Navigating the clean-up of shell companies

The Companies Act, 2013, does not define a “shell company” and no other piece of legislation provides any guidance on what it constitutes. However, the term is generally understood to mean thinly capitalized companies with minimal assets and non-existent business operations.

Historically, these companies were deliberate arrangements created to benefit from favourable tax treaties. This explained the limited economic activity. However, over time these innocuous companies were used for unscrupulous activities. Today, they are synonymous with illegal activities like money laundering, insider trading, financing terrorist organizations and Ponzi schemes.

To curb the use of shell companies, ensure greater transparency and corporate compliance, it was notified on 26 March 2014 that sections 92 and 164 of the 2013 Act would come into effect from 1 April 2014. It required all companies to file their annual returns, setting out the prescribed particulars. It stated that directors of companies that failed to file financial statements or annual returns of the company for any continuous period of three financial years would be disqualified from being reappointed as directors of any company for a period of five years.

Compared to the Companies Act, 1956, the provisions of the 2013 Act had wider application and were more stringent. They imposed a stricter regime with higher penalties for defaulting companies; and increased the quantum of punishment along with extended provisions for disqualification of directors due to failure to file financial statements or annual returns, to all companies. Earlier, this was limited to public companies. These stricter provisions led to representations requesting a transitional period/one-time opportunity to enable companies to file pending financial statements and annual reports to avoid attracting stricter penalties, higher fees and provisions relating to the disqualification of directors.

Consequently, on 12 August 2014, the Union ministry of corporate affairs (MCA) introduced the Company Law Settlement Scheme (CLSS). The CLSS granted a period of two months to file their pending annual returns, extended immunity and reduced the quantum of additional fees to be paid for such filing. It provided that the directors of companies that availed of the CLSS would not be disqualified. Whilst the CLSS was initially intended to be in force for a period of two months, it was subsequently extended on 15 October 2014 and 14 November 2014 for, respectively, a month, and then till 31 December 2014.

Thus, effectively, non-compliant companies were granted a period of more than four months to remedy their infractions. Whilst several companies used the CLSS to become compliant, the number of defaulters continued to be quite large. They failed to utilize the CLSS and regularize their record with the registrar of companies (RoC).

Finally, starting July 2017, various RoCs released lists of companies struck off from the register of companies due to their failure to file annual returns for a continuous period of three years. In September 2017, this was followed by a list of directors associated with such companies. They were disqualified from being on the boards of any company for a period of five years.

Retrospective legislation entails the application of law to facts and events that occurred prior to the date on which such law came into effect. This is typically challenged when it increases the penalty stipulated or adversely affects vested rights under the pre-existing regime.

The provisions relating to disqualification due to failure to file annual returns came into effect only on 1 April 2014. Therefore, any disqualification based on failure to file annual returns for periods

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prior to FY2014-15 would effectively make the provision an act of retrospective legislation. This argument is buttressed by the fact that the 1956 Act did not provide for disqualification of directors of non-compliant private companies.

When one trawls through the series of notifications issued by the MCA in this regard, it is evident that based on representations made by the non-compliant companies, they were given a reasonable opportunity to file their annual returns and become compliant with provisions of the 2013 Act. However, despite the risk of increased penalties and potential disqualification of their directors, some failed to heed the changes.

The present challenge to the stricter provisions of the 2013 Act, coming three years post its implementation and after the grant of concessions for easier transition, seems like an afterthought. Nonetheless, it is technically valid.

The 2013 Act allows companies to hold their annual general meetings within six months from the closing date of the financial year. Thereafter, companies have another 60 days to file annual returns. If the MCA had waited until 30 November 2017 before issuing the list of disqualified directors, it would be based on non-compliance for a period of three years after 1 April 2014 and would not be susceptible to challenge as retrospective legislation. In its eagerness to curb the misuse of shell companies, it got ahead of itself.

While it remains to be seen how the MCA and the courts will deal with the challenge, it will certainly be interesting to evaluate the behaviour of the non-compliant companies and directors. As one of the grounds of their challenge is lack of adequate time to comply, it will be interesting to observe whether they will use the time during the pendency of this dispute to file their historical annual returns and become compliant.

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