

DIRECTORS LAW AND COMPLIANCE CERTIFICATE SESSION I

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INTRODUCTION

The business of a company is managed by the directors. The directors are expected to act collectively as a board, although the memorandum or articles of association may also provide for delegation of extensive powers to smaller committees or even to individual directors.

Applicable Legislation

- The Companies Act (Chapter 386 of the Laws of Malta)
- The Memorandum and Articles of Association
- Rules, Codes and Rulebooks issued in relation to specific sectors (financial services, gaming and listing rules)

Article 136A of the CA

“a director of a company shall be bound to act honestly and in good faith in the best interests of the company.”

In addition, the directors of a company shall promote the well-being of the company and shall be responsible for:

- (A) The general governance of the company and its proper administration and management; and
- (B) The general supervision of its affairs.

The term “director” is not defined in the CA - simply provides that “director” includes

“any person occupying the position of director of a company by whatever name he may be called carrying out substantially the same functions in relation to the director of the company as those carried out by a director”.

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- Almost invariably, directors are individuals (physical persons). The CA however recognises the notion of a “corporate director” and occasionally companies do have bodies corporate as directors. A “body corporate” is defined as an entity having a legal personality distinct from that of its members, and includes a foreign corporation.
 - A company whose securities are listed on the Malta Stock Exchange may however, only have individuals as directors.

*Function and
Composition of
the Board*



Functions of the Board

- Define the strategy and policy of the company
- Establish an internal and external reporting system
- Assess and monitor the company's operations, opportunities, threats and risk

Composition of the Board

- The Board of Directors should be of sufficient size to meet the requirements of the business
- Should be composed of members who have the required knowledge
- Listed companies should have a minimum number of non-executive directors
- It is recommended that at least 1/3 of the board members are non-executive and the majority of these should be independent

Responsibilities of the Board

- The **Code of Principles of Good Corporate Governance for Listed Entities** states that all directors should:
 - i. exercise prudent and effective controls enabling risk to be assessed and managed;
 - ii. be accountable for all actions or non-actions arising from discussion and actions taken;
 - iii. by them or their delegates;
 - iv. determine the company's strategic aims and organizational structure;
 - v. regularly review management performance and ensure that the company has the right mix of financial and human resources to meet its objectives and improve the economic and commercial prosperity of the company;
 - vi. acquire a broad knowledge of the business of the company;
 - vii. be aware of and be conversant with the statutory and regulatory requirements connected to the business of the company;
 - viii. allocate sufficient time to perform their responsibilities; and
 - ix. regularly attend meetings of the Board.

Different Types of Directors

Executive vs Non-Executive Directors

Executive Directors

- Concerned with actual day-to-day management
- Have executive functions in addition to board duties that would be delegated to them by the Board or Articles of Association.

Non-Executive Directors

- External directors
- More of an advisory/supervisory role to protect the company's interests
- Main role is the Oversight and monitoring of management decision making.

RESPONSIBILITIES AND DUTIES AT LAW ARE IDENTICAL

Independent vs Non-Independent Non-Executive Directors

Independent Non-Executive Directors

- Free from any present and past business, family or other relationship with the entity, shareholder/s or the management of either.

Non-Independent Non-Executive Directors

- External directors generally representing the interests of a major shareholder

RESPONSIBILITIES AND DUTIES AT LAW ARE IDENTICAL

De jure Directors and *De facto* Directors

De jure Directors

- Person formally appointed as director.

De facto Directors

- Person may not have been formally appointed as director
- person carries out substantially the same functions in relation to the direction of the company as those normally carried out by a director.

De jure Directors and *De facto* Directors

In **Re Hydrodam (Corby) Ltd.**, the Court suggested the following definition of a **de facto director**:

“[a] de facto director is a person who assumes to act as a director. He is held out as a director by the company, and claims and purports to be a director, although never actually or validly appointed as such. To establish that a person was a de facto director of a company, it is necessary to plead and prove that he undertook functions in relation to the company which could properly be discharged only be a director. It is not sufficient to show that he was concerned in the management of the company’s affairs or undertook tasks in relation to its business which can properly be performed by a manager below board level.”

Shadow Directors

- People who are not directors but occupy some position of influence in a company (e.g. a majority shareholder)
- In the habit of giving directions to the directors of the company

Alternate Directors

- Appointed by a director
- Usually entitled to perform all functions of his appointed as a director in his absence
- M&As of the company must explicitly provide for possibility to appoint alternate directors.

Appointment of Directors

Appointment

- Appointment by Shareholders
- Appointment by casual vacancy
- Appointment by third parties

Appointment (cont.)

- The first directors of the company are identified in the **original memorandum of association** delivered for registration (appointment by shareholders).
- After incorporation, **changes in the directors may occur**. The rule is that the shareholders appoint and remove directors which right is normally exercised in the Annual General Meeting of a Company. For removal of directors there is a procedure that needs to be followed.
- There may be Articles which hold that directors **are in office for a fixed term, or else there may be a rotating system**.
- If the Articles are **silent**, directors **hold office from one General Meeting to another** and if not removed, they are automatically reappointed.
- In case of regulated entities, the director's appointment shall become effective upon approval by the relevant Authority.

Appointment (cont.)

- In the meantime, a director **may resign, or pass away in which case there is a casual vacancy** (article 140 (6) of the CA). This is not filled by the shareholders, but by the other remaining directors. This is therefore an exception to the rule. The person who has been appointed to fill in a casual vacancy will remain in office until the next General Meeting and at that meeting the shareholders will decide whether they will be keeping such a persons or not.
- Articles of the company sometimes contain a 'Share Qualification Clause'; for a person to be appointed as a director, such person must also be a shareholder of the company. If an individual is appointed to a board of directors which has a share qualification clause, he is given 2 months to acquire shares in that company. If he does not do so, he cannot stay on as a director of the company (article 139(2) & (3)).

Eligibility

Eligibility

- Eligibility
- Any person aged 18 years +
- Maltese or Foreigner

Disqualifications

Disqualifications

Any person who:

- Is interdicted or incapacitated;
- Is an undischarged bankrupt;
- Is convicted of any crimes affecting public trust or theft or of fraud or of knowingly receiving property obtained by effect of fraud; and
- Is an unemancipated minor or a person who is subject to a disqualification order in terms of article 320 of the CA

may not be appointed as a director of a company.

Disqualifications (cont.)

Dr Kevin Dingli noe vs. Dr Joseph Bonnici noe et. (Commercial Court – 1995, Court of Appeal – 2002, Court of Appeal – 2003)

Facts:

The Commercial Court and Court of Appeal examined a number of issues relating to the disqualification of directors.

The plaintiff (one of the two directors of a company) had discovered that the defendant Prokidis (the other director) had been convicted of fraud by the Greek courts.

As a consequence, the banks were refusing to provide services to the company as long as Prokidis continued to be a director.

The plaintiff, relying on art.125(b) of the Commercial Partnerships Ordinance, asked the Court to declare that Prokidis was disqualified from exercising powers of a director and to order the Registrar of Partnerships (the second defendant) to register the disqualification and removal of Prokidis as director.

Prokidis pleaded that the Court had no jurisdiction to entertain the claim and that the plaintiff had no juridical interest in filing the proceedings.

Disqualifications (cont.)

Decision:

Both the Commercial Court and Court of Appeal delivered elaborate judgements on the issues involved and essentially reached the same conclusions.

- **On the question of juridical interest of the plaintiff**, it was held that although in the normal course it would be the board or the general meeting which would take action, in the name of the company, to obtain a declaration that a director is disqualified, in the particular case, a third party had an interest in filing such proceedings if he could establish the potentiality of harm.
- Both the Commercial Court and the Court of Appeal had no doubt that the plaintiff was so affected and therefore had every right to sue to have his co-director removed to avoid further prejudice.

Disqualifications (cont.)

Decision:

- The Commercial Court also noted that while a number of provisions in the Commercial Partnerships Ordinance identified the persons entitled to take action, the provision dealing with the disqualification of directors was silent on the matter.
- The Court also held that the fact that the Greek judgements had been delivered were held to be sufficient for the purposes of the disqualification provisions in the Commercial Partnerships Ordinance.
- Finally, it should be noted that the Commercial Court further declared that its judgement was not to have retroactive effect as otherwise the rights of third parties would be violated, especially the rights of those persons who had previously contracted with Prokidis as a director of the company. The Court of Appeal, while noting that no appeal had been filed on this issue by the plaintiff and that therefore this issue had become res judicata, agreed with the reasoning of the Commercial Court on the question of retroactivity.

Vacation of Office of Directors

Vacation of Office of Directors

- Expiration of period of office
- Disqualification
- Resignation
- Death
- Removal
- By a court order
- Liquidation

Directors' Powers

POWERS OF DIRECTORS

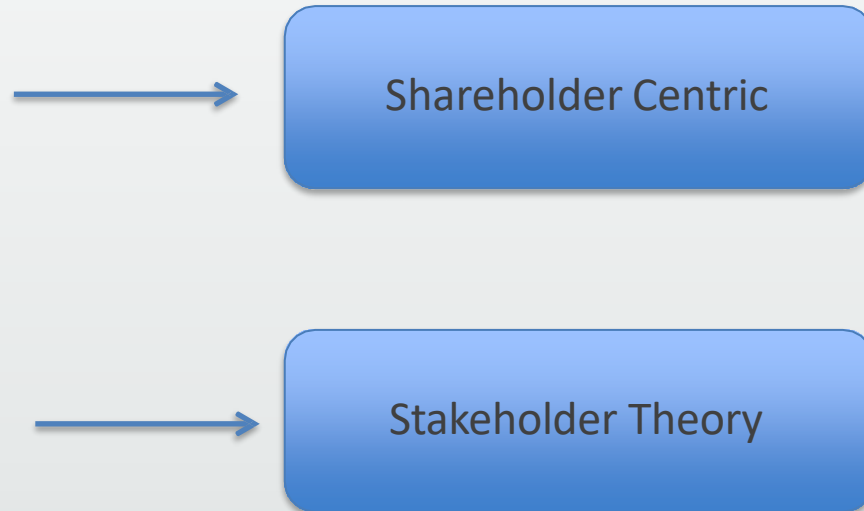
- It is common for directors to be granted broad discretionary powers.
- Arguments in favour: efficiency/smooth managements;
- Risks: Abuse of power

LIMITS ON DIRECTORS' POWERS

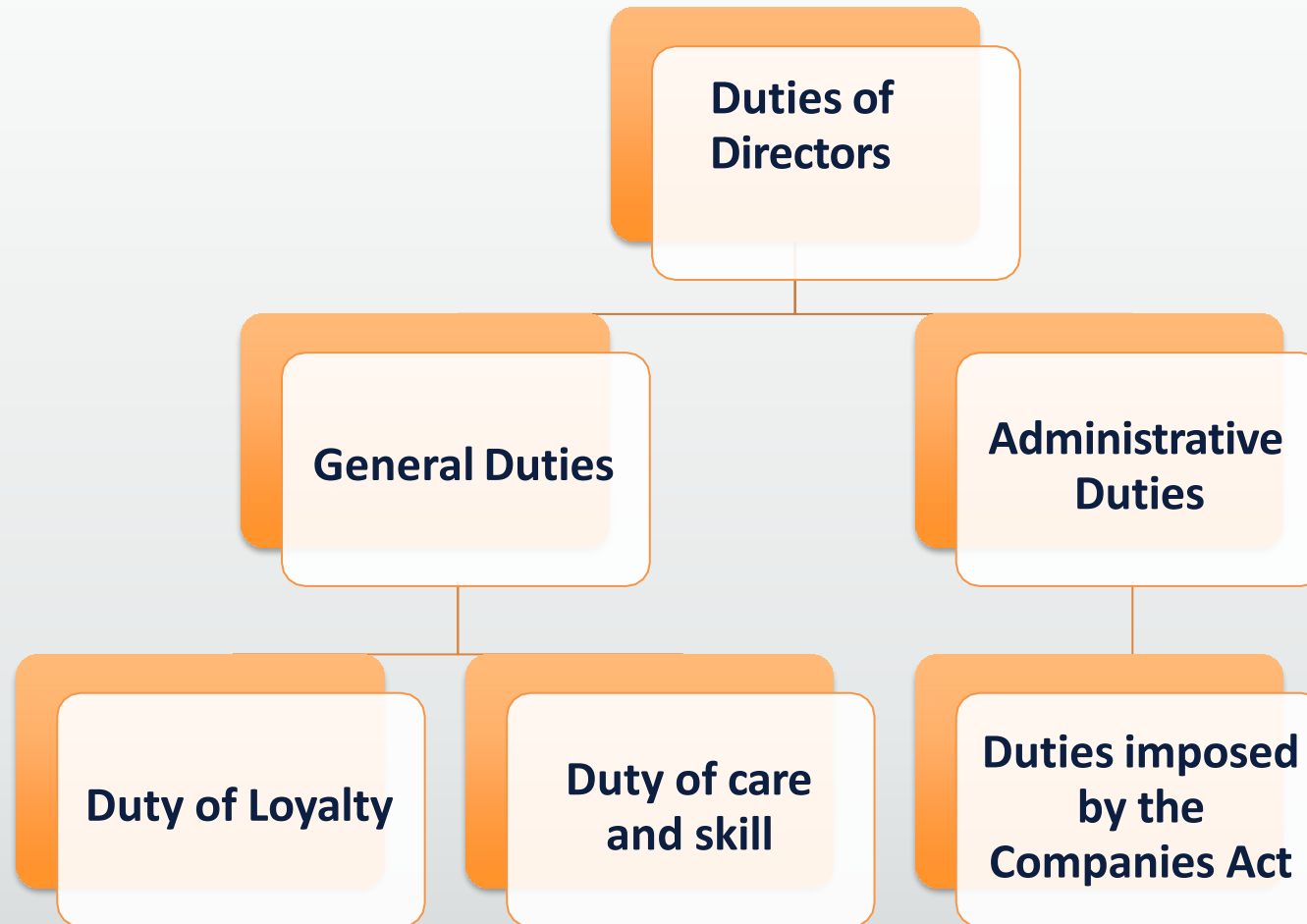
- Limits are those imposed in the M&As or anything contained in the law which requires a shareholders' resolution at a general meeting.
- Another restraint on potential abuse is the set of duties which company law imposes on directors.
- However, anything done by a director which is beyond his powers, shall be binding on the company unless that act exceeds the limits of their authority by virtue of the CA.
- Any limitation on the powers of the directors cannot be relied on as against third party even if it arises from the company's M&As.

FOR WHOSE BENEFIT IS A COMPANY RUN?

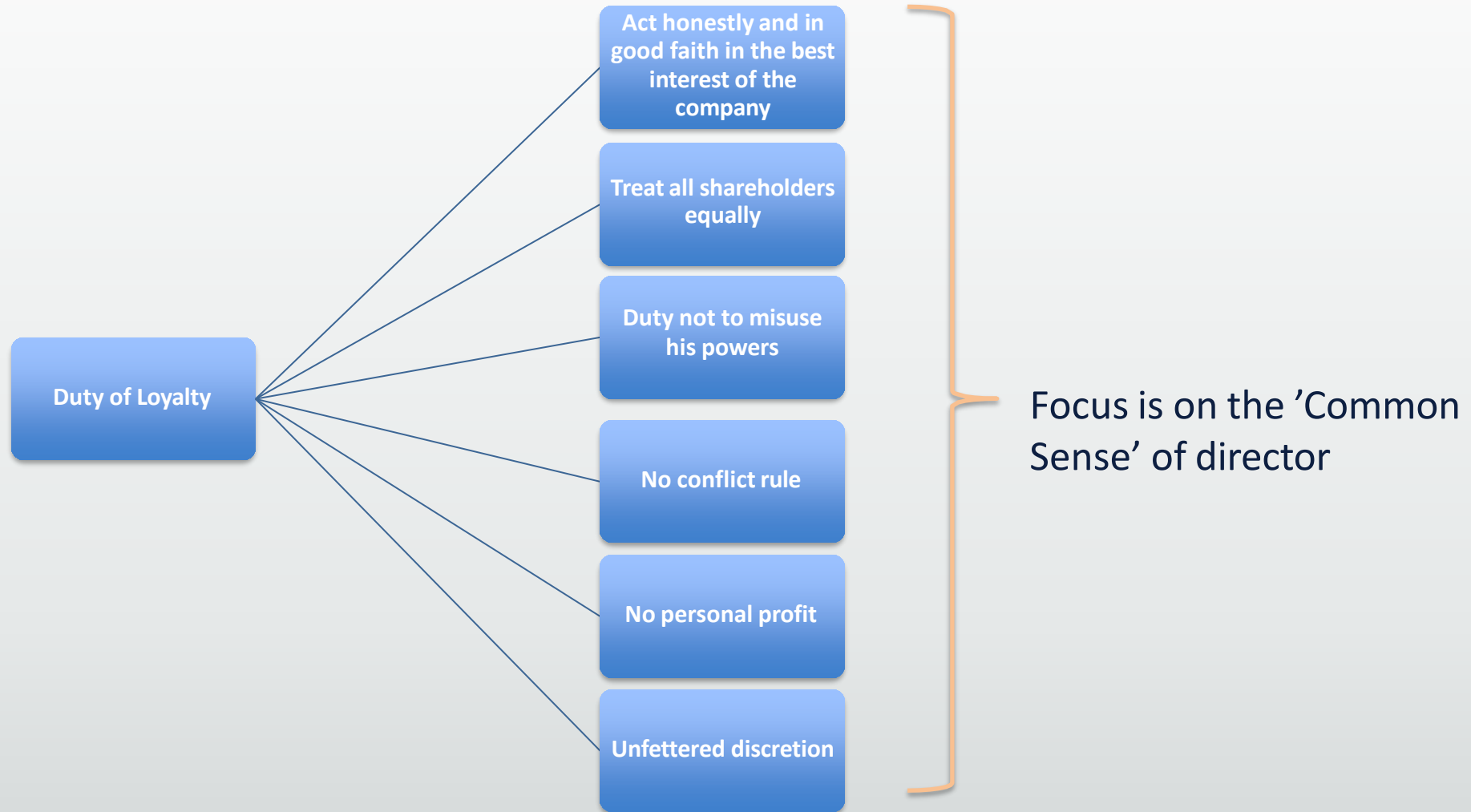
Various theories have been proposed as to how a company should be run and ultimately to whom directors owe their duties:



DIFFERENT TYPES OF DUTIES



DUTY OF LOYALTY



A. The duty to act honestly and in good faith in the best interests of the company.

- Art.136A(1) of the Companies Act
- Compliance with the rule is tested in 'common sense' principles.

Re.Smith & Fawcett Ltd

- _ Directors are required to act bona fide in what they consider, and not what a court may consider, is in the best interests of the company

Re. W & M Roith Ltd

- _ There need not be actual dishonesty for there to be a breach of duty. It is sufficient that the board did not direct their minds to the questions as to whether the proposed transaction is in the interests of the company

B. Equal treatment of all shareholders

- Scottish Cooperative Wholesale Society Limited v. Meyer
- Nominee directors owe their duties to the company as a whole and not the shareholder which appointed it.
- Mutual Life Insurance Co of New York vs. Rank Organisation Limited
- Court considered that the decision of the directors not to issue shares in favour of all the ordinary shareholders (excluding Canadian and American shareholders) was not to have been in breach of the equality of treatment principle in view of the onerous requirements which the Securities and Exchange Commission and the equivalent Canadian commission imposes.

C. Proper use of powers/ Improper Purposes

- Duty to remain within their powers.
- Directors must not do any act or enter any transaction which is illegal or ultra vires or beyond the powers conferred to them.
- Directors cannot exercise any powers for a purpose other than that for which they were conferred. Even if the directors act honestly for what they believed to be in the interest of the company, they may still be liable for breach of duty if they exercise their powers for a different purpose than that for which they were conferred.

Third party reliance (Article 137)

- Notwithstanding anything contained in the memorandum and articles of association relating to the manner in which the representation of the company is to be exercised, anything done by the BoD which exceeds the limit of its authority or by any director which is beyond his powers is binding on the company unless that act exceeds the powers granted to BoD or to a director, as the case may be, by virtue of the Companies Act (A. 137 (4)).
- Any limitation on the powers of the BoD or of any director of the company cannot be relied on as against third parties independently of whether that limitation, published or not, arises from the memorandum or articles or from any resolution of the general meeting or from a decision of the board of directors (A. 137(5)).

Third party reliance (Article 137)

- Where an act of the company falls outside the company's object the company is not bound if it proves that, when the act was done, the third party knew that it was outside the company's objects or the third party could not in view of the circumstances have been unaware thereof.
- Provided that the publication of the memorandum and articles of the company is not in itself sufficient to prove that the third party knew, or could not have been unaware, that the act was outside the company's objects. (A.137(6)) .

Howard Smith Ltd v. Ampol Petroleum Ltd

- The directors had the power to issue shares in W Millers;
- W Millers was subject to a hostile takeover bid by a large petrol company called Ampol. Ampol already controlled 55% of the shares in the company;
- Another company, Howard Smith, however, had offered to better the terms of employment of the directors in the future and for this reason, the directors did not want Ampol to complete the takeover bid;
- The directors issued new shares to Howard Smith with the effect that Ampol was not in a position to takeover the company.
- The court decided that it was not improper for the directors to issue shares to a large company to secure the financial stability of the company, however if the purpose was solely to dilute the majority voting power to obtain some personal advantage, then the issue of shares would be improper and not in the best interests of the company.

D. Duty to avoid conflicts of interest

- Positive duty on directors to ensure that their personal interests do not conflict with the interests of the company.
- A director having a continuing material interest that conflicts with the interests of the company should take effective steps to eliminate the grounds for conflict.
- Conflict of interests can be managed (A. 145 of the CA).

E. Prohibition of loans, guarantees to directors

- Art.144(.1)(a) of the CA provides this prohibition. However, there are carve outs to this general rule.
- Consequences of such a breach is that the unlawfulness of the contract will make such contract null ab initio.

F. No profit rule

- Prohibits directors from:
 - (a) making secret or personal profits from their position without the consent of the company;
 - (b) making personal gain from confidential information; and
 - (c) using any property, information or opportunity for their own or anyone else's benefit.

MISUSE OF INFORMATION / CORPORATE OPPORTUNITY

Industrial Development Consultants v. Cooley

Cooley was employed with IDC and was involved in negotiations with the Eastern Gas Board to secure construction contracts for IDC. It was clear that EGB were no longer interested in contracting with IDC. The board of EGB approached Cooley to take on a position with EGB. Cooley resigned and joined EGB on the premise that he was sick. IDC accepted the resignation.

The court held that Cooley occupied a fiduciary position which subjected him to an obligation to avoid possible conflicts of interest between his personal interests and his fiduciary duties. Although he knew that EGB was embarking on a new project but not willing to contract with IDC, he used that information for personal gain. The court found him liable on the grounds of misuse of information.

G. Duty not to compete with the company

- A director may not carry out business which is in competition with that of the company on whose board he sits unless shareholder approval is obtained.
- A breach of this article may give the company an option of either taking action for damages and interest against the director or demand payment of any profits made by him in contravention of the rule.

H. Unfettered discretion

- Not provided for in the Companies Act.
- Directors cannot validly contract with one another or with third parties as to how they will vote at future board meetings or conduct themselves in the future, even if there isn't an improper motive or purpose and even if no personal advantage is to be gained by the directors under this agreement.
- This does not mean that if in the bona fide exercise of their discretion, the directors have entered into a contract on behalf of the company, the directors cannot in that contract validly agree to take such further action as may be necessary to perform the contract.

I. Duty to promote the well-being of the company

- This duty is laid down against a background of a broader statement, also contained in Art.136A(2), that the directors of a company are to promote the well-being of the company and are responsible for the general governance of the company and its proper administration and management; as well as the general supervision of its affairs.

DUTIES OF SKILL AND CARE

Art.136A(3) specifically obliges directors to exercise “the degree of care, diligence and skill which would be exercised by a reasonable diligent person having both;

- knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by or entrusted to that director in relation to the company; and
- the knowledge, skill and experience that the director has.”

Re City Equitable Fire and Insurance Co Ltd

- A director need not exhibit in the performance of his duties, a greater degree of skill
- than may reasonably be expected of a person of his knowledge and experience.

Dorchester Finance Co vs Stebbing

- Subjective test applied to the skill of that particular director, but he was nevertheless required to exercise the diligence that an ‘ordinary man may be expected to take’.

DUTIES QUA MANDATORY

- Directors are subject to the duties on mandatories in the Civil Code insofar as these do not conflict with the Companies Act.
- One such duty is that of carrying out the mandate so long as the mandatory is vested therewith. The mandatory also has a duty to render account of his management to the mandator. In the case of non-performance of such duty, the mandatory is answerable for damages and interest.

FIDUCIARY DUTIES

A fiduciary is defined as a person who:

- Owes a duty to protect the interests of another person;
- Holds, exercises control or powers of disposition over property for the benefit of other persons, including when he is vested with ownership of such property; or
- Receives information subject to the duty of confidentiality and is aware that such information is intended to be confidential.
- Fiduciary obligations are set out in the Civil Code. However, in reality many overlap with those set out in Article 136A of the Companies Act.

OTHER STATUTORY DUTIES

- Duties relating to the keeping of statutory registers and minute books
- Duties relating to the filing of returns and documents
- Duties relating to board and general meetings
- Duties relating to record keeping and financial statements
- Duties relating to the liquidation of the company
- Miscellaneous duties

CSP Regime

- Subject to certain exemptions, a person who by way of business acts as director of a company may qualify as a 'person offering company services' under the Company Service Providers Act, thus falling within scope of the MFSA rule book on company service providers.
- Depending on the number of directorships being offered, the director may be required to obtain a license/authorization with the MFSA or set up a company and be subject to various ongoing capital, solvency and governance requirements.

DUTIES OF DIRECTORS OF LISTED ENTITIES

A director sitting on a board of a company that has its securities admitted to listing has a number of additional obligations to comply with. Principally, one must meet continuing disclosure requirements, including:

- a) Company Announcements
- b) Related Party Transactions
- c) Dealing in Securities
- d) Financial Market Abuse (insider dealing, unlawful disclosure of inside information and manipulative practices)

(A) COMPANY ANNOUNCEMENTS

- The Listing Rules provide for a variety of instances in which a company announcement is to be made, including:
- Price sensitive facts which are not public knowledge (inside information);
- Any change in the board of Directors, co-sec or any other senior officer;
- Date of meeting at which dividend is to be proposed by the directors; and
- Planned mergers, amalgamations, disposals or acquisitions; and material changes to capital structure.

(B) RELATED PARTY TRANSACTIONS

- Care must be taken with respect to the effect of related party transactions in the financial position and performance of the company. Audit committee must approve the RPT.
- Definition of “related party”:
 - A person or a close member of that person’s family is related to a reporting entity if that person has control, joint control, or significant influence over the entity or is a member of its key management personnel.
 - An entity is related to a reporting entity if, among other circumstances, it is a parent, subsidiary, fellow subsidiary, associate, or joint venture of the reporting entity, or it is controlled, jointly controlled, or significantly influenced or managed by a person who is a related party.

(C) DEALING IN SECURITIES

- Directors of listed company shall not deal in any of the securities of the company:
- When he is in possession of unpublished price-sensitive information in relation to those securities;
- Prior to the announcement of matters of an exceptional nature involving unpublished price-sensitive information in relation to the securities' market price;
- On considerations of a short-term nature; and
- Without giving advance notice to the Chairman.

D. FINANCIAL MARKET ABUSE

Three main facets:

- Insider Dealing;
- Unlawful disclosure of insider information; and
- Manipulative market practices.

Insider dealing

- The Prevention of Financial Markets Abuse Act (Cap. 476 of the laws of Malta, the 'PFMAA') and the Market Abuse Regulations imposes additional obligations on directors in view of the fact that directors are automatically deemed to be persons in possession of *Inside Information*.

Insider dealing

- Defined as:
 - Information of a precise nature, which has not been made public, relating, directly or indirectly, to one or more issuers or to one or more financial instruments, and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments;
- Insider dealing arises where a person possesses inside information and uses that information by acquiring or disposing of, for [their] own account or for the account of a third party, directly or indirectly, financial instruments to which that information relates.

II. Unlawful disclosure of inside information

- Unlawful disclosure of inside information arises where a person discloses inside information to any other person and such disclosure is not made in the normal exercise of his/her employment, profession or duties.

III. Manipulative market practices

- Occurs by virtue of the entry into a transaction which gives or is likely to give, false or misleading signals as to the supply of, demand for, or price of, a financial instrument or the transmitting false or misleading information

The Code of Principles of Good Corporate Governance provides that the board has the first level of responsibility of executing four basic roles of corporate governance:

