THE ROLE AND OBLIGATIONS OF NON-EXECUTIVE DIRECTORS UNDER MALTESE LAW

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1. Introduction: The World of Corporate Governance

During the last two decades, the corporate governance debate has gathered momentum in Europe. It was nurtured in its infancy, through the publication of the American Law Institute's Principles of Corporate Governance in 1994, the United Kingdom's Cadbury Committee Report in 1992,[1] together with the numerous corporate governance codes that spread throughout Europe;[2] Malta being no exception.[3]

Although there is no strict definition of the term 'corporate governance', its wider spectrum has been said to engulf practically anything that concerns the manner in which companies, listed or not, are governed, and includes *inter alia*, directors' duties, minority rights and creditor protection.[4]

The issue that occupies a central post within the sphere of corporate governance is that of 'corporate control'. This brings to the forefront all of the persons, whether natural or legal, that work to embody the company's will and life strategy. Indeed, this broad spectrum of control finds one interweaving through several items of importance, among which are the role and rights of shareholders; the composition and duties of the board of directors, employees and their involvement within the company's governance, and the interaction between all of these stakeholders.

Any corporate structure will normally entertain a division between ownership and effective control. This division is mainly adopted by economically large companies that more often than not belong to the public sector. These larger companies have begun to embrace the notion of a group of corporate managers that develop a corporate strategy

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[1] The American Law Institute's Principles of Corporate Governance (1994) are available at <http://www.ali.org/index.cfm?fuseaction=publications.ppage&node_id=88> while the UK Cadbury Committee Report (1992) is available at <http://www.ecgi.org/codes/documents/cadbury.pdf>.

[2] For instance, the French Recommendations on Corporate Governance, see <http://www.ecgi.org/codes/code.php?code_id=40>; or the Corporate Governance Code for Polish Listed Companies (The Gdansk Code), see <http://www.ecgi.org/codes/code.php?code_id=99>.

[3] Malta eventually introduced the Principles of Good Corporate Governance in 2001; see <http://www.ecgi.org/codes/code.php?code_id=80>.

[4] Andrew Muscat, 'Principles of Maltese Company Law' (Malta University Press, 2007) 544.

at the hands of their expertise and corporate loyalties, and not upon the potentially self-interested desires of the shareholders.

In general, Maltese company law provides the bare minimum for the board of directors. Unfortunately, therefore, the world of corporate governance *vis à vis* the officers of the company, in particular the directors, has been rendered rather ambiguous. Whether the board of directors acts in view of its corporate loyalties or in tandem with personal needs that do not have corporate fruition at heart, is a matter that, like many others, rests upon human nature and personal interests of the people who run the corporate entity.

No one corporate structure ensures a problem-free environment. Remedies to cater for such issues have however been formulated, such as the post of the 'non-executive director', set up through modern corporate governance guidelines and recommendations, with the aim of ensuring that boards do not abuse of the strength that accompanies a managerial status. Inside directors generally serve as executives of the company; however the non-executive director is not affiliated with the company, and is to be roped in to keep tabs on the behaviour and performance of corporate management. In this way, the notion of 'control' is ironically, in itself, controlled and supervised by the independent person who takes up the role of a 'non-executive director'.

The more ironic part, that shall be the pivot of this article, is that despite the *prima facie* advantages which such post may cultivate, the non-executive director is not legally regulated under Maltese law. The Maltese jurisdiction has had its share of participation in the corporate governance debate. Indeed, the Maltese authorities have taken steps to introduce a number of measures both in relation to listed companies and public interest companies. The guidelines to be taken into consideration here are the Code of Principles of Good Corporate Governance[5] *vis à vis* listed companies, and the Corporate Governance Guidelines[6] containing recommendations for best practice *vis à vis* public interest companies. Although the post of the non-executive director is embodied within the Code and Guidelines, both fail to constitute hard law and are thus non-mandatory.

Following this form of *lacuna* in the Maltese Companies Act[7] that fails to give substance or even mention of the non-executive director's post, several questions crop up: Who is

[5] Appendix 8.1 of the Listing Rules issued by the Listing Authority of the Malta Financial Services Authority available at <www.mfsa.com.mt/mfsa/files/listing%20authority/listing%20rules/full/files/Listing%Rules%20190606.pdf>.

[6] Available at <www.mfsa.com.mt/Files/Publications/Corporate%20Governance/CG%20Guidelines%20for%20Public%20Interest.pdf>.

[7] Chapter 386 of the Laws of Malta, Companies Act.

the non-executive director? Should this entity be regulated within the Companies Act, or does it suffice to have a law that is silent on the matter?

This article shall deal with the above questions, and shall predominantly focus on the local sphere, with a brief discussion of the situation on a European Union plane and beyond.

2. The Non-Executive Director

Rather than defining the term ‘director’, the Maltese Companies Act provides a description, stating 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 direction of the company as those carried out by a director’.[8] Though the first directors are always generally identified within the memorandum of association, any person may hold the *de facto* post of ‘director’ within a company, whatever his designation.

The directors manage the business of a company;[9] unlike the shareholders, who effectively own the company. Shareholders are more likely to look to their own interests.

In actual fact, there are different types of directors. The main distinction that concerns this article is that between executive and non-executive directors. The distinction is nowhere to be found within the Companies Act; yet the non-executive director concept may be derived from the model articles contained in Part I of the First Schedule to the Companies Act.[10] A *prima facie* analysis of the Companies Act will therefore lead one to conclude that the responsibilities and liabilities of both executive and the non-executive directors are identical.

Executive directors are definitely found within every company,[11] and are generally delegated powers by the board or directly by the company’s articles. They are more often than not provided with separate employment contracts. They are wholly dedicated to the company and so affiliated. The managing director, for instance, is a typical executive director. He is usually appointed by the board to deal with the company’s most crucial daily affairs.

[8] ibid art 2(1).
[9] ibid art 137(3).
[10] See ibid regs 67, 69, 70, and 83. The reference in these regulations is to a director ‘holding an executive office’.
[11] ibid art 137 (1) and (2).

Non-executive directors carry out a different function. They are outside directors, and very different animals to inside directors, or executive directors, who normally serve or have served as executives for the company.[12]

In practice, the non-executive director's functions are specific. Although his post shall also aid the fruition of the company, it shall not do so executively, or managerially. The non-executive director is the guardian of a neutral sanctity that looks to protect the company's interests, and not those of the shareholders or managers; without which, a company faces the risk of internal conflict and abuse.

This leads one to conclude that non-executive directors must be independent and impartial, capably and competently maintaining their supervisory roles within certain designated areas, such as public relations or finance. When the company is endorsing the non-executive director's post, it is simultaneously ensuring that the board remains loyal, especially in cases of conflict of interest.

Kevin James Fenech, in his article 'The Non-Executive Director',[13] highlights the following example:

> Sir Stelios, founder and largest shareholder (owning [thity-eight] percent shares) of EasyJet (low cost airline) strongly disagrees with outgoing chief executive Andy Harrison's decision to go-ahead with the CAPEX of new aircraft (circa [one hundred]). He argues that now is not the time to invest in new (expensive) aircraft but to control costs and improve profitability. EasyJet, apparently, only made £1 profit per passenger last year and CAPEX in new Airbus jets will only mean that the company will struggle to pay out dividends for the years to come and certainty be unable to make the £[four] profit per passenger which Stelios argues is possible.
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> Without delving into the intricacies of who is right, I think that we can all relate to this sort of tension between the executive directors, the chairman, top management and the shareholder(s). You don't have to be a multi-million plc to relate to, or empathise with, these tensions and this is why I think a NED armed with enough information and resources to keep all concerned on their toes is healthy in the modern day business. The NED would in this example, force top management to take note of the largest shareholder's reasoned arguments and test the robustness of management's

[12] See Kevin James Fenech, 'The Non-Executive Director'*The Times of Malta* (Malta, 1 July 2010) <http://www.timesofmalta.com/articles/view/20100701/business-comment/the-non-executive-director.315661> accessed 20 October 2012.
[13] ibid.

CAPEX decisions and share the findings with fellow directors in the boardroom.[14]

Realistically, these conflicts fare common within the corporate structure, especially when the company enjoys a real division between management and ownership. Non-executive directors are thus more commonly found in larger private companies and in public companies, in which they perform an advisory and supervisory role.[15]

Such companies will engage a voluntary distinction between executive and non-executive directors, by the written inclusion on the board of part-time non-executive directors within the company's articles. The primary reason for this, of course, is the larger stakes involved *vis à vis* investors and elsewhere when the company grows in stature. Although the above illustrates the importance of the non-executive director's post, the question as to why the Maltese legislator has failed to regulate this entity within hard law remains.

The non-executive director is hardly regulated anywhere in the world: save for an indirect implementation of these independent supervisory persons within a two-tier corporate board structure in Continental jurisdictions, as shall be seen hereinafter, where there is a permanent and hard division between the executive directors on an executive board, and the non-executive directors on a separate supervisory board. Malta exercises the one-tier board structure, wherein all directors form the 'Board of Directors'. In Malta, private companies are entirely free to decide whether or not they would like to engage non-executive directors, or whether they would like to endorse the two-tiered structure. As shall be seen, this has become a viable option through the establishment of the SE, or *Societas Europaea*.

The Code of Principles of Good Corporate Governance[16] puts forwards several recommendations for listed companies, and includes various provisions that serve as guidelines for implementation by public companies. It is modeled on the UK Combined Code on Corporate Governance of 2003.[17] In 2001, it was recommended in draft form by the Working Group on Corporate Governance set up by the Malta Stock Exchange.[18]

The Code was then incorporated into the Listing Rules. The Working Group favoured the Anglo-American market-oriented model of corporate governance, wherein

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[14] ibid.

[15] John Hynes Farrar and Brenda M Hannigan, *Farrar's Company Law* (4th edn, Butterworths Law 1998) 332.

[16] Available at <http://www.mfsa.com.mt/files/publications/Events/Corporate%20Governance%20Principles%2017.10.05%20_2_1.pdf> accessed 20 October 2012.

[17] See <http://www.fsa.gov.uk/pubs/ukla/lr_comcode2003.pdf> accessed 28 October 2012.

[18] Draft available at <http://www.ecgi.org/codes/documents/code_malta.pdf> accessed 28 October 2012.

shareholders' interests are safeguarded against the managers' actions; yet, also took into consideration the Continental stakeholder oriented, 'constituency' model, which puts forward that those in charge of the company are responsible for various interests, such as creditors and the community at large. In 2005, the Malta Financial Services Authority (hereinafter 'MFSA') revised the aforesaid draft, taking into consideration the EU Commission Recommendation of 15 February 2005.[19] In 2006, the Code was completely revised in a largely non-binding form.[20]

Principle 3 of the Code puts forward that the board 'should be composed of executive and a number of non-executive directors (including independent non-executives).' A blend of executive and non-executive directors should place the board in a position to exercise both a supervisory and management function. Indeed, one finds that this principle is to an extent emulating the Continental two-tier board structure in an effort to ensure that both supervisory and management constituents are present within the boardroom.

The Code lays down a mandatory requirement in relation to non-executive directors in listed companies.[21] The board of directors of a listed company must establish and maintain an Audit Committee of at least three members, the majority of which should be non-executive directors. The Committee should also be chaired by a non-executive director. Although the principles are non-mandatory, a declaration of compliance by the directors and a report by the auditors must still be made. Visibly, the Maltese authorities have taken a stricter approach in relation to listed companies.

The Corporate Governance Guidelines for Public Interest Companies establish similar provisions to the Code with regard to the non-executive director.[22] These were published by the MFSA in 2006 and are intended to apply to companies 'having an impact on the public in general'; companies 'whose operations affect a substantial sector of society.'[23] There is no need for a report by the auditors or a declaration of compliance by the board; yet public interest companies have been urged to adopt the Guidelines, and to simultaneously highlight their adherence thereto in corporate annual reports.[24]

Imperatively noteworthy is that the Code and the Guidelines with their non-binding nature, although emanating best practice techniques, will not have a grandiose effect on corporate governance in general. This is because the mechanisms set to engage such

[19] Commission Recommendation 2005/162/EC, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2005:052:0051:0063:EN:PDF> accessed 20 October 2012.

[20] (n 16).

[21] See Rule 8.56 of the Listing Rules.

[22] See (n 6) Principle 3 of the Guidelines.

[23] (n 6) Introduction to the Guidelines.

[24] ibid.

suggestions and transform them into realities are not found within hard law, and further yet, do not touch upon all kinds of companies. This seeming *lacuna* has been debated time and time again, yet no steps have been taken to properly regulate the post of the non-executive director.

While it is recognisable that strict and hard regulation of the non-executive director may lead to a less versatile and a more onerous world of corporate governance, it is also understandable that lack of express legal recognition of this persona may bring about several disadvantages, including possibly, a breakdown of loyalty and best practice within the boardroom. The following sections of this article shall thus work to explore the pros and cons surrounding the issue.

3. The European Perspective and Foreign Jurisdictions

The company's structure and composition are, throughout the world, largely left to be regulated by the company's internal constitution. A main difference surrounding various jurisdictions is whether their corporate governance style revolves around the one-tier or two-tier boards.

The one-tier board has been rendered the norm in the United States and the Commonwealth, including Britain. Given Malta's ties with British company law,[25] the typical Maltese company is also one-tiered. Such corporate structure entertains a single body that discharges both supervisory and managerial functions.

The situation is different in Continental jurisdictions such as Germany, wherein public companies, or the *Aktiengesellschaften*, must implement a two-tier board. The *Aktiengesetz*, or the statute, puts forward the functions and the methods of appointment of each board. Directors are indirectly and premeditatedly split into those that are executive and those that are not, for it is the managing board that runs the company, and the supervisory board that monitors such management. The main function of the supervisory board is to promote accountability and provide strategic guidance.[26]

The Maltese Companies Act does not regulate the formation of the board. Although the single-tier board is practically the norm, it is not theoretically mandatory. It has however become common practice for day-to-day operations to be delegated unto a 'management board', being considerably more specialised in nature.

As an EU member state, Malta is to be associated with the market-oriented system. Hence, our jurisdiction by its nature relies on standards of managerial behaviour that cultivate the protection of corporate investors. In her doctoral thesis, Dr Ruth Zammit puts forward that two sets of behavioural standards abound in this regard - the duty of care, and the duty of loyalty; while the latter forbids the officers of a company from

[25] The Maltese Companies Act 1995 is thoroughly based on the UK Companies Act 1985.
[26] (n 4) 553.

entering into illegal misappropriation of corporate assets or self-dealing transactions, the former becomes a benchmark against which all managerial decisions are to be taken.[27]

It is noteworthy that, particularly in the case of private companies of a one-tier jurisdiction, where a company is left free to organise its own composition and governance, it is left up to the shareholders to ensure that the corporate constitution will provide for a system of internal checks and balances to ensure healthy board performance and a proper discharge of duties by the company's officers. The appointment of competent non-executive directors, who, within the unitary board structure, serve as supervisory creatures, will serve to ensure just that. Independence and impartiality are therefore other important characteristics of the government structure.[28]

The Maltese Companies Act is modeled largely on the UK Companies Act 1985 while incorporating a few provisions from elsewhere, including New Zealand. It suffices to briefly analyse the positions of both jurisdictions in comparison to Malta.

The New Zealand Companies Act 1993[29] does not distinguish between executive and non-executive directors. However, in the context of directors' duties, the Act recognises the distinction between directors who are in a position to know more about the company's business and those whose involvement with the company is limited. Non-executive directors are certainly not free from responsibility, but their involvement is a factor to be taken into account in assessing whether a director's duty of care has been breached.

The Financial Markets Authority (hereinafter 'FMA') and NZX Limited are two key regulators of New Zealand's capital markets.[30] In their publications and relevant legislation, there is some recognition of non-executive directors. The FMA issues the Corporate Governance in New Zealand Principles and Guidelines handbook.[31] Guideline 2.1 states that every issuer's board should have an appropriate balance of executive and non-executive directors. It also encourages the board to set out in writing specific expectations of non-executive directors. The Guidelines recognise that non-executive directors can contribute a particularly independent perspective to board decisions, making the board more effective. However, nothing explicitly works to demarcate the

[27] Ruth Zammit, The Emerging European Corporate Governance Model (Doctor of Laws thesis, University of Malta, 2005) 71.
[28] ibid.
[29] Available at, <www.legislation.govt.nz/act/public/1993/...0/096be8ed806f5bc8.pdfm> accessed 10 January 2013.
[30] NZX Limited is a New Zealand Stock Exchange, regulating listed companies and market participants to ensure an efficient and transparent marketplace.
[31] Available at <http://www.fma.govt.nz/media/178375/corporate-governance-handbook.pdf> accessed 10 January 2013.

distinction between executive directors and non-executive directors. Under the NZX Listing Rules[32] there is also a minimum number of independent directors required on a company's board. Moreover, there are various tax legislation provisions relating to non-executive directors, for instance, Section CD 20 of the New Zealand Income Tax Act 2007.[33]

The position in the UK is somewhat similar. There is no standalone regulatory regime for non-executive directors. Nevertheless as is applicable to the Maltese scenario and corporate law in general, non-executive directors are directors just the same. They must comply with the same statutory duties as any other director. It may be argued that this lack of separate regulation will ensure that the non-executive duties remain entirely devoted to the company, as should remain the various duties of all executive directors.

The UK Corporate Governance Code (herein referred to as the 'UKCGC'),[34] is a set of guidelines for listed companies prepared by the UK Financial Reporting Council. It addresses non-executive directors in its provisions relating to the composition of boards of directors. The aim of the UKCGC is to promote best boardroom practice among listed companies, and to set out good practice recommendations, covering issues such as board composition and effectiveness, the role of board committees, risk management, remuneration and relations with shareholders.

Similarly to the Maltese scenario, the UKCGC is not legally binding, but operates on the principle of 'comply or explain'. The UK Listing Rules require companies in the UK with a premium equity listing to comply with the provisions of the UKCGC, or explain to their investors in their annual report why they have not so complied.[35]

The non-executive director has been the topic of much debate at EU level. In 2003, the European Commission issued a Communication entitled 'Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward',[36] with a view to upgrading corporate governance across the EU by harmonising minimum standards of corporate governance practices, including the boards of directors with non-executive directors. It is noteworthy that the distinction between executive and non-executive directors has also featured in the 'Principles of

[32] Available at <https://www.nzx.com/market-supervision/rules/nzsx-and-nzdx-listing-rules> accessed 12 January 2013.

[33] New Zealand Income Tax Act 2007, available at <http://www.legislation.govt.nz/act/public/2007/0097/latest/DLM1512301.html> accessed 10 January 2013.

[34] Available at <http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx> accessed 28 October 2012.

[35] Available at <http://fsahandbook.info/FSA/html/handbook/LR> accessed 20 October 2012.

[36] COM(2003)284 available at < http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2003:0284:FIN:EN:PDF> accessed 20 October 2012.

Corporate Governance 2004',[37] issued by the Organisation for Economic Co-operation and Development.

The Fifth Company Law Directive, originally proposed in 1972, was never adopted. The original text, the spirit of which is now embodied in the Regulation to establish a European Company Statute and its related Directive concerning Employee Involvement in European Companies,[38] dealt with the 'internal structure' of the public company.[39]

One may thus say that Maltese law formally recognises the two-tier system for the *Societas Europaea*. An SE may be created on registration in any one of the Member States of the European Economic Area.[40] Through the aforementioned Regulation, which is directly applicable to Malta, a European Company opting to register in Malta may choose to utilise the two-tier board.[41]

This largely Continental form of corporate governance potentially implemented by the SE through the two-tier structure, postulates both a *de jure* and *de facto* divide between the Management Organ and the Supervisory Organ. With one exception, no person may be a member of both; this is a means of cultivating independence.[42] This structure would thus indirectly incorporate the role of the non-executive director and raise his status to a level that is well-beyond simple nomenclature; attaching his position to real practice.

The UK has been greatly affected by the SE. Indeed, the adoption by SEs registered in the UK of two-tier board structures is potentially an exciting development, since it may create a 'spill-over' effect from the SE into domestic law.[43] It is still early days, however, one may safely put forward that, keeping in mind Malta's close affiliation with UK company law and any such related developments, the SE could be the next step in a potentially larger embrace of the post of the independent or non-executive director.

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[37] Available at <http://www.oecd.org/daf/ca/corporategovernanceprinciples/31557724.pdf> accessed 20 October 2012.

[38] Council Directive 2001/86/EC, supplementing the Statute for a European Company, with regard to the involvement of employees.

[39] Dorresteijn and others, Kluwer Law and Taxation Publishers (eds), European Corporate Law (1994) 51.

[40] Council Regulation 2157/2001/EC, art 1(1), available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2001:294:0001:0021:EN:PDF> accessed 15 October 2012.

[41] ibid art 38 and Recital 14.

[42] Art 39(3). The exception is where the Supervisory Organ nominates one of its members to fill a vacancy on the Management Organ, during which period that member's supervisory functions are suspended.

[43] Please see Paul L Davies, *Gower and Davies' Principles of Modern Company Law* (8th edn, Sweet & Maxwell 2008) 401.

It is also worth mentioning the European Commission's Proposal on capital requirements, termed colloquially the CRD IV Package.[44] This once again sheds light on the importance of regulating the financial services field with the utmost diligence. This is aimed at the enhancement of the banking sector, wherein it shall work to replace the current Capital Requirements Directives,[45] with both a directive and a regulation in order to ensure the constitution of a step towards improving the safety and soundness of the financial system.

Various recommendations for the organisation of boards within the credit institutions concerned are found within the Proposal. It puts forward the able idea of the management body carrying out tasks in its 'supervisory function'. This is imperative for instance, in ensuring that the remuneration policies are designed in a way that permits integration into the institution's risk management, and that such remuneration policies are monitored at acceptable time intervals.

It suffices to say that the recognition of the Supervisory Organ and supervisory functions of the board at an EU level highlights the importance of such within the corporate structure. Although the emphasis has not as yet reached the recognition of potential regulation of the private company boardroom, the question is to be asked as to whether perhaps, it should.

4. The Maltese Perspective: Pressing Issues and Case-Law

Prior to discussing a way forward, it is imperative to discuss the current issues that surround the non-executive director's post. Maltese law does not differentiate between the executive and the non-executive director, and certainly does not dictate the structure and form that the boardroom is expected to take. The million-dollar question is the following: is the liability of the executive director the same as that of the non-executive director? Their roles differentiate extensively in practice, yet it pleases the legislator to have them regulated identically, albeit indirectly so. Any person appointed as director in the articles of the company, be he of the managerial kind or of the independent, supervisory kind, shall be a director for the purposes of law, and shall owe the company the same obligations and loyalties.

This reality renders the following statement true and evident: there is a *de facto* distinction between the two posts, yet there is no *de jure* distinction. The following section shall discuss this potential *lacuna*, while examining the various legal sectors involved and whether such lack of regulation is desirable.

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[44] Please see <http://ec.europa.eu/internal_market/bank/regcapital/new_proposals_en.htm> accessed 11 December 2012.

[45] The current Capital Requirments Directives: Directive 2006/48 and 2006/49 available at < http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0048:20100330:EN:PDF> and < http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:177:0201:0201:EN:PDF> respectively.

4.1 Liability

The question of liability is an age-old debacle. All directors, without distinction, owe duties of loyalty towards the company they act for.[46] The Maltese Courts have held: *'[h]uwa kuncett stabbilit li l-obbligi tad-diretturi ghandom ikunu rivolti lejn l-interess massimu tas-socjeta nnifisha u mhux lejn il-membri ta l-istess socjetà.'*[47] Directors are also fiduciaries of the company, and in 2004 the legislator introduced this notion into the Maltese Civil Code.[48]

A discussion of liability entails regard to Article 147(1) of the Companies Act.[49] One may argue here that although, *prima facie*, the liabilities of all directors are equal, no matter their executive or non-executive status, should the matter fail to be settled extra-judicially, the court may take into consideration the aforesaid article. This provision holds that the personal liability of the directors in damages for any breach of duty shall be joint and several, however, where a particular duty has been entrusted to one or more directors, only the latter shall be liable in damages. In this regard, companies would do well to ensure that, should any non-executive directors be appointed, their specific duties be listed formally within the company's statute. This could provide independent directors with the peace of mind that they should, within the remit of Article 147, only be liable for the specific duties outlined in the company's statute, which will in their majority, differ from the duties entrusted upon executive directors.

Perhaps due to our lack of observation of precedent, the blurred division between executive and non-executive directors' liability has not however, been clarified judicially. While certain specific instances, such as fraudulent trading, are justified in placing equal burdens of responsibility on both executive and non-executive directors without distinction, the matter may differ when dealing with general criminal and civil suits.

As has been previously highlighted, non-executive directors are not properly involved in the day-to-day functioning of the company. The question has to be asked, therefore, if it is just to hold a non-executive director liable for an offence committed by the company's officers in their managerial capacity. The Courts have displayed different views on the matter.

In an interesting Maltese judgment,[50] the situation related to a non-executive Chairman of a company that operated a catering establishment. He was charged with a number of

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[46] This was established in 1902 in a leading UK High Court case: *Percival v Wright*.

[47] *Charles Sant Fournier v Dr Philip Attard Montalto'* [2001] CCFH 841/1994/1, 29. Translation: It is an established concept that directors' obligations are to be directed toward the maximum interest of the company itself and not toward the same company's shareholders.

[48] Chapter 16 of the Laws of Malta, Civil Code, art 1124A.

[49] (n 7).

[50] *Il-Pulizija v Dr George Cassar* [1998] Court of Criminal Appeal (217/96).

criminal offences that related to food safety. The Court held that once a person sits on the board of directors, then one is duty bound to exercise the due diligence that is requested of the board by law.[51] This diligence would ensure that no such breaches of duty occur. The director, despite his independent status, could not avoid prosecution by remaining passive in his actions.[52] In order to escape liability, he must prove without distinction from all executive directors that he took all necessary measures to prevent the commission of the offence.

The pitfall here lay in Article 13 of the Interpretation Act.[53] The heart of this article merits a separate discussion, yet it is safe to say that such provision establishes equal liability for all kinds of directors, be they executive or non-executive.

The Court therefore felt that it did not matter whether the person was a non-executive director or otherwise. If a person occupied a position on the board of directors, he could and would be held liable given the circumstances, no matter his status.

An important case that went in the opposite direction[54] postulated the following facts. The defendants, Xuereb, Busuttil, Ellul Vincenti and Gauci were all directors charged with the involuntary homicide of a worker working on a construction site. Xuereb was an executive director of the company in question, in charge of its general operations. Architect Ellul Vincenti and Gauci were non-executive directors. In fact, Xuereb testified that on a day-to-day-basis, the aforesaid did not know where the works were being carried out. Rather, it was the managers who had this knowledge. Indeed, Ellul Vincenti testified that because he was a non-executive director, with his specific duties and functions stipulated in the company's statute, he lacked the adequate powers to give

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[51] ibid 2. The original Maltese language version as taken from the unofficial copy of the judgment reads as follows:

> *Meta l-persuna hatja ta' reat kontra xi disposizzjoni ta' dan l-Att jew ta' xi regolamenti maghmula bis-sahha tieghu tkun kumpannija jew ghaqda jew korp iehor ta' persuni, kull persuna li, fiz-zmien ta' l-eghmil tar-reat, kienet direttur, manager jew segretarju jew ufficjal iehor bhal dawn ta' dik il-kumpannija, ghaqda jew korp ta' persuni jew kienet tidher li qed tagixxi f'xi kariga bhal dik titqies li tkun hatja ta' dak ir-reat kemm-il darba ma tippruvax li dak ir-reat ikun sar minghajr it-taghrif taghha u li kienet ezercitat id-diligenza kollha xierqa biex ma jsirx ir-reat.*

[52] ibid 3. The original Maltese language version as taken from the unofficial copy of the judgment reads as follows: *'Fi kliem iehor, mhux bizzejjed li direttur jibqa' passive bla ma jiehu interess, jew bla ma jiehu interess bizzejjed, f'dak il jkun qed isir mill-kumpannija […]'.*

[53] Chapter 249 of the Laws of Malta, The Interpretation Act art 13,which holds,

> […] when an offence is committed by a body of persons, whether corporate or unincorporate, every person who, at the time of the commission of the offence, was a director, manager, secretary or other similar officer of such body, or was purporting to act in such capacity, shall be guilty of that offence unless he proves that the offence was committed without his knowledge and that he exercised all due diligence in order to prevent the offence.

[54] *Il-Pulizija v Angelo Xuereb, Cecil Busuttil, Joseph Ellul Vincenti and John Gauci* [2001] Of Magistrates (Criminal Judicature) 593/1999.

orders to the workers involved. It was also not within his remit to carry out site inspections. His only responsibility was to view the company's policies, and to ensure that they were followed.

The Court went into the different roles these different persons held within the boardroom. It held that if a director does not, in terms of his statutory duty, maintain an active supervision of the company's affairs with diligence, he stands the risk of being left in the dark due to his own negligence.

The Court put forward that there must be some nexus between the way the director acted on the board and the involuntary homicide they were being accused of. The Court maintained that there was no way in which Gauci, as a non-executive director within the given circumstances, could be held criminally responsible. Indeed, he could not give orders and was not responsible for the employees or workers in question. It also stressed that the same would apply to Ellul Vincenti, also a non-executive director. In fact, the Court went so far as to term Ellul Vincenti, *'direttur passiv.'*[55] The company's statute rendered him responsible solely for issues relating to management meetings, and not for construction or building matters. Xuereb on the other hand could have potentially been held liable, but he managed to prove that he did everything normally done to ensure safety at work. The Court concluded by holding the victim solely liable for his own death, deeming him negligent.

It can thus be seen how, upon a *prima facie* analysis, the legislator has chosen to treat non-executive directors and executive directors in an almost identical manner within the Maltese Companies Act and other hard law. This has, perhaps unfortunately, rendered the courts more powerful in their interpretation of the various legal provisions dealing with directorship liability, particularly in the criminal and civil sectors.

To conclude, it is worth taking note of the phenomenon that is strict liability. This is seen in fiscal laws, such as the Maltese VAT Act, [56] wherein there is *a juris et de jure* presumption that a director shall be held jointly and severally liable with the company for VAT shortfalls.[57] Again, there is no distinction between executive and non-executive posts. It is safe to say that, as the situation now stands, it will be up to the court to exercise its discretion should such situations arise.

4.2 Financial Services, Public and Private Companies

The authorities have taken stricter steps within the financial services regime, wherein directors are exposed to more burdensome responsibilities. Financial services

[55] ibid 26. Translation: Passive Director.

[56] Chapter 406 of the Laws of Malta.

[57] ibid art 66 (5).

companies involve positions of public trust. This automatically means that a heftier standard of conduct exists *vis à vis* a financial services company's officers. A company carrying on regulated financial services activities would be expected not to pursue solely its shareholders' best interests but it should also take into account the interests of its customers and investors.[58] This therefore means that directors of authorised financial services companies shall owe their obligations towards their regulators as well as to their customers, undertaking to abide by ordinary company legislation together with the specialised financial services regime in place.

UK companies are regulated by the UK Financial Services Authority (hereinafter 'FSA') if they carry on regulated financial services business activities. Directors of an FSA-authorised company will be performing a 'controlled function', as specified under Article 59 of the UK Financial Services and Markets Act 2000.[59] Indeed, the FSA has, in its rules, specified separate controlled functions for, *inter alia*, the positions of chief executive, executive director, and non-executive director. The FSA must approve the appointment of any person wishing to perform a 'controlled function', including non-executive directors. It will assess whether a candidate is 'fit-and-proper' to perform the functions of the non-executive director of an authorised financial services company. A candidate's honesty, integrity, reputation, competence, capability and financial soundness will be considered.[60] If the candidate is approved for the position, he must then comply with the FSA's Statements of Principle for Approved Persons.[61]

The financial services sector in Malta endears a similar fate. In relation to the regulation of credit institutions, one finds the MFSA, the key regulator in this regard, which has formulated the Financial Institutions Rules.[62] Rule 5(a) puts forward that a licensed financial institution shall not be regarded as conducting its business in a prudent manner unless the directors include non-executive directors as the MFSA considers appropriate, having regard to the nature and scale of operations of the institution and who shall act in a control capacity in questioning the approach of the executive directors and other management. Similarly to the position in the UK, Rule 5(b) posits the 'fit-and-proper' test, wherein every person who is a director, controller, partner or any other officer of the institution is a fit and proper person to hold that particular position and to carry out business with integrity and skill. Non-executive directors, of course, will be subject to such test. Rule 5(b) also holds that without prejudice to Article

[58] Robert Attard, *Responsibilities of Officers of a Limited Liability Company* (Malta Institute of Management, 2010) 77.

[59] Available at <http://www.legislation.gov.uk/ukpga/2000/8/contents> accessed 20 October 2012.

[60] For more about this process, please see <http://fsahandbook.info/FSA/html/handbook/FIT> accessed 28 October 2012.

[61] For the rules setting out the FSA's expectations as to the conduct of approved persons, please see <http://fsahandbook.info/FSA/html/handbook/APER> accessed 28 October 2012.

[62] Available at <http://www.mfsa.com.mt/Files/Announcements/Consultation/Documents/Draft%20Bill%20-%20Financial%20Insitutions%20Rule.pdf> accessed 20 October 2012.

24 of the Financial Institutions Act,[63] the MFSA, in assessing whether a person has the relevant competence, soundness of judgment and diligence, shall consider the experience of similar responsibilities, qualifications and training.[64]

The Financial Institutions Rules, like the position within the UK, therefore, ensure that licensed companies entertain a number of non-executive directors. Furthermore, all corporate officers must undergo a 'fit-and-proper' test. One can therefore see how the authorities have deemed it fit to enhance the boardroom's supervisory aspect, for instance, with the compulsory appointment of non-executive directors, in the financial services sector. This will in turn, contribute to the promotion of a boardroom that embraces stability, loyalty and overall good governance.

The question to be asked, primarily, is the following: why have the authorities taken to a more stringent, albeit soft regulation of the non-executive directors' role *vis à vis* the financial services sector, while accommodating for the same role in relation to public interest companies and listed companies, yet willfully neglecting to treat this entity where private companies are concerned?

Private companies have remained untouched. In the wake of tighter regulation being postulated through the guidelines and rules issued by the MFSA, it may be safe to put forward that, in the author's opinion, it may do private companies good to be exposed to such provisions. In fact, these guidelines are more often than not thought of as putting forward 'best practice' techniques.

The Working Group, in its preparation of a model set of rules of corporate governance for listed companies had proceeded to justify the engagement of corporate governance guidelines for listed companies. It did so by highlighting that such companies entertain a greater distinction between ownership and control than private companies, 'where the manager is usually the owner or where at least the dichotomy between ownership and management is more of a legal fiction than it is fact.'[65] The Working Group had remarked that applying such rules to private companies where there is a likelihood of identity between ownership and management would be futile, and, as moreover seen in the Report, compliance could fare too costly for the realms of practicality.[66]

Yet one may take into consideration that more than a decade has passed since the Working Group submitted its final Report in October 2001. Furthermore, although it may be said that non-executive directors are not required in smaller companies due to

[63] Chapter 376 of the Laws of Malta.
[64] ibid art 24 deals with the Disqualification of Officers, and holds that, *inter alia*, no person who has been adjudged bankrupt, or who is interdicted or incapacitated, shall act or continue to act as an officer of a financial institution.
[65] See The Working Group's Report on Corporate Governance available at <http://www.ecgi.org/codes/documents/code_malta.pdf> 3 of 6.
[66] ibid.

the smaller scale of operations and potential identity between the owners and directors, this does not hold with larger private companies. Additionally, the argument that non-executive directors would be too burdensome for small private companies does not apply to the larger ones.

With an ever-increasing amount of private companies in Malta and beyond, perhaps it is high time that private companies are provided with some form of guidelines that in their own merits consider the post of the non-executive director. This is simply to ensure that every company takes note of a recommended split between the supervisory and managerial sides to each board. Indeed, such recommendation will fare fruitful to any private company that postulates a division between ownership and control, however slight that division may be.

Non-executive directors could prove very useful in substantially large companies since a proper maintenance of accountability and fairness should also be in a private company's agenda. To determine whether a company should have these directors within their operational structure, a formidable equity capital threshold coupled with debt capital and operating profit can be implemented. Such directors could oversee a number of issues in the company such as director remuneration. They may also keep a lookout for excessive debt financing, thus making sure that the company does not become too geared. Since large companies tend to expand due to their larger profits, non-executive directors could also oversee if such expansion is in the best interest of the company and its shareholders, without jeopardising the company's future due to excessive expansion.

The MFSA has only recently published a Corporate Governance Manual for directors in Funds.[67] This Manual refrains from differentiating between executive and non-executive directors, burdening both in the same manner: but has definitely proven a step in the right direction with regard to the way in which it stresses the importance of an adequate corporate governance model.[68]

4.3 General Notions

[67] Available at <http://www.mfsa.com.mt/pages/readfile.aspx?f=/Files/About%20Us/careers/CPDC/8_9_March_Investment/2013_02_15%20MFSA%20Corporate%20Governance%20Manual.pdf>.

[68] ibid 1:

> Corporate governance is a tool that assures investors in a company that the company's objectives and operations will be carried out in a manner that benefits the best interests of the company. This is true whether the company is a public or private company; a fund; a special purpose vehicle; a corporate general partner of a limited partnership or a corporate investment manager; a holding company with limited activity; or a company with extensive operational activities.

Should the non-executive director fail to be independent, he may as well resign from his post and walk the boardroom floor, heading right into the world of management. A paramount question revolves about how independence may be safeguarded. In the UK, the Corporate Governance Code has had its fair share of impact on public companies.[69] It is also good practice for privately owned companies to adopt the same standards and very useful for non-executive directors to be aware of this Code.[70] Indeed, in its quest to protect their independence, *inter alia*, the Combined Code[71] puts forward that the non-executive directors must not have been an employee of the company in the last five years, and must not have had a material business interest in the company for the last three years. Moreover, he must not receive income other than director fees; must not have close family ties with company advisers, directors or senior employee, and may neither represent significant shareholders. He must also not serve as a non-executive director for more than nine years with the same company.

One therefore finds that the authorities have put in place these various recommendations applying to certain companies, and have tried their best to logistically ensure that the non-executive director is present, independent, and capable of ensuring the fruition of the company's interests together with the management's loyalty.

However, the problem arises when one begins to draw a line between theory and practice. An Australian study highlighted the risk posed if independence is not safeguarded at both a theoretical and practical level.[72] The results indicated that thirty-five percent of non-executive directors were involved in transactions with their companies, which potentially threaten their independence.[73] The findings further put forward that a given board's majority would tend to be constituted by a combination of insider and what were termed for the purposes of this study, 'grey' area directors whose independence was likely to be tainted. A situation could here arise, as illustrated by the study, wherein companies, through a non-executive majority on their boards, would appear to comply with national recommendations, but would in actual fact be controlled by a potentially self-interested internal management.[74] This is just one example of the practical problems that could arise in a corporate governance world that, of course, is run behind the scenes and dominated by natural persons.

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[69] Available at <http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-September-2012.aspx> accessed 28th October 2012.

[70] See <http://www.nonexecutivedirectors.ie/independenceandNED.html> accessed 28 October 2012.

[71] (n 17).

[72] Peter Clifford and Robert Evans, 'Non-Executive Directors: A Question of Independence' (1997) 5 4 Corporate Governance: An International Review 224–231.

[73] ibid.

[74] ibid.

A potential solution could be the introduction of a 'fit-and-proper' test, ensuring that the potential candidate comprehends the intricacies of the job. In his Report, Higgs notes that people are the key, and that the quality of appointees is critical to improving the effectiveness of non-executive directors.[75] Indeed, the Code currently provides that the majority of non-executive directors should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgment, leaving it to the various corporate boards to identify which of its non-executive directors are suitable.[76] This definition provides the corporate world with little guidance as to what this fit and proper test should entail. The idea of having such a test regulated may, however, become sticky in practice; leading to a situation that disheartens potential non-executive directors from taking up the role. One would also have to go about the process of holding this test, which may render the appointment of such directors slow, inefficient and possibly pricey.

Higgs also comments that although his recommendations are targeted at the UK Listed sector, they may also be attractive to a wider spectrum of companies.[77] It may be argued that while all companies are encouraged by the regulator and the relevant guidelines to entertain the post of the non-executive director within their boardrooms, the lack of hard regulation poses threats to this encouragement becoming a reality. The issue remains a difficult one to fathom. What remains to be discussed is a way forward; should there be the need for one, of course.

5. The Way Forward

Keeping in mind that the non-executive director and the executive director are two whose loyalties must, without distinction, lie with the company's amelioration; it may be nonsensical to introduce a divergence in their role and obligations within hard law. On the other hand, it suffices to point out that a more stringent regulation of the two roles could undoubtedly clarify any accountability issues, potentially protecting independent directors who live outside the company and may not have hard and fast access to the frequent transactions carried out by the management.

Nevertheless, it is suggested that the legally equal treatment of the executive and non-executive director may be viewed as an adequate starting point for establishing liability. One could argue that segregating non-executive functions and duties from those which are executive, could lead to a situation that easily cultivates abuse. This could occur, for instance, if the directors' duties are not properly laid down in a company's statute. This may lead to a situation where, when push comes to shove, a director who had, during a company's lifetime, assumed executive liabilities, may try to escape a certain kind of liability by taking on a non-executive guise.

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[75] See <http://www.ecgi.org/codes/documents/higgsreport.pdf>17 accessed 28 October 2012.

[76] UK Corporate Governance Code (n 34) 12.

[77] ibid 13.

The non-executive director is not always fully aware of what is taking place in the company's executive world, for it is not his job to be so affiliated. Perhaps this is a fact that should be noted in the Companies Act, and adequate liability placed upon both posts as per their functions in practice. A clarified delineation may better attract potential candidates for the non-executive director post. It could moreover be argued that a detailed outline of their functions and specific duties within hard law would ensure that judicial discretion does not go henceforth into the unknown, and that fairness is maintained through a simple judicial observance of the law at the very brewing of trouble. As the situation currently stands, it has become very much left up to the courts' discretion to entertain who, within the boardroom, is liable for what.

Having recognised the importance of the supervisory aspect within the corporate structure, a potential solution could be for Malta to embrace the Continental two-tier system. This would, of course, entertain an enormous overhaul in Maltese company law, yet it is an option that ought not to be disregarded. As has been seen, the European Company provides the option of a two-tiered structure. Surely, the recognition of such corporate structure at a regional level emphasises the fact that it may pose various advantages for any given company; particularly those endowed with more stringent duties *vis à vis* the public sector, such as listed companies.

Its structure renders readily accessible the independence required upon the appointment of a non-executive director. The interplay between the Management Organ and Supervisory Organ, despite an added form of bureaucracy, could potentially offer the most enhanced form of corporate governance around. Despite the possible positives that such amendment may bring in, it would suffice to remember the feedback that had been put forward in response to the failed Fifth Company Law Directive. The UK had fiercely opposed the introduction of a mandatory two-tier board. The Economic and Social Committee, in delivering its opinion on the first draft in 1974, had stated that, '[...] the introduction of the structure proposed by the Commission for all national *sociétés anonymes*[78] would be attended with practical and psychological difficulties in some Member States [...].'[79]

Nevertheless, it may be argued that times have changed since 1974, and it would be comforting to think that Member States are now equipped with enough corporate expertise at an intergovernmental level to ensure the proper functioning of a two-tier structure. This remains a point open debate.

The unitary structure, however, has been strongly supported in consultation responses, through the embrace of executive knowledge within the board, alongside non-executive

[78] Translation: limited liability companies.

[79] See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:1974:109:0009:0016:EN:PDF> accessed 28 October 2012.

directors who can bring wider experience.[80] It thus enjoys its fair share of advantages and is by no means a definite factor that may hinder the efficiency and functions of a non-executive director.

Whether or not Malta would do well to legislate unto the role of the non-executive director remains, therefore, a point open to contestation. There seems to be no clear thesis as to whether the two-tier continental approach would strongly triumph over the unitary structure. It is without doubt, however, that the Maltese authorities have begun to take steps in order to recognise this post in a more stringent manner.

This in itself possibly augurs a future wherein the non-executive director will be regulated within hard law, and his role appreciated and implemented by a vast range of companies. Until then, it suffices to say that a way forward begins with a public awareness of the non-executive director's post, together with a diligent observance of the guidelines and best practice techniques that are published from time to time by the authorities. This will ensure that the next step, whatever that may be, is a step in the right direction.

[80] See <http://www.ecgi.org/codes/documents/higgsreport.pdf> 25 accessed 28 October 2012.