Corporate Law: Issues in Focus

Corporate Law in the Millennium Legal Writing Competition for Juniors.

Attorney-at-Law

Introduction

Jurisdictions throughout the world are experiencing the need for changes to their corporate laws. In some countries the process began much earlier and has gained considerable ground. In.others, particularly in developing countries, the pace of change has been much slower. This paper discusses some of the merging trends, suggested reforms in Sri Lanka and areas that might need attention in a setting where there is much attention on the role of the private sector, foreign investment and the development of the capital market.

1. Corporate Governance

The importance of corporate governance is a matter that is increasingly gaining the attention of authorities in most countries, given its implications on stakeholders' interests. Corporate governance is generally understood to mean the system by which companies are managed. In the United Kingdom, the Cadbury Committee released its report on corporate governance, and some companies in Sri Lanka also followed its recommendations. Later, 'The Combined Code: Principles of Good Governance and Code of Best Practice, was issued by the London Stock Exchange in 1998.

Similarly, the General Motors' (GM) Board Guidelines, developed by the GM board in 1994 have been widely applicable in the USA. GM's Code constantly refers to the board's responsibilities to the company's customers, employees and suppliers. India also has released its code titled, 'Desirable Corporate Governance - A Code' in 1998.

The Organisation for Economic Corporation and Development (OECD) also addressed vital issues relating to this area and released its work titled, 'Principles of Corporate Governance, in April 1999. The OECD principles, in particular, address the following1,

a) Rights of shareholders b) Equitable treatment of shareholders c) Role of stakeholders d) Disclosure and transparency e) Responsibilities of the Board

In 1996, the Council of the Institute of Chartered Accountants of Sri Lanka (ICASL) set up a committee to make recommendations on matters relating to 'financial aspects of corporate governance'. Mr. RomeshdeSilva, President's Counsel, former President of the Bar Association of Sri Lanka (BASL) was a member of this Committee.

In its final report2, dated 12th December 1997, the ICASL made recommendation to effect amendments to the following,

a) Securities and Exchange Commission (SEC) Act b) Rules and regulations of the Colombo Stock Exchange (CSE) c) Companies Act d) ICASL Act and e) Formulation of a Code of Best Practice, applicable to all listed companies

The Committee's specific recommendations included the following,

- the code be directed to all listed companies, unit trusts, fund management companies, finance companies, banks and insurance companies - other companies to be encouraged to follow the Code - companies required to follow the Code must make statement of compliance

- clear division of responsibilities between the chairman and the chief executive officer

- the calibre and number of non executive directors on a board should be such that their views will carry significant weight in the board's decisions (the recent establishment of the Institute of Directors is perceived to be a factor that will enhance the role of the non executive director)

- the appointment of non executive directors should be a matter for the board as a whole, and their selection process should be based mainly on merit

- expenses of individual directors in obtaining professional advice to be borne by the company subject to prior approval of the board

- formal training for directors to give them basic knowledge in areas other than their own including short in house courses

- procedures to be laid down for the functioning of Audit and Remuneration Committees, which will be headed by non executive directors

- the Remuneration Committee will report to the Board regarding the remuneration of executive directors

- the finance function of the company will be the specific responsibility of a board director

- annual reports should include a statement regarding directors responsibilities for financial statements. This is in addition to a formal statement in the notes to the accounts stating that accounts have been prepared in accordance with Sri Lanka Accounting Standards

- directors statement in the annual report regarding effectiveness of the company's systems of internal control

- directors statement in the annual report regarding extent of compliance. This should set out the extent to which statutory payments have been made, provision for retirement gratuities and payment of management fees

- the company secretary should have the minimum qualification under the companies Act, and should advice the chairman and the board on complying with the Code

- the board of directors should draw up codes of ethics and statements of business practices for board members as well as employees and publish them internally

- the chairman's review should cover the performance of the company during the past year, and the future prospects during the year

- directors' statement indicating that they are satisfied about the company being a going concern

The Code emphasises the importance of non-executive directors, a view shared by many experts on corporate governance issues3.

The ICASL's Code has not prescribed term limits for directors. The Combined Code (U.K) requires directors to be submitted for re-election at least every 3 years while the GM guidelines (U.S.A) requires formal review of each director's continuation on the board after 5 years.

One of the most important issues not covered by the Code is succession planning/management development, whereas the GM guidelines prescribe a statement by the chief executive officer in the annual report on succession planning.

The Combined Code recommends the interaction of institutional investors with the board, a point not dealt with by the ICASL Code. The U.K Code also requires companies to establish 'a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration of individual executive directors. No director should be involved in fixing his or her remuneration' {Principle B2 of the Code). The company's annual report should contain a statement of remuneration policy and details of each director's remuneration4.

ICASL's report concluded, 'we are confident that these initiatives would enhance the levels of corporate reporting, auditing systems and board effectiveness in the Sri Lankan environment, all of which would further instill confidence and thus foster the growth and sustenance of Colombo's stock market.'5

This Code is, however, not mandatory in its application, and only serves to be of persuasive-value. The Securities and Exchange Commission of Sri Lanka by circular dated

4th January 2000 addressed to directors of public companies drew attention to the need to practice good corporate governance to avoid business disasters. This circular was only a recommendation to follow the ICASL's Code of Best Practice, and the disclosure of the company's corporate governance practices.

The SEC's circular said that the disclosures should ideally relate to the following,

a) The board's role in the management process.

b) How the board is organised to fulfill that role.

c) What authority the board delegates and to whom.

d) How the board holds the chief executive and management accountable for the result of the company.

e) How the board monitors compliance with laws and regulations, and the boards policies.

f) How the board evaluates its own performance.

g) The disclosure policy followed by the board.

h) The board's policy on ethical conduct and how it is enforced,

i) Information on shareholder value, or total shareholder return.

A similar circular (Public Finance Circular No.PF/PE3) was addressed by the Department of Public Finance in November 1999 to all commercial corporations and government owned business undertakings.

It is submitted that although compliance was only voluntary when the code was introduced in order to maintain a flexible framework, it may now be opportune to consider whether any of the recommended practices needs to be made compulsory.

Compliance with best practices assumes importance not only because of the current attention on good corporate governance but also because of the concern of foreign investors in investing in Asian economies following the currency crisis, for which one of the reasons attributed was poor corporate governance.

2. Reform of Company Law In response to the growing need for company law reform, a draft law was prepared by the Advisory Commission on Company Law appointed in terms of Section 422 of the Companies Act No.17 of 1982. The Advisory Commission proposed the reforms with the following objectives.6

a) Minimise barriers for small businesses seeking to incorporate.

b) Encourage efficient and innovative management by giving directors wide discretion in business judgement and at the same time imposing effective controls against abuse of power.

c) Remove unnecessary limits on small businesses to structure themselves.

d) Rehabilitation of businesses facing temporary difficulties.

e) Provide simple, quick and fair procedures for realising and distributing effects of defunct companies.

Some of the concepts that have been suggested are as follows7:

a) The incorporation of single shareholder companies when the shareholder is either a body corporate or if he is a natural person, a body corporate is nominated to succeed him until Court appoints an executor or administrator.

b) Measures have been suggested to encourage the incorporation of private companies. Where the company can be kept solvent shareholders may enter into agreement in writing to issue shares, make distributions, repurchase or redeem shares, financial assistance to purchase own shares, transactions that could confer benefits on a director.

c) It is proposed to simplify incorporation by forwarding an application to the Registrar of Companies with basic details, and stating that the company would be engaging in commercial activity. The company also may adopt the Articles prescribed in the proposed Act.

d) Minority shareholders opposed to major changes in the company could have their shares bought over at a fair price. This proposal allows the majority to proceed with its plans, while respecting the minority shareholders' concerns.

e) The restriction, imposed by section 55 of the Companies Act, on a company giving financial assistance to purchase its own shares is proposed to be relaxed, and the draft sets out the circumstances in which such assistance could be provided. This is line with recommendations by the Jenkins Law Committee, chaired by Lord Jenkin, in 1962, which were subsequently incorporated in the U.K. Act, and also followed in other jurisdictions.

f) The draft recommends the setting up of a 'Companies Disputes Board' to expedite dispute resolution, bring about conciliation, mediation and arbitration to solve disputes.

g) Directors duties, which have not been spelt out in the present Companies Act, will be set out under the following headings, - acting in good faith and in the best interests of the company compliance with the Act and Articles standard of care to be exercised use of information and advice These sections are based on the New Zealand Companies Act8

h) The board of directors, it has been proposed, will be under a statutory duty in certain situations to state that the company is in a solvent state. Breach may entail penal sanctions. A director who believes that the company is unable to pay its debts should forthwith call a board meeting, which should consider whether a liquidator has to be appointed.

Salutary though these provisions may seem, the proposed Act has remained in draft form for several years. Much as the need for evaluation and reform of the legal framework is necessary, in the backdrop of change both locally and in the global environment, such reform must also be given effect without delay in order that investors, company stakeholders and the capital market react positively.

3. Listing in the Colombo Stock Exchange

Only about 240 companies are listed in the Colombo Stock Exchange, with many reluctant to seek listing. Several factors may influence the decision to avoid listing, including market conditions and the regulatory framework. Family companies, in particular, are reluctant to do so in view of the disclosure requirements.

Although relaxing the disclosure standard is a debatable issue, authorities should address their minds to the possibility of giving incentives and simplifying procedures to obtain listing. It is worth noting that even the over-the-counter (OTC) market, with its less stringent rules, has failed to attract as many companies as it should have. This aspect requires consideration when formulating strategies to revitalise the Colombo stock market.

4. Maintaining the Minimum Float

Although public listed companies are required to maintain a minimum float of 25%, investigations by the regulatory authorities have revealed that about 25% of companies fail to adhere to this requirement.

In Hong Kong, maintenance of the minimum float is mandatory, while in Singapore it is not. Sri Lanka needs to give careful thought, as maintaining the float will increase the market's liquidity9.

5. Mergers and Takeovers

Mergers and takeovers in Sri Lanka are regulated by the Company Takeovers and Mergers Code of Sri Lanka promulgated by the Securities and Exchange Commission of Sri Lanka.

The Code strives to guarantee fair and equal treatment to shareholders of target companies

This Code was based to a large extent on the London City Code on Takeovers and Mergers. However, while the London City Code is flexible and self-regulating, the Sri Lankan Code is rigid and statute based.

Some principles found in the London City Code, such as the anti frustration rules, are not found in Sri Lanka's Code. The London City Code also vests a degree of discretion on the London City Panel to deal with certain situations, which Sri Lanka's Code does not vest in the SEC. The local Code contains provisions on anti fraud and insider dealing which give rise to considerable difficulties. The regulatory regime is also deficient in procedural rules.11

Mr. Marsoof12 expresses doubt whether Sri Lankan courts would show the reluctance displayed by English courts to intervene in respect of decisions by the London City Panel. The constitution of the London City Panel enables important professional bodies involved in takeovers to pick their representatives, while in Sri Lanka it is the relevant Minister who is empowered to make appointments to the Commission.

The London City Code (general principle 7) requires shareholder approval before action in respect of company affairs can be taken after the communication of a bona fide offer or where such an offer is imminent. This is not provided for in Sri Lanka's Code. Our Code also does not contain other anti frustration rules found in the London City Code. These factors may result in litigation, proving costly and damaging to both the offeror and offeree companies in takeover and merger situations.

It may be important, therefore, to consider whether Sri Lanka's Code needs further review, especially in view of increasing activity in Sri Lanka in the sphere of takeovers and mergers, which includes foreign interest in local target companies.

6. Disclosure Requirements

Reasonably stringent disclosure requirements have been imposed for listed companies. Criticisms have yet been leveled that the requirements do not afford sufficient protection to minority shareholders.

Sri Lanka's accounting standards, which have been modeled on International Accounting Standards (IAS), have attempted to bring about as much transparency to financial reporting. The Sri Lanka Accounting and Auditing Standards Act No.15 of 1995 was enacted to give legal effect to enforcement of standards recommended by the ICASL.

The first set of standards published in gazette extraordinary No.1056/19 of 2nd December 1998, were effective for financial statements commencing from 1st January 1999. These standards will be applicable to Specified Business Enterprises (specified in the schedule to the Act).

The Act sets out the duties and responsibilities of Specified Business Enterprises and their officers. The Act also set up the Sri Lanka Accounting and Auditing Standards Monitoring Board, which has commenced monitoring compliance.

This legislation could certainly raise, the standards of financial reporting and bring about more responsibility from the board of directors. Its success, however, will hinge on the effectiveness of the enforcement machinery and on its constant review and feedback.

7. Regulatory Framework

Several regulatory bodies govern the functioning of companies in Sri Lanka. These include the SEC, the CSE, the Registrar of Companies, Sri Lanka Accounting and Auditing Standards Monitoring Board, the Accounting Standards Committee of the ICASL, the Auditing Standards Committee of the ICASL etc.

It may be worthwhile if the authorities would consider whether fusion of the different authorities by bringing them under an apex body would increase the overall efficiency and effectiveness of the existing regulatory framework.