Who is Responsible for the Downfall of Companies: A Critical Study of Sri Lankan Law

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Background

The well-known saying that the 'Private Sector is the Engine of Growth' implies that a company is a creature of the law for the purpose of economic gain (other than the negligible percentage of non-profit entities) and not to sustain losses. However, in practice, many companies do not achieve their goal of making profit and cause hardship to all stakeholders. Is the law adequately covering the duties of responsible persons; who is responsible for the losses, if they can be identified; how can the duties posed on those personnel be enforced; can they be held liable; are there any ways to prevent company making losses or at least whether the damage can be reduced, are the questions for research. Downfall of companies is considered in three stages in this research for the purpose of analysis. Companies sustaining losses in certain transactions, but still stable and solvent is the first stage; companies in financial crisis and striving hard to survive by using the means available under the Companies Act of 2007 of Sri Lanka (CA 2007) is the second stage and the last stage is after the commencement of insolvent winding-up.

The role companies play at present is different from the historic era. The widespread acceptance of CSR has converted companies from the position of mere commercial entities to corporate citizen status which are legally and socially responsible for a wide range of duties. While shareholder value is retained, an expanded notion of stakeholder is given prominence. Companies owe a duty not only to shareholders but to employees, consumers, suppliers, society and the State. If these stakeholders enjoy the fruits of earnings, or in other words get benefit out of companies' profits, are they not responsible when the company suffers losses?

Firstly, employees as stakeholders are not part of internal management of the company. They will learn about the downfall (the 1st stage referred above) only when the bonus is not paid. Even in such a situation the employees have no right to interfere in the management of the company. It is to be noted that Sri Lanka does not have a provision similar to s.172(1)(b) of Companies Act 2006 of the UK which provides that the directors of a company must regard interests of the employees.

Secondly, the consumers and suppliers are in no better position and they do not have any special information as to the company's financial position. Suppliers may be alert when their bills are not settled, but their rights are limited to that of a creditor. The Companies Act of Sri Lanka has not provided for any right to the creditor during the life of the company. In the recent Australian case of *McCracken v Phoenix Constructions (Qld) Pty Ltd* [2012] QCA 129, the Queensland Court of Appeal reaffirmed the orthodox position that creditors, (or other persons whose interests are affected) are not entitled to claim damages against a director personally for contravention of s.1324(10) of the Corporations

Act of Australia, and unanimously held that the Act did not empower the trial judge to award damages to Phoenix Constructions (the creditor) and to do so was contrary to the intent of the statutory provisions.

Thirdly, the recipient of the benefits of the company is the society or the public at large. The Companies Act 2007 allows public inspection of certain records. (S.120 of CA 2007) and in addition, financial statements of all PLCs are published in the newspapers. These are sufficient for any smart citizen to become aware of a company's plight. However, the people are too busy in this competitive world and have no time to spend on something in which they are not directly connected.

Fourthly, the State has given, by law, freedom for companies to do any business or activity or enter into any transaction (s.2 (2) CA 2007) and do not interfere unless there is crisis.[1] In such situations of difficulties the State intervenes through its agencies such as CB or SEC in the interest of the public. The Seylan Bank financial crisis is a good example of how State intervention prevented the fall of the bank. Nevertheless it will not be possible for the State, through CB, to revive a non-banking company in crisis, but may be possible through the SEC which reviews the Annual Reports of all PLCs, although it is not a statutory duty. The SEC may be in a position to detect losses in the 1st stage that is referred above.

Fifth and the last category of stakeholder are shareholders who are important in the life of a company. Shareholders take part in the profits of the company by way of dividends, bonus shares and capital gain. They have the right to obtain copies of annual reports (s.167 of CA 2007) and right to inspect minutes and resolutions (s.119 of CA 2007). Hence, they are privy to company's financial status. Although remedies are available under ss.224, 225 and 234 of the CA 2007 of Sri Lanka, the general trend in Sri Lanka is that the shareholders are not vigorous and very hard to find an active shareholder like the petitioner in *Amarasekera v. Mitsui & Co. Ltd*. Courts are also mindful about shareholder actions that are very costly as in *Prudential Assurance Co v. Newman Industries* [1982]. At the same time the shareholders do not owe fiduciary duty towards the company.

The whole responsibility ultimately rests on the board of the company. Directors are equivalent to trustees and bound by fiduciary duties. The directors statutory duties are mainly under ss.187,188,189 of CA 2007 and out of these s.187 speaks of acting in the best 'interests of the company' which is very wide and could hold any director responsible for breaching the same. In addition ss.219 and 220 are paramount duties on directors when they come to know that the company is not financially stable. Moreover, Solvency Test is another important mechanism introduced in the CA 2007 to curb situations of financial crisis. Civil and criminal liabilities of Directors provided in the Act for non-compliance/contravention are also mechanisms to urge directors to comply although the liability provisions are rarely enforced. PLCs are under a further stringent obligation to adopt corporate Governance. Nevertheless, the Sri Lankan statute lacks a provision similar to s, 172 of CA 2006 of UK which provides that the directors owe a duty to promote the success of the company. This is referred as one of the interesting innovations by authors who, at the same time raise doubts as to the interpretation of this requirement, as in *Item Software (UK) Ltd v. Fassihi* [2004].

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[1] For example, the Seylan Bank PLC crisis during 2009/11 or NSB-The Finance PLC issues.

Methodology

The study uses Mixed Method Procedures, including both qualitative and quantitative methods. The approach is qualitative in the sense that it is an in-depth analysis of the stakeholders' responsibilities and directors' duties on a comparative basic from library and web sources. It is quantitative partly since the researcher's intent is to do a case study of some PLCs that are not making profit. The focus of the research is limited to quoted public companies (PLCs) of Sri Lanka.

Conclusion

Society must play a more responsible role since the downfall of companies has an indirect impact on them. Educating public in this regard is necessary and the steps taken by SEC in this regard are insufficient in the opinion of the researcher. It is a commendable move that the inaugural meeting of the proposed 'Investors Association' took place on the 20th June 2012 with the participation of the SEC representatives. This association, once formed must perform as a watchdog. The SEC should take stern steps when annual reports are not submitted. Timely action of reprimand/warning or delisting when companies do not earn profits is necessary. These should be published in a simple manner for the public to understand. Easy methods to enforce directors' duties should be introduced. Stakeholders should be informed of possibility of disqualification orders under ss.213 and 214 and especially under s.214(1)(d). As suggested,[2] the current duty of directors should be to maximize value in the long term interest, taking into consideration the co-operation between shareholders and other constituencies as being the basis on which such value maximization can best be achieved.

Keywords: Stakeholder Responsibilities, Directors' Duties

[2] See Modern Company Law for a Competitive Economy, A Consultation Document from the Company Law Review Steering Group, UK, February 1999.