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SMALL AND MEDIUM ENTERPRISES

The importance of their sustainability and growth

NEWSPAPER POST

DIRECTORS AND SMALL COMPANIES – a discussion paper

The company was an extraordinary invention. It helps to remember how the notion of the company started and how it grew. The company as we know it today evolved over centuries from the joint stock company which first started being properly regulated in the early 19th century. The original company was typically a big, hugely expensive and risky enterprise. Buying and fitting out vessels often for cross-oceanic expeditions, or the building of canals and railroads. The creation of the company and the benefit of official incorporation had its critics and caused controversy. Objections and concerns increased extensively when the great concession of shareholder limited liability was added.

That is now history, but it is an instructive and interesting story. Today, the main legislation on companies in Malta is the Companies Act 1995. Companies are legal fictions and the creation of law; they exist because the Companies Act allows it. Today the corporate form is used as a vehicle for less ambitious objectives, even for single transactions or to hold an asset.

A company is an artificial legal person which enjoys the rights of human persons without many of the disadvantages. It has proved extremely flexible and resilient and can undertake any business whatsoever. The company can be used for simple as well as complex transactions and has served business growth well. It can issue shares to investors who benefit from limited liability. Unfortunately it has also protected fraudsters, speculators, tax evaders and sundry wrongdoers, as well as dodgy directors.
In Maltese economic experience, the company is by far the most popular and the most important form of business organization. So it is our business as lawyers and accountants to understand it well. Today some 85,000 companies exist on the official company register held at the MFSA which has housed it since 1997. Most are private limited liability companies. Public companies are fewer in number, possibly about 80.

Our first modern company law was the Commercial Partnerships Ordinance (CPO) which was drawn up in the late 1950's by Maltese legal experts and brought into force in 1965. The Ordinance was a good law for its time and proved particularly successful in promoting the private limited liability company. On the other hand, the Ordinance (CPO) was eventually found to be very lacking in such areas as the winding up of companies, the duties of liquidators and the duties and responsibilities of directors.

An area which has attracted much merited scholarly and judicial attention during these past twenty-five years is directors' duties and personal liability. Whole books have been written about the subject. Companies are primarily led and directed by the directors. The CPO more or less allowed directors to be largely unregulated and shareholders and directors were allowed too much power and discretion to determine the direction and destiny of the company very often at the expense of third parties. This led to the abuse of the corporate form and of the benefit of limited liability given to the shareholders. In fact, this unregulated situation led to much abuse by directors and shareholders at the expense of the company's creditors, customers and employees. Directors (and shareholders) felt immune, and in practice, to a large extent, they probably were.

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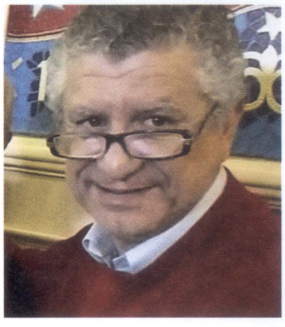

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DAVID FABRI HEADS THE DEPARTMENT OF COMMERCIAL LAW AT THE UNIVERSITY OF MALTA. HIS MAIN AREAS OF INTEREST AND RESEARCH ARE REGULATION, FINANCIAL SERVICES LEGISLATION, CONSUMER POLICY AND PROTECTION, CORPORATE LAW, WHISTLE-BLOWING AND BUSINESS ETHICS.

The substantial abuse of the lack of adequate regulation of directors under the CPO framework was therefore evidence, if any was needed, that companies and their operators needed to be adequately regulated and monitored and provision should also be made to punish wrongdoers where appropriate. Self-regulation has not worked and more detailed regulation was necessary to protect creditors, employees and other third parties. The law is now clearer and in 1995 the Registrar was assigned significant powers of intervention and investigation. Having proper legislation and higher standards should lead to the added benefit that more people will be prepared to place their trust into dealing with companies, small and big.

For many purposes, the Companies Act does not distinguish between small and big companies. It does however draw important distinctions between public and private companies. The distinction between listed and unlisted public companies is also significant because listed companies are more strictly regulated. Indeed, the directors of listed companies have to adhere to a whole set of additional rules and responsibilities arising under the Financial Markets Act and the Prevention of Financial Markets Abuse Act and other rules arising thereunder.

It is probably correct to say that the Companies Act seems more concerned with the distinction between private and public companies, than between big and small companies. This fundamental issue was addressed when important amendments to the Companies Act were being considered in 2003. Let us focus on just three of these provisions. Article 329A which introduced a new duty on directors was made applicable to all companies which may find themselves in financial distress, and a suggestion that it should apply solely to public companies was discarded. On the other hand, the new Company Recovery Procedure introduced by article 329B was only applied to companies which were not "small companies" as therein defined.

And finally, the very important article 136A which introduced a general statement of directors' duties, even before UK law did, drew no distinctions and was made applicable to directors of all companies. This was founded on a clear policy intent to lay down one common standard of conduct for all directors of all companies, big or small, private or public. The aim was to close the hatches and let now one out, with little room for quibbling or playing with words. If you are a director then you have the responsibilities of a director. With such responsibilities come potential liabilities for breach of those duties as set out in the law, including potential civil and criminal liabilities. Article 136A tried to put a halt to the usual half-baked excuses and whinging by directors trying to escape liability for their dereliction of duties and wrongdoing. It was no longer possible to plead one's own incompetence or ignorance, which was often another fashionable attempt to escape culpability. The intention was to simplify matters by having one principle apply to all companies equally. On the other hand, criticism predictably was directed against the one-size-fits-all approach. Some confusion and a race to the bottom could have arisen had the law opted to differentiate between different types of directors: directors of small as against big companies, or of private and public companies; or between the so-called non-executive and executive directors, a distinction which today seems to enjoy a certain unmerited popularity.

Good and ethical corporate governance should be adhered to irrespective of the size and type of company. Good governance is not the preserve of public or listed companies. If it falls upon smaller companies to set a standard in how they are run or should be run, then so be it. Companies and their employees, customers and creditors enjoy a better run in the long term if they are properly and ethically administered and operated. Employees would better serve an honest employer and consumers respond favourably to a company which takes their concerns seriously and whose directors are perceived to be fair and honest.

Companies, whatever their size, should not be set up to cheat one's spouse, partner, business associates, customers and creditors, or to break the law in opaque ways. This has happened and will probably continue to happen, but companies big or small should conduct themselves as good corporate citizens, safeguarding not just the place of work but the broader environment outside. Companies should have more ethically defined objectives based on a culture favouring lawful and correct behaviour. In this context, the role to be played by the directors is pivotal and crucial. As the leading officials of the company, directors should lead by example setting the ethical tone which employees will discern and follow.