MODERN FINANCIAL REGULATIONS HAVE MADE "PIERCING THE CORPORATE VEIL" EASIER

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Preamble

Along with the evolution of the market economy a clear separation of the actors involved in a business firm, i.e. owners of the capital and those who specialize in employing the capital for production of goods and services become visible. Accordingly, the directors of a company function as the agents of the corporation, and the managers execute the decisions taken by such directors. Fiduciary duty of the Board of Directors (BoDs) towards shareholders has been a challenging task from the time companies came into existence. In today's financial services industry also, the role played by BoDs in safeguarding their stakeholders has been problematic. Modern stringent regulatory regimes emphasize the pivotal role required to be played by the BoDs of banks and other financial institutions. This paper concentrates on the laws applicable to failures of BoDs of financial institutions to act with care and diligence.

Introduction

In the "Wealth of Nations" Adam Smith states that directors of joint stock companies, being managers of other people's money would be unlikely to manage it with the same "anxious vigilance" shown by the active partners in a smaller firm (Hovenkamp, 2009). Reports on failed finance companies and banks in Sri Lanka and elsewhere have revealed that poor performance and malpractices perpetrated by BoDs have caused such collapses. Siphoning off funds from financial institutions has been a key reason for a number of these failures. There are instances where a board membership is considered an honour or a perk instead of a substantive job. According to the Companies Act No 07 of 2007 of Sri Lanka, Directors are supposed to act in good faith in the best interest of the company and with care and diligence.

The concept of the separate legal personality of a body corporate

The concept of the separate legal personality of a company was introduced by the Soloman V Soloman & Co Ltd case (Rajib, 2018). It introduced the notion of the "corporate veil" drawing a line between directors, promoters, shareholders on the one hand and the corporate body on the other. However, with the evolution of company law and other laws related to the financial services industry, maintaining the corporate veil has become more challenging. When the public funds are at stake, there can be severe pressure to lift the corporate veil.

Piercing the Corporate Veil

"Piercing the corporate veil" is the term used to describe an action pursued against a company that ultimately reaches the personal liability of owners and shareholders (Karapanco, 2013). Since an artificial person is not capable of committing an illegal act, the corporate personality has to be removed to identify the persons who are really guilty. This challenges the argument that a corporation exists independently of its owners and that the owners are normally not held accountable for the obligations of the corporation. Basically, the notion of "piercing the corporate veil" allows lifting of the curtain of a company's legal personality. In some jurisdictions, this process is considered as "disregarding the corporate entity". Courts have lifted the corporate veil to see the real state of affairs having considered the social consequences of offences. In the United States v. Milwaukee Refrigerator Transit Company case, the court held that where the notion of a legal entity is used to defeat public conveniences, justify wrong, protect fraud or defend crime, the law will disregard the corporate entity and treat it as an association of persons. In the Singer India Limited vs Chander Mohan Chadha case, the court highlighted that the concept of a corporate entity was evolved to encourage and promote trade and commerce but not to commit illegalities or to defraud the people (Kanchi, 2009). These judgments demonstrate that individual directors always need to take due reasonable care and deliver their duties in good faith.

Corporations have no souls

In the recent past, whitecollar crime has shifted from individual perpetrators to corporates. Common law countries have considered imposing criminal liability on corporates whereas European jurisdictions have shown reluctance to do so (Healey et al, 2016).The economic and social role of the corporation has been one reason for such exemption. The lack of "mens rea" i.e. the mental element for a corporate to commit a crime also became a justification to prevent corporate liability. In Sutton's Hop case, Lord Coke denied the corporation's liability because corporations have no souls. (Hardack, 2014). However, considering the increasing number of financial frauds by corporates it can be argued that having criminal liability will ensure sanction against offenders. This will also encourage more precaution and compliance with rules and regulations by companies.

It is noteworthy that the Serious Fraud Office of the UK did not charge any of the organizations involved in the LIBO /EURIBOR scandal. They charged only the individuals. Those employees argued that their actions were condoned and encouraged by their employers (Turksen & Ryder, 2015). The requirement to identify the "controlling mind" of a small company is relatively easy. However, it is difficult in the case of a large conglomerate. In such event, corporate criminal liability will ensure deterrence. It will also be helpful to increase trust in business entities. In the case of Sri Lanka, public trust in financial institutions is of paramount importance in maintaining systemic stability.

Too big to jail

According to the notion of "corporate criminal liability", prosecutors can lodge charges against the corporation, its managers or both. One argument, as mentioned above, is that such actions will incentivize companies to have crime control policies.

However, along with the emergence of large conglomerates in the financial services industry, a concern that such firms are "too big to jail" has arisen (Choi, Lee, & Kang, 2018). In some jurisdictions prosecutors are reluctant to take action against large corporations as this creates an adverse impact on employees and other stakeholders. An example is the massive job losses that occurred after the multinational accounting firm Arthur Anderson LLP was convicted for its role in the Enron Scandal. When there are such constraints in prosecuting corporates, more attention is paid to taking action against individual managers. Functioning always within the applicable legal frameworks would therefore, be the best defence for such individuals. In Sri Lanka, laws applicable to financial services do not require the proof of any specific "mens rea" or culpable state of mind, nor do they make reference to any such mental element in imposing liability on corporations.

The Banking Act No 30 of 1988 states that licensed banks shall be liable for the contraventions or failure to comply with any provision of the Act or the conditions imposed thereunder. Section 53 (1) of the Finance Business Act No 42 of 2011 also states any person shall be liable for the violation of the provisions of the Act. The provisions of the section 51 of the Securities and Exchange Commission of Sri Lanka Act No. 36 of 1987 states that any person (means natural and legal person) who contravenes any provision of the Act shall be guilty. According to the provisions of section 90 of the Regulation of Insurance Industry Act, inter alia, any company which carries on insurance business, or commences any insurance business, without being duly registered under the said Act shall be guilty of an offence punishable under this Act.

Personal criminal liability

The above laws extend a criminal liability to directors and other key officials of a body corporate which commits an offence under the respective legislation. The provisions of Section 80 of the Banking Act state that any person who being a director, manager, officer or employee of a licensed commercial bank or licensed specialised bank fails to take all reasonable steps to secure compliance by the respective bank with the requirements of the said Act, to be guilty of an offence. In terms of the provisions of section 53(2) of the Finance Business Act, Section 51(3) of the Securities Exchange Commission Act and Section 104 of the Regulation of Insurance Industry Act where an offence under the said Acts is committed by a body corporate, every person, who at the time of the commission of the offence was a director or an officer of the body corporate, shall be deemed to be guilty of that offence unless he/she proves that the offence was committed without his/her knowledge, or that he/she exercised all due diligence to avoid the commission of such offence.

Furthermore, the provisions of Section 20 of the Finance Business Act state that where any finance company fails to repay a deposit or fails to pay interest thereon to a depositor, on demand, every director, manager or secretary of such company shall be guilty of an offence under this Act. For the first time these provisions have been invoked recently by a group of depositors against a BoD of a licensed finance company. According to the section 57(1) of the Finance Businesses Act using company funds by a director, manager or secretary to pay a fine imposed on them is also an offence.

Moreover, the provision of Section 189 of the Companies Act specifies that directors shall not act in a manner which is reckless or grossly negligent and shall exercise the degree of skill and care that may reasonably be expected of a person of his/her knowledge and experience. Section 219 of Companies Act speaks of the duty of directors on insolvency. If a director believes the company is unable to pay its debt, a meeting shall be called to consider the relevant actions. This is important for financial institutions. If the entity is not solvent, BoDs should take appropriate measures promptly before the regulator intervenes. It is, therefore, vital for the directors and other employees of companies to ensure all the boxes of compliance framework are ticked by them. When significant reputational risk exists for individuals if they act negligently, they may be compelled to take more proactive anti-fraud measures to counter economic crimes.

The USA Securities and Exchange Commission has successfully prosecuted cases against mutual fund directors who violated their fiduciary duties. Directors of the firms named Worthington Foods Inc, Immucor Inc and Cell Pathways Inc were found guilty of insider trading. Officers and Directors of Del Global Technologies Corp Inc were prosecuted as they caused the company to engage in improper revenue recognition (Rampos, 2006).

If you are a director of a finance company or a bank, you will be held accountable in the event of failure to prove that all possible measures were taken to prevent the occurrence of financial frauds and other regulatory violations in the organization. The advantage of this legal

position is the prompting of corporates to ensure strong internal controls, systemic monitoring and improved escalation of issues related to breach of laws to management.

The Federal Reserve has introduced a mechanism to require BoDs to ensure that management takes all the remedial measures for the category of concerns named “matters requiring attention”. In that manner, BoDs can be more effective in holding management accountable.

In terms of the above mentioned laws of Sri Lanka, the “state of mind” of a director or other official could become relevant to exclude personal criminal liability. In strict liability offences prosecutors are not required to look at the “mental element”. The law has provided ample guidance for the BoDs to do the right thing. Such legal obligations should not be treated as barriers to the growth and development of corporate entities. Instead, they should be seen as measures to create a conducive business environment which is essential to promote foreign and domestic investment. Directors should not treat these laws as hindrances to their business innovations. As long as the decisions and functions are within the legal framework and directors act with responsibility and accountability to their stakeholders there is no need to fear the consequences of “ piercing the cooperate veil”.

Deferred Prosecution Agreement (DPA)

This mechanism has become a common resolution in investigating corporate crime in the UK & USA. Under DPA, the government agrees to suspend and drop prosecution in exchange for the company paying a large fine and agreeing to government supervised reform actions. Such an arrangement may help corporations to undertake an independent reform processes to mitigate frauds and corruption. Through recourse to DPAs regulators can make BoDs accountable for enhanced compliance frameworks. Individual directors and managers will be required to play a significant role in ensuring compliance with the enhanced obligations under DPAs.

Senior Managers Regime

In order to improve culture and accountability in financial institutions, the Financial Conduct Authority of the UK has introduced a “Senior Manager Regime.” According to the latest rules, references must be sought by the Key Management Personnel (KMP) from all former employers for the previous six years before submitting for the regulatory references. The Senior Managers Regime is an example for piercing the corporate veil to encourage individuals of financial institutions to take greater responsibility for their actions. This new regulatory framework has made it easier for both financial institutions and regulators to ensure accountability of BoDs and KMPs.

The Senior Managers Regime also highlights the fact that regulatory authorities are focusing on the actions of the individual senior manager as opposed to the overall actions of the firm. Market integrity cannot be achieved only by regulators. Financial institutions and employees

should also be more responsible and accountable for their conduct. Regulators can raise the standard of conduct, governance and compliance. Although there is no Senior Managers Regime in Sri Lanka, firms can improve genuine accountability by removing vague or bureaucratic structures which obscure transparency and blur the lines of accountability.

Following the wide range of regulatory reforms that were designed to reduce the likelihood and severity of another financial crisis, the role boards of financial institutions are required to play is more expensive and challenging. Among such regulatory frameworks guidelines on Corporate Governance are prominent.

Good corporate governance is crucial in averting financial crises

26 years ago, Sir Adrian Cadbury, in the UK, introduced a voluntary corporate governance code. Boards can establish an important frontline defense by creating good governance mechanisms. Thirteen fundamental Corporate Governance Principles were introduced by the Basel Committee on Banking Supervision. Those principles deal with effective competence of the BoDs and their obligations. Corporate Governance emphasizes the collective oversight and risk governance responsibilities of the Board. Bank BoDs are required to establish organization risk appetite limits and ensure that an agreed risk strategy is implemented within a framework of effective controls. The manner and material of corporate decision making has significant bearing on the economic development agenda of a country. At the Board meeting the dissenting directors should get their concerns recorded. Such records would act as defenses in the event of legal actions to prove that all reasonable steps were taken by the individual director to ensure that the relevant entity functions in conformity with the applicable legal frameworks.

All of the above mentioned international and domestic laws expect effective boards to develop a robust and coherent business strategy for the firm. When such a clear strategy is available aligning the risk band of the company with the same is not difficult.

Doing the bare minimum should never be acceptable

Risk management capabilities of the senior management will be of paramount importance in delivering effective outcomes. The BoD should also be able to take informed decisions always. BoD should, therefore, ensure the effective flow of management information. Clear communication of “what” and “how” is very important. Employees at all levels should have an understanding of the company’s business strategy. This should be a knowledge which goes beyond the vision and mission statements. The BoDs should always be engaged, involved and aware. They should also be mindful of the obligations toward all the stakeholders of the company and to the country. Scrutinizing management information in order to achieve the above objective is important.

Culture may not be measurable but it’s manageable

Establishing the governance systems is also a key responsibility of the BoD. This relates to the famous notion of the tone from the top. Ensuring the independence of risk management and internal audit functions should be a prime element of a policy based governance system. According to Andrew Bailey (2018), “Culture is not stopping bad things from happening. BoDs have a responsibility to encourage and incentivize good things as well”.

Even a free market economist like Milton Friedman has stated that in a free enterprise a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society both those embodied in law and those embodied in ethical custom.

Conclusion

“Piercing the corporate veil” is mainly used as a tool to bring corporate actors’ behaviour into conformity with a particular statutory scheme. Ensuring compliance with all applicable rules and regulations would, therefore, be the key to justify and defend the acts of BoDs.

Irrespective of the size of a company, strong and effective boards are required for financial institutions to deliver their desired objective of contributing to the country’s economic growth. Senior Managers should also be fit and proper persons to implement the business strategy designed by the board of directors. Operating at arm’s length when handling transactions which have conflict of interests and observing corporate formalities always will help the BoDs to avoid “piercing the corporate veil.” Documenting all business decisions and proper handling of board minutes would also be important in proving the proper conduct of BoDs.

Behind the corporate curtain there are natural persons i.e. shareholders, directors, managers and other employees. Hence, directors and KMPs should ensure that when the corporate personality is uncovered or unveiled, they would not be held guilty of any wrongdoing. In the context of recent legislative reforms and regulatory enforcement actions, it is important for the BoDs to understand their duties and obligations and the limits of legal safeguards. Directors should not ignore the red flags raised in the reports and opinions presented to them. Demanding additional information where necessary will enable the directors to take informed decisions. There is no single blueprint for avoiding personal liability of BoDs. However, adherence to well established best practices stipulated in relevant laws will help to reduce the likelihood of such a liability.

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