

**ROLE OF NON-EXECUTIVE DIRECTORS IN CORPORATE GOOD GOVERNANCE:
A CASE OF LICENSED FINANCE COMPANIES IN SRI LANKA**

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Introduction

The concept of corporate good governance has become a jewel in the prevailing economic conditions of a country. It provides rules, regulations, policies and procedures to corporate constituencies such as board of directors, management and shareholders to ensure the impartiality, transparency and integrity within the organizations. In the area of public listed companies where the public securities are involved in the financing process, the boards of directors play a crucial role as it is their ultimate responsibility to direct, control and lead the company appropriately to safeguard all the stakeholders at large.

Concept of Corporate Governance

The concept of corporate governance comprises of rules, regulations, policies and procedures to corporate constituencies such as board of directors, management and shareholders to ensure the impartiality, transparency and integrity within the organizations. The

directors' ultimate responsibility is to navigate the company by providing an appropriate stewardship in order to achieve its goals whilst establishing the corporate good governance practices within the company. The absence of corporate good practices will create detrimental consequences to a company.

The corporate governance received the spot light with the establishment of the Cadbury Committee in England in 1991 chaired by Sir Adrian Cadbury. This was set up to address the financial aspects of corporate governance which particularly suggested that the boards of all listed companies need to comply with the code of best practices. Furthermore, the lucidity of introducing particular responsibilities to the directors and other stakeholders in the company could create an escalation of the confidence of investors which surely become an added advantage to the business.

Subsequent to the evolution on corporate governance in the United Kingdom and in other jurisdictions, Sri Lanka has also

taken positive steps to strengthen the corporate good governance in the finance sector of the country.

Legal and Regulatory Framework in order to Establish Corporate Governance in Listed Finance Companies in Sri Lanka

In Sri Lanka, companies are regulated and controlled by various statutory enactments and guidelines. The implementation of the code of the best practices (non – mandatory) is based on “comply or explain rule”¹ which could be considered as “Soft Laws”.²

Moreover, Finance Business Act no. 42 of 2011 was introduced to monitor the financial transactions. This monitory process includes different rules, regulations, directions and notices to licensed finance entities issued by monetary board of Central Bank of Sri Lanka (CBSL), Colombo Stock Exchange (CSE) and the code of best practices. The department of supervision of non- bank financial institutions of the CBSL maintains the monitory and regulatory operations pertaining to licensed finance companies, with the intention of confirming that these bodies are in

accordance with the minimum key requirements prescribed by CBSL. These operations are conducted through off-site and on-site observations. These regulations are published under the provision of said finance business act regarding minimum capital adequacy and liquidity procedures, provisions regarding bad debts, and limitations regarding single borrowers and corporate governance. Issues pertaining to non-compliance with major requirements and defects in the financial situation of a finance company are brought into the attention of its board of directors through these enactments to ensure whether any remedial action is required by the relevant finance company in order to prevent the circumstances of any financial catastrophes in the future.

CBSL has issued a numbers of directions³ which addressed major areas in corporate governance such as electing members to the board,⁴ powers and responsibilities vested on the board of directors⁵ procedures of the board meetings⁶ formation of the board,⁷ guidelines to determine the fitness and propriety of directors’⁸ delegation of authorities,⁹ functions of the chairman and

¹ R Kraakman, J.Armour, P.Davis,L Enriques,H.Hansmann,Hertig,K.Hopt,H.Kanda and E.Rock. The Anatomy of Corporate Law : A comparative and Functional Approach, Second Edition(Oxford University Press 2009),p68

² R Kraakman, J.Armour, P.Davis,L Enriques,H.Hansmann,Hertig,K.Hopt,H.Kanda and E.Rock. The Anatomy of Corporate Law : A comparative and Functional Approach, Second Edition(Oxford University Press 2009),p67

³ Directions such as Finance Companies (Corporate Governance Direction, No. 3 of 2008

and Amended Directions No.s 04 of 2008 and 06 of 2013

⁴ Finance Companies (Corporate Governance) Direction No.3 of 2008,s 4(9)

⁵ Finance Companies (Corporate Governance) Direction No.3 of 2008,s 2

⁶ Finance Companies (Corporate Governance) Direction No.3 of 2008,s 3

⁷ Finance Companies (Corporate Governance) Direction No.3 of 2008,s 4

⁸ Finance Companies (Corporate Governance) Direction No.3 of 2008,s 5

⁹Finance Companies (Corporate Governance) Direction No.3 of 2008,s 6

chief executive officer¹⁰ board appointed committees,¹¹ financial statements and disclosures.¹² These directions articulate a board which consists of strong independent components separated from the rest of the management, other stakeholders and who should not be involved in the performance of the company directly but in a supervisory level.

Role of Non- Executive Directors in a Licensed Finance Company

Types of Directors

The board of directors of an organization holds a vital role and usually entrusted with the principal authority pertaining to its corporate matters.¹³ Since an organization is a mere legal entity which has no physical existence, the administration and control power are vested with directors. With regard to the basic theories and principles in company law, shareholders appoint a board of directors to control and exercise their rights on behalf of them.¹⁴

Furthermore, directors can be classified as executive, non-executive, independent, non-independent, nominee, alternate or shadow. Even though the company law has accepted the theory of executive and non-executive directors, the companies act has

not provided any recognition as such.¹⁵ However, in the case of *Harold Holdsworth & Co (Wakefield) Ltd Vs. Caddies*¹⁶ the executive directors had been defined as those who engage in executive function of a company and having responsibilities in the capacity of executive managers. They enjoy immense managerial powers other than non-executive directors. Besides, the non-executive directors do not involve in executive functions but play the role of an advisor and/or a supervisor. The listing rules of CSE¹⁷ and the directions of CBSL¹⁸ have also recognized and divided the functions of directors as executive, non-executive, independent and non-independent.

Amount of Directors

Except in the scenario of a public listed company which should include a minimum of two directors, all other entities shall consist of at least one director.¹⁹ However, the company has the discretion to decide the minimum and the maximum amount of the directors of the company and the quorum for its meetings by the means of the articles of association. According to the Code of Best Practices on Corporate Governance of Sri Lanka, when there are only two non-executive directors in the board, both of them must be

¹⁰ Finance Companies (Corporate Governance) Direction No.3 of 2008,s7

¹¹ Finance Companies (Corporate Governance) Direction No.3 of 2008,s 8(2)

¹² Finance Companies (Corporate Governance) Direction No.3 of 2008,s 10

¹³ R.Kraakman, J.Armour,P.Davis,L Enriques,H.Hansmann,Hertig,K.Hopt,H.Kanda and E.Rock.The Anatomy of Corporate Law : A comparative and Functional Approach, Second Edition(Oxford University Press 2009),p13

¹⁴Cabral, Harsha, Dr., Duties of Company Directors & Corporate Governance in Sri Lanka,(2001),p.2

¹⁵ Wickramanyake, Arittha, R, Company Law in Sri Lanka (2007), p. 173

¹⁶ (1955) 1 AII ER 725

¹⁷ Listing Rules of Colombo Stock Exchange, Rules 7.10.2 and 7.10.2

¹⁸ Finance Companies (Corporate Governance) Direction No. 3 of 2008 and No. 4 of 2008, s. 4(3) of Central Bank of Sri Lanka

¹⁹ Companies Act No.7 of 2007,s 201

independent. If it is more than two non-executive directors in the board, then two or one third of the amount of non-executive directors whichever is higher should be independent.²⁰

The listing rules stipulate that in an instance where there are only two non – executive directors, both shall be independent. In other occurrences, two or one third of the non- executive directors elected, whichever is higher shall be “independent”.²¹ Moreover, each non-executive director is required to submit an annual declaration stating the independency or non-independency against identified criteria.²²

Qualifications of a Director

According to section 202 of the companies act, the qualifications to be a director are not complex as they seem to be. Moreover, the companies’ articles may also provide ancillary qualifications required to be a director.

As per section 2.1 of the direction no. 03 of 2011 on the fitness and propriety of directors and officers performing executive functions, the monetary board has issued a wide range of criteria to be considered in appraising the fitness of a person to be qualified as a director. This includes notable concerns like the

possession of academic and/or professional qualifications or experiences in banking and/or finance sector or convicted by any court in Sri Lanka and/or in any other country, or declared by a court as a person with an unsound mind etc.

Besides, finance entities should obtain and submit affidavits and declarations from directors and officers selected to perform executive functions.²³ Further, a letter of confirmation stating the degree of performance of his/her duties should be obtained from the organization in which he/she precedes the appointment, in order to submit for necessary approvals from the department of supervision of non-bank financial institutions.²⁴ Further, affidavits and declarations should be submitted annually by each and every director before the annual general meeting if such director is nominated for reappointment.²⁵

The corporate scandals that have taken place in Sri Lanka and worldwide have alerted the regulatory authorities in implementing and strengthening the standards of corporate good governance. In strengthening the corporate good governance in Sri Lanka, the establishment of non-executive directors and the inclusion of detailed duties of the directors in the companies act play a vital role. Prior to this enactment, the duties and

²⁰ Code of Best Practices on Corporate Governance 2013 of Sri Lanka, s 1, principle A.5.2

²¹ Listing Rules of Colombo Stock Exchange, Rule, 7.10.2

²² Listing Rules of Colombo Stock Exchange, Rule, 7.10.2.b

²³ Finance Companies (Assessment of Fitness and Propriety of Directors and Officers Performing Executive Functions) Direction No.03 of 2011, s 3.1

²⁴ Section 3.2 of Finance Companies (Assessment of Fitness and Propriety of Directors and Officers Performing Executive Functions) Direction No.03 of 2011, s 3.2

²⁵ Section 4.1 of Finance Companies (Assessment of Fitness and Propriety of Directors and Officers Performing Executive Functions) Direction No.03 of 2011, s 4.1

responsibilities of directors were considered according to the common law principles.

The articles of association shall also facilitates the management of domestic matters such as agreements between the company and its shareholders, the company and its directors, the company and its secretaries etc. Further, directors should act accord to the company's articles.²⁶

Accordingly, a director should act with due care and skill at a degree expected from a person of his/her knowledge and/or experience.²⁷ This standard of care explicit in section 189 of the companies act. The director is granted to rely on guidance and details given by a qualified person/expert. Moreover, disclosure of directors' interest pertaining to shares and business dealings are explicit under the provisions of the companies act.²⁸ When a director gets to know that he/she has an interest in a transaction or a proposed transaction he/she should disclose his/her interest and gets it recorded in the company register. Even though failure of such disclosure wouldn't invalidate the transaction²⁹, held him/her personally liable for an offence.³⁰ According to section 219 and 220, directors are held liable (both criminal and civil) for their acts which exceed the power conferred on them. It's the responsibility of the board to take

necessary remedial actions whenever it's required.

There are particular provisions which impose "personal liability" on the director which consists of criminal and civil liability separately.³¹

The Doctrine of Independent Directors and their Liabilities

The concept of independent directors is a method of trusteeship which emerged in the United States. They are board members who are bound by moral, competence, public service duty and individual character concerns. Moreover, along with the appointment strategy which can be considered as the rights of shareholders to elect members of the board, many jurisdictions have recognized the trusteeship role of non-executive independent directors as one of the key features of corporate good governance.³² The rationale behind this concept lies to the extent that some or all members of the board of directors should not hold any senior executive positions of the company. Their role can be considered as the gate keepers or watch dogs of the organization to prevent situations of self interest and other misbehaviors within the corporate management. The Cadbury Report of 1992 has explained the importance of non-executive directors' contribution in the decision making process of the board.

²⁶ Companies Act No. 07 of 2007,s 188

²⁷ Companies Act No. 07 of 2007,s 189

²⁸ Companies Act No. 07 of 2007,s 191 and s 200

²⁹ Companies Act No. 07 of 2007,s 192 (3)

³⁰ Companies Act No. 07 of 2007,s 192 (4)

³¹ Cabral Harsha, Dr. Duties of Company Directors & Corporate Governance in Sri Lanka(2011),p. 22

³² R Kraakman, J.Armour, P.Davis,L

Enriques,H.Hansmann,Hertig,K.Hopt,H.Kanda and E.Rock. The Anatomy of Corporate Law : A comparative and Functional Approach, Second Edition(Oxford University Press 2009),p68

Further, this can be considered as one of the key features of good corporate governance which helps to address the agency problems in a company.³³ In addition, corporate governance strategies have supported the establishment of the role of non-executive directors in the listed finance entities by the means of mandatory rules such as the directions issued by the monetary board of CBSL.

The role of non-executive directors can be referred as an impartial protector which provides wide range of protection to all the corporate constituencies. Thus, they clearly help to establish robust corporate governance.

The listing rules of the CSE indicate the amount of independent directors required to be in a company and the context for defining and disclosure requirements relating to independent directors.³⁴ Further it emphasizes the necessity of having an independent non-executive director as the chairman of the related party transactions review committee.³⁵

The directors should have a clear knowledge and identification of their duties and responsibilities and their ignorance will not be an excuse.³⁶ According to the provisions of the companies act, a shareholder can take an action against the company in the court²⁶ or by providing information to the “external regulator” for not complying

with the provisions of corporate governance.

Reviewing the Directors’ Duty of Care and Skill

Section 189 of the companies act explains the standard of skill and care which should be considered by a director. When a director is utilizing or fulfilling his/her duties of a company he/she shall not act recklessly or negligently but he/she must perform his/her duties at a degree of skill and care that may reasonably be expected of a person of his knowledge and experience.³⁷

The common law has articulated this duty of care doctrine in a subjective manner. In the case of *Re City Equitable Fire Insurance Company*³⁸ court held that the standard of skill and care of a director varied and depend on the actual knowledge and experience he/she possesses and thus, it is subjective.

However, the section 189 of the companies act has contemplated on the traditional company law principles yet it has not explicitly expressed the minimum degree of care expected from the directors.

Conclusion

The major reasons behind corporate scandals are fraudulent business management, absence of proper involvement from relevant authorities and

³³ R Kraakman, J.Armour, P.Davis,L Enriques,H.Hansmann,Hertig,K.Hopt,H.Kanda and E.Rock. The Anatomy of Corporate Law : A comparative and Functional Approach, Second Edition(Oxford University Press 2009),p68

³⁴ Rule 7.10.2 of the Listing Rules of Colombo Stock Exchange, Rule7.10.2

³⁵ Rule 9.2.2 of the Listing Rules of Colombo Stock Exchange, Rule 9.2.2

³⁶ Cabral Harsha, Dr. Duties of Company Directors & Corporate Governance in Sri Lanka, (2011) , p 7

³⁷ Companies Act No. 07 of 2007,s 189

³⁸ (1925) Ch 407 at 428

moderate and excessive risk taking procedures. Thus, the role played by the non-executive directors can be considered as the role of gate keepers or watch dogs of the organization to monitor situations of self interest and other misconducts within the corporate management. However in certain circumstances, political influences can be experienced in the appointments of board of directors (especially) to the public listed companies. These appointed members could be highly political persons and it may eventually affect the trusteeship in the role of independent directors.

Moreover listed finance companies in Sri Lanka need to guarantee the adherence to the companies' act, articles of the association and regulations and directions imposed by CBSL and the listing rules of CSE. Thus, the regulations and procedures should not be ambiguous or highly complex.

From the perspective of as to whom the board of directors obliged the duty of care and good faith, the legal system of Sri Lanka has failed to implement the modern theory of establishing the interest of all corporate constituencies involved. The review of the companies act indicates that there is no recognition has been provided for the "proper purpose doctrine"³⁹ or considered it as a part of the directors' role of good faith in Sri Lankan legal context.

In conclusion, it is much vital to codify the duties of the directors by statutes and other regulatory frameworks to ensure the accomplishment of corporate good governance.

³⁹ This concept of an 'equitable principle' had been included in Section 171 of the United Kingdom Companies Act 2006 and explains that directors' duty is to act in accordance with the Companies' Articles and exercise powers only to the extent and to the purpose that they are granted to. This duty is formed on the basis of the fiduciary duty to act only

for the 'proper purpose' and not for any hidden motive.