irrelevant'[25]. The creditors are not expected nor required to wait until the assets are realized. The rationale behind the solvency test as held in *Re DML Resources Ltd*[26] is that "[…] as shareholders stand behind creditors on priorities in which they are paid on insolvency, it is inappropriate for a shareholder to receive benefits, ahead of creditors, at a time when the company is insolvent". In essence, in recognition of the important role played by the creditor: secure or unsecure, mechanisms have been introduced to the prevailing commercial law to guarantee that protection is afforded to them. The solvency test is a reflection of such measures taken to achieve this objective.

A similar view has been expressed by Gower and Davies who have opined that "[i]t is clearly a sensible measure of creditor protection that a company should be subject to constraints on its freedom to transfer assets to shareholders by way of a distribution … There would be little point in giving a creditors priority … in a winding up if there were no limits on the company's freedom to return assets….whilst it is going concern"[27] As evinced from the above analysis, directors face challenges of maintaining and enhancing the solvency position of the company. Section 57 of the Act is important in this regard as it specifies that the directors are vested with an obligation to ensure that the

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[21] Section 57 of the Act
[22] ibid
[23] Ibid 15 p. 167
[24] Arittha R. Wickramanayake, 'Company Law in Sri Lanka', First Edition, Author 2007, 2007 p. 93
[25] Winding up | ACCA Global https://www.accaglobal.com/ca/en/student/exam-support-resources/fundamentals-exams-studyresources/f4/technical-articles/winding-up.html
[26] (2004) 3 NZLR 490, 492; See, ibid p.116
[27] Paul L. Davies & Sarah Worthington, *'Gower & Davies' Principles of Modern Company Law'* (9th Ed, Sweet & Maxwell, 2012) p.314

company pays its debts as they become due and ensure that the financial soundness is proved as per the balance sheet limb. Failure to satisfy requirements in one limb is deemed a failure to satisfy the solvency test.

The risk faced by the creditors is mitigated as the solvency regime focuses on the net assets of the company and its ability to pay its debts and also requires the company to act transparently. This will ultimately guarantee the company greater financial stability. As adverted to the capital maintenance notion which failed in its sole objective of protection of creditors, the solvency regime provides increased elasticity in return of capital to shareholders while assuring such activities would not adversely affect the concerns of the company in line with the interests of the creditors. In light of the positive characteristics and beneficial nature of the solvency test, it has to be noted that if the solvency test is passed, a creditor is deemed to have adequate safety regarding his credit. However, it could be viewed that the solvency test should follow the general requirement of law which requires the accounting of assets and liabilities to represent a "true and fair" view of the state of affairs of the company[28]. In actual sense, the creditors have no visibility on the accuracy of the solvency test or of any frauds committed over passing it. Section 57(2) is pertinent in determining solvency. Accordingly, some key aspects the board needs to take into consideration and attend to include: (a) the most recent financial statements of the company made in accordance with section 151 of the Act; (b) circumstances the directors are aware of or ought to be aware of which have a direct effect on the value of the company's assets and liabilities; and, (c) valuation of the assets either by fair valuation or another method of the company's assets and liabilities.

The concept of the solvency test *per se* is not found in the UK Act. It is submitted that one of the reasons for the absence of a statutory solvency test could be due to the absence of the concept of stated capital in the UK Act. Unlike in Sri Lanka, UK law still maintains the distinction between authorised capital, paid up capital and the concept of share premium, which are all concepts that have been done away with in Sri Lanka consequent to the enactment of the Act. Under the UK Act, creditor protection is guaranteed under the doctrine of the "legal capital rule". The rationale of this doctrine is the regulation of capital of a company by imposing a minimum equity capital requirement and the prevention of risky alterations of the capital. As a result, companies are protected from being under-capitalized and the state of solvency is facilitated.

Chapter two of the UK Act imposes the first component of the legal capital requirement. As per the minimum capital rule, investors or promoters are compelled to invest a specific amount of assets for the company to be registered. Inability to comply with the minimum capital rule could mean the inability to commence business as a public company as per section 761, UK Act. Section 762, UK Act asserts the need to obtain a "trading certificate". A minimum capital amount of GBP 50,000 or an equivalent amount in Euros is specified in section 763, UK Act. It must be stated that, these requirements only pertain to public companies in the UK.

It could be argued that the basis for the above measure is the influence of the Second Directive adopted by the European Union. It is in keeping with this approach to EU law, it is argued, that the UK company law has also adopted the "one size fits all" policy. This approach has been greatly contested since it does not take into consideration aspects such as the size, industry and risks associated with each industry. The minimum capital rule has been the subject of criticism, particularly on the point that its effectiveness diminishes as the company grows. Growth of the company dilutes the impact the initial capital limit has upon the company at its inception. Secondly, the "one size fits all" approach is deemed faulty since it does not account for the dynamics associated with the industry.

[28] Section 57(2),151 of the Act

Reduction of Capital

The circumstances under which a company can reduce its stated capital is important from a creditor protection standpoint. In terms of Section 529 of the Act, 'distribution' excludes the 'transfer' of shares of a company to shareholders since that would be tantamount to a 'reduction of the stated capital' and it was illegal for a company to acquire its own shares under the common law. As established in the case of *Trevor v. Whitworth*,[29] in which Lord Watson ruled that "[i]t is inconsistent with the essential nature of a company that it should become a member of itself. It cannot be registered as a shareholder to the effect of becoming a debtor to itself for calls". The object of this rule was to ensure that directors applied the equity capital of the company in keeping with its objectives.

Similarly, as a corollary to the notion that share capital is maintained for the benefit of the creditors, it is manifest that any reduction of stated capital must also be subject to rigid rules. In this context, Justice Harman enunciated the key determinants pertaining to reduction of stated capital in the case of *Re Ratners Group* PLC[30]. Accordingly, the court has to be satisfied with three principles before it grants permission for the reduction of stated capital, i.e., that all investors are treated equally, the shareholders must have had the proposals relating to reduction properly explained to them, and that 'the creditors of the company are safeguarded so that the money cannot be applied in any way which is detrimental to creditors'.

As mentioned above, ascertaining the solvency of a company depends on what its stated capital is. In the context of the relationship between creditor protection and the stated capital of a company, the measures available for a creditor in the event of stated capital reduction, must be looked into. A company may by way of a special resolution, reduce its stated capital to an amount it thinks appropriate in compliance with the provisions of the Act. To assure that persons dealing with the company are aware of such a decision, the Act requires a company to publish a public notice of such reduction of stated capital at least sixty days prior to the passing of a shareholders' resolution to reduce stated capital[31]. This provides a certain degree of protection to the creditors in order to take action, when such reduction is to be made by a company. As per Section 59(3) of the Act, where a company has agreed with a creditor that it will not reduce its stated capital below a predetermined amount without the prior written consent of the creditor or without meeting certain conditions, a resolution to give effect to a reduction of capital will be invalid and of no effect. It has to be noted that the above provision offers protection only to those creditors with whom the company has agreed that it will not reduce its stated capital. It does not offer protection to a creditor if such a covenant is not agreed between the company and the particular creditor. In other words, the creditor will have no recourse to vindicate his rights or protect his interests in the absence of such a written agreement.

The prohibition on a company from accruing its own shares[32]and providing financial assistance[33] in connection with the purchase of its own shares has been removed and thereby now allowing a company to proceed with both of these, provided the solvency test is satisfied.[34] However, it is submitted that such notice would have minimum practical effect since the company is not required to obtain permission from the court to effect the reduction in stated capital. According to Kanag-Iswaran and Wijayawardana, the difference between the position under the Companies Act No. 17 of 1982 and the Act is that 'the discretion placed upon court is now exercised by the board

[29] (1882) 12 App. Case at page 409
[30] [1988] BCLC 685.
[31] S. 59(2) of the Act
[32] S. 64 of the Act
[33] S. 70 of the Act
[34] Under the previous Sri Lankan company law, it was required sanction of the court to reduce the authorized capital in addition to the special resolution.

of directors, who will also be required to be guided by those principles',[35] i.e., principles such as the protection of the creditors.

Consequent to the redemption of or purchase of shares, if the Board of Directors believe that the company cannot fulfill the requirement of solvency having obtained the certificate from auditors, it shall resolve that the stated capital be reduced by the amount that the company would fail to satisfy the solvency test, without a special resolution, and notwithstanding any agreement with a creditor not to reduce the stated capital, with public notice not less than 60 days and with consequent notification to the registrar of companies[36]. By virtue of section 65 of the Act, should a company be unable to purchase shares as contracted, the party to the contract retains the status of a claimant and ranks subordinate to the rights of creditors. As per section 68 of the Act, where a company receives notice from a shareholder exercising the option to redeem the shares, and in terms of section 69 of the Act, where the redemption of shares is on a specified date, the former shareholder ranks as an unsecured creditor for the sum payable on redemption.

With reference to the situation in the United Kingdom, in comparison with the Sri Lankan context, Chapter 10 of Part 16 of the UK Act governs the reduction of share capital and is thus concerned with the protection of the creditor. In line with the principles enunciated in *Re Ratners Group PLC*[37] and *Trevor v. Whitworth*[38], the UK Act requires companies to obtain the approval of the shareholders by way of a special resolution, as well as permission of the court for a reduction of share capital[39]. As provided in section 642, UK Act, a resolution for the reduction of share capital should be supported by the "solvency statement". Once the resolution is passed, it should be brought before the court for confirmation as per section 645, UK Act. The UK Law has further protected the creditors of a company by incorporating section 646, UK Act, which concerns the reduction of capital rules by the court. This section offers creditors the right to present their objections against the reduction of the share capital of the company and to appeal to the courts[40]. In response to such an appeal, the court may make an order confirming the reduction of capital on such terms and conditions as it deems fit[41].

It is stipulated in the UK Act that it is unlawful for a company to make a distribution if its net assets (assets minus liabilities) are less than its called up share capital and un-distributable reserves, which include the share premium account[42]. However, this rule is only applicable to public companies. Private companies may make a distribution only out of the profits of a company available for the purpose[43]. It appears that in relation to distributions Sri Lankan law is more advanced in its creditor protection rules particularly as the requirements in Sri Lanka are much more stringent. Therefore, the board of directors are required to exercise extra caution prior to making a distribution. Regarding the recovery of distributions, the Act specifically provides that a distribution made at a time when the company did not satisfy the solvency test immediately after the distribution, that it may be recovered by the

[35] Ibid 15
[36] N.S. Ameresekere, Salient Features of Companies Act No.7 of 2007, Company Law Advisory Commission,2008, p13
[37] Ibid (29)
[38] Ibid (24)
[39] S. 641(1) (b), UK Act
[40] If the reduction in capital involves diminution of liability of unpaid share capital or paid up share capital, creditors are entitled to object for such reduction. It is the discretion of the Court to make an order in this regard which is dealt in Section 646 of the UK Act. Accordingly, Court shall ascertain even without an application from the creditor the amounts due to creditors, nature of the claim etc. and publish notice stating that within which the creditors may apply to enter into the list or exclude from the list. Once creditors name is listed and if the company admits the liability, the claim must be secured by the company. If the company does not admit the full amount of the debt, equivalent sum has to be preserved as a contingent or not ascertained amount fixed by the Court.
[41] Section 648 (1), UK Act
[42] Section 831(1), UK Act
[43] Section 830, UK Act

company from the shareholder except in certain specified circumstances[44]. Additionally, where the directors have acted in violation of their duty in relation to the solvency test when making a distribution, the directors who failed to take reasonable steps to ensure that procedure relating to distributions was followed or who signed the solvency certificate, will be personally liable to the company to repay to the extent of the distribution that the company is not able to recover from the shareholders[45].

The UK Act specifically states that a member is liable to repay distributions which have been made illegally[46]. However, the UK Act does not have express provisions imposing a duty on directors to repay an illegal distribution. Nevertheless, it has been established in *Exchange Banking Co (Flitcroft's case)*[47] that directors who cause the company to pay unlawful dividends are under a duty to restore to the company the value of the assets wrongfully paid. It has been observed *obiter* in *Commissioners of HM Revenue and Customs v. Holland*[48] that the directors are strictly liable for illegal distributions.

Section 647, UK Act provides further protection for creditors by imposing a penalty for the officers of the company who fail to include the list of creditors with the amounts due to them. If an officer intentionally or recklessly conceals the name of the creditor or misrepresents the nature of the amount of the debt, he then commits an offence. Thus, it is clear that the relief for the creditors under the Companies Act UK is rather direct and simple. Even in situations when the creditor has not taken action, it is the responsibility of the company to include all creditors' names and their due amounts when the company wishes to reduce their capital. In the case of the Sri Lankan Act, the responsibility is solely vested in the creditor to make an application.

The section 219(1), another novel feature of the Act, provides that a director of a company who believes that the company is unable to pay its debts as they fall due, shall forthwith call a meeting of the board to consider whether the board should apply to court for the winding up of the company and the appointment of a liquidator or an administrator or carry on further the business of the company. 219(2) of the Act provides where a director referred to in subsection 219(1) of the Act fails to comply with the requirement of that subsection and at the time of that failure the company was unable to pay its debts as they fell due, and the company is subsequently placed in liquidation, the court may on the application of the liquidator or of a creditor of the company, make and order that the director shall be liable for the whole or any part of any loss suffered by creditors of the company as a result of the company continuing to carry on its business, provided that three specific conditions have been met. As per section 219(3) of the Act, the three conditions include situations where, the board does not resolve to apply to court for the winding up, if at the time of that meeting there were no reasonable grounds for believing that the company was able to pay its debts as they fell due; and if the company is subsequently placed in liquidation. The section 656 of UK Act 2006 has a similar provision.

As per section 220(1) of the Act, in a situation of a serious loss of capital where the net assets of the company are less than half its stated capital, the board of directors are required to call an extraordinary general meeting of shareholders. This meeting should be called to discuss the nature, extent and cause for losses which resulted in a serious loss of capital of the company as well as the measures which ought to be taken by the board to prevent further losses or to recoup the losses already incurred. An analogous provision is contained in the UK Act as well[49]. However, the provisions in the UK Act are only applicable in respect of public companies, whereas the provisions

[44] Section 61(1) and 31(4) of the Act
[45] Section 61(2) of the Act
[46] section 847(1) and (2), UK Act
[47] [1882] 21 ChD 519
[48] [2010] 1 WLR 2793
[49] S. 656, UK Act

of the Sri Lankan Companies Act extend to all companies other than companies limited by guarantee[50]. This provision acts as a whistle blower to the stakeholders as it ensures that they are informed about the direction the company is heading.

It is submitted that upon a comparison of the Sri Lankan provisions pertaining to serious loss of capital with the provisions in English law, the scope and application of the Sri Lankan law is much broader as it applies to all limited liability companies other than guarantee companies. In this instance too it is materially important from the perspective of creditors of private companies, since the said provisions would compel persons controlling such companies to adopt responsible financial practices and to take proactive remedial measures if there is an imminent crisis in the financial situation of a company.

Discussion and Analysis

It is evident that the solvency test plays a vital role in protecting the creditors' right during the lifetime of the company as it requires the directors to pay consideration to this in various activities before they discharge their duties. It ensures that corporate bodies maintain strict financial discipline and emphasizes on the steps required to be taken by the company as well as the responsibility vested with the board of directors in an adverse situation. The board could be held responsible if it acts in a reckless manner. The provisions of the Act relating to the solvency regime has paved the way for companies to contemplate action that were previously prohibited or allowed only subject to stringent requirements. A company now has more freedom to distribute its money or property as it wishes subject to one important obligation, i.e., that the directors of the company must be satisfied that immediate to making certain transactions that the company will satisfy the solvency test.

Additionally, the concerns of the creditors have been minimized as the safeguards built in by the solvency regime focus on the net assets of the company and on its ability to pay its debts, whilst also requiring the company to act in a more transparent manner. The solvency test plays an important role in the management of companies, and while it gives directors more freedom it also presents challenges in the form of greater responsibility and potentially greater liability of directors. When discharging their powers and discretion they are to be vigilant and required to ensure that the company has sufficient financial resources at all times, so that there is no significant risk of the company being unable to meet its obligations when they fall due.

It is evident that the UK law allows creditors to go to court to object to a reduction in order to protect their interests[51] in the event they are unhappy with a company reducing its capital. This is in contrast to the Sri Lankan position, under which the creditors are not provided the right to object to a reduction and are relegated to the role of mere observers. The English legal developments have always aligned towards the courts independently regulating any reduction of stated capital. The rationale for requiring permission of the court for measures such as reduction of stated capital was laid down in *Trevor v. Whitworth*[52], where it was held that the court is then empowered to 'prohibit every transaction by which the money already paid to the company in respect of his shares is returned to him, unless the court has sanctioned the transaction'.[53] Upon a comparison between the Sri Lankan legal regime and the UK regime, the involvement of the courts in the context of stated capital reduction is a point where the two regimes diverge.

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[50] S. 35(1), of the Act read with the Third Schedule
[51] Section 645 and 646, UK Act
[52] Ibid p 409
[53] Ibid p 423

Although the Act has altogether dispensed with the requirement of seeking court permission in reducing the stated capital, and permits a company to reduce its stated capital by adopting a special resolution by its shareholders[54], nevertheless, a company is permitted to arrive at an agreement with a creditor whereby the company is required to obtain the creditor's permission to conduct a reduction of the stated capital[55].

It must be noted that the third limb prescribed by Justice Harman in *Re Ratners Group PLC* clearly seeks to evaluate the feasibility of a capital reduction from the perspective of creditors. As the present framework stipulated in the Act has done away with any independent evaluation of such measures by the court, it has vested the discretion of determining the suitability of such capital reduction with the company itself. As such, the present scheme in the Act may not necessarily serve the best interests of the creditors. In such a setting, it is submitted that the provisions in the UK law pertaining to reduction of stated capital are more desirable than the provisions in the Act from a creditor protection perspective, as a neutral institution such as the courts are expected to objectively look into the relevant facts and strike a balance between all the relevant principles. However, it is submitted that the same extent of objectivity cannot be expected from directors. Nevertheless, it must also be noted that the Sri Lankan law has adopted a more streamlined process for the reduction of stated capital. The UK law has also embraced this approach to a certain extent by enabling a private company to reduce capital without reference to court, provided that it complies with certain prerequisites. Section 643, UK Act provides that the directors of a private company should furnish a "solvency statement", together with the requisite shareholder approval[56], and that it should be registered as per section 644, UK Act.

‘Thus, the solvency test introduced by the Act strives to achieve its goal in two ways: firstly, it acts as a warning sign to the management and the board of directors of a company, so that they are well informed of the company’s financial stability and can ensure that the company is financially healthy. Secondly, if the company has already become insolvent, the plight of the company, its officers and the penalties are also laid down under the test’[57].

Recommendation

It is noted that one of the material differences between the Sri Lankan and UK Law is the availability of a statutorily defined solvency in the Sri Lankan statute which is binding on both private and public companies. From a creditor protection perspective, the binding character of the solvency test is particularly important in relation to private companies, since such companies are mostly controlled by a few shareholders who would most probably be the directors as well.

The inclusion of criminal liability with regard to any failure to comply with capital adequacy requirements would serve as a deterrent to reckless directors. Jurisprudentially, as the companies enjoy special privileges merely because of the incorporation, imposition of such stringent sanction would be just and fair especially in Sri Lankan context. Liability of directors for the debts of a company are necessary, and would be a positive development from the perspective of creditors as it would act as a supplementary safeguard to them. The need to have a disqualification code for directors is necessary, as seen in the UK Company Directors Disqualification Act of 1986. Such developments are also beneficial from the perspective of the company, as they would compel those who are managing companies to exercise prudence and transparency in conducting their affairs.

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[54] S. 59 of the Act

[55] Section 59(3) of the Act

[56] Section 641(1) (a) read together with Section 642, UK Act

[57] W. I. Nanayakkara The Solvency Regime – A Critical Evaluation of the Legal Framework in Sri Lanka p.3 https://cmb.ac.lk/wp-content/uploads/THE-SOLVENCY-REGIME.pdf

Conclusion

From the above analysis, it appears that even though the company law regime in Sri Lanka contains certain instances in which creditor protection has been taken into account, a creditor cannot rely solely on the company law regime to obtain protection. Certain incidents in Sri Lanka have raised doubts as to whether creditors are actually protected. The company law needs to contain strong measures to ensure the sustainability and growth of the companies. The existence of a company, in a broader sense, is for the purpose of its own economic benefits and for the benefit of all the stakeholders. Hence, company law needs to be designed to balance the interest of the creditors with the interest of all the stakeholders in order to achieve the ultimate result of boosting national economy.

Whilst the Sri Lankan law offers a certain degree of protection to the creditors through the mechanisms established by the solvency test, it should also be noted that if the companies reduce the capital that the creditors would then solely have to rely on the directors to take action. Although this allows the directors to focus on taking expedient decisions to meet the profit-making goals of the company, this can prove to be disadvantageous to the interests of the creditors. Whilst the UK law protects the creditors through the mechanism of legal capital, it also provides recourse to the creditors by allowing them to assert their rights by directly going to courts. This secures the entitlements of the UK creditors through an independent mechanism, and thus provides an enhanced protection to the creditors in the UK. Thus, it is evident that the comparison between the two jurisdictions have shed light on areas of the law which ought to be looked in, in order to enable creditors a greater degree of protection when their rights are risk. Thus, this is an area worth the attention of all policy-makers concerned, in order to ensure that the existing system may be improved to an adequate level. Such policy revisions would in the short run offer a comprehensive system of legal protection to corporate creditors, and in the long run greatly aid the development of the Sri Lankan economy.

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Author's Biography

Upon graduation, W. I. Nanayakkara joined the academic staff of the Faculty of Law of the University of Colombo, as a permanent lecturer. Having passed the Attorneys-at-Law final examination conducted by the Sri Lanka Law College with honours, she enrolled as an attorney-at-law of the Supreme Court of Sri Lanka. Presently she is a Professor in the Department of Commercial Law. She obtained her M.Phil Degree and LL.M in the area of Company Law. She teaches Company Law, Business Law and International Investment Law at the Faculty of Law in the undergraduate level and Advanced Company Law and Banking Law in the postgraduate level. She has presented papers in the areas of Globalization, Corporate law, Contract Law, Banking law etc. nationally and internationally. She has published papers in the areas of Corporate, Banking, International Investment, Land, Business and Consumer Law. Currently she serves as the Dean of the Faculty of Law.