Foreword

Philip T. N. Koh’s article is a welcome contribution to understanding a director’s duties of good faith, care, skill, and diligence. As he writes, “[A] director must act in the best interests of the company and honestly apply his mind to the issue at hand.... A director needs to take care in his decision-making. In short, he must not act negligently.”

In reflecting on his thoughts, my mind was directed to the wisdom to be found in 150 years of jurisprudence in Commonwealth countries.

One principle is that a board can delegate, but it cannot abdicate its responsibilities. This speaks to the fundamental division between the board’s role, that of strategic direction, and management’s duty of executing the board’s strategy. The board must monitor management’s performance, even though it does not directly carry out the actions. As Koh notes, courts have rejected the argument that a lower standard of care should apply to non-executive directors than to executive directors.

Second, a court should be slow to substitute its hindsight for the foresight of directors. Facts typically emerge in the discovery process of a trial that were unavailable, vague, or in dispute when a decision was reached. Justices must base their decisions on an understanding of the facts that directors had when they made their decisions.

Third, a director can rely on information received from an advisor or employee, unless he has reason to enquire, in which case, he cannot then remain supine. In short, he must query and act. As Koh writes in his analysis of an Australian court’s decision, “a director may not rely on the judgment of others if there is notice of mismanagement or if an investment poses an obvious risk, and if the director knows or should know of facts which would awaken suspicion and put a prudent person on guard.”

Fourth, the duties of care and skill are light compared with the heavier duty of good faith. Good faith connotes intellectual honesty and acting in the best interests of the company. These are overriding principles.
Running as a golden thread through all these principles and to be seen in Koh’s article, is that of intellectual honesty and its application by directors in acting in the best interests of the company and only the company as their principal. While directors are accountable only to the company, in today’s world, they must take into account the legitimate expectations of stakeholders linked to the company by its business.

“The board of a 21st century corporation has the imperative to navigate the shoals of regulatory landmines without making a shipwreck of its entrepreneurial energy and strategic thrusts,” Koh writes, aptly summarizing one major challenge for directors. Having in place effective corporate governance best practices and training directors to understand their duties are essential steps in improving the sustainability of companies.

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REFORM REALISM AND THE BOARDROOM

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At exactly 3.16 pm on 19 July 1989 a jet plane flying over the US mid-west blew apart. Twelve thousand meters above the US mid-west, shards of the engine’s rotor cut through the rear of the aircraft, shredding its hydraulic systems. As fluid bled from the hydraulic tubing, the pilots in the front of the plane lost command of the rudder, elevators, and ailerons essential to stabilizing and guiding the craft. Immediately, the plane twisted into a downward right turn. United Airlines Flight 232 from Denver to Chicago, with 296 people aboard, was out of control.1

In many ways an aircraft disaster is a vivid metaphor of the difficulties of managing the circumstances when corporations hurtle out of control, with converging complexities and connections of decision making in a turbocharged environment and conditions of high uncertainty.

The events of the 1990s were a decade where our corporate lives experienced seismic shocks from within and without. Cherished institutions experienced fissures and cracks, with their foundations shaken to the core. Corporations that we worked with went into bankruptcies. Banks, the citadel of our savings and the sign of systemic stability in the economy, had to be bailed out by taxpayers’ monies. Our corporate landscape was littered with the debris of broken covenants.

At most times, the directors and officers of companies are content to travel in autopilot mode, that is, until a sharp, unexpected and often blinding event can send us reeling and ricocheting into an environment that shatters the our cozy assumptions into a tailspin.

We must also acknowledge the key impact of the following:

- the role of technological change in the growth and evolution of firms
- the impact of innovation on management strategy and knowledge
- globalization, the integration of markets and hyper-competition
- the convergence of industries leading to the disintermediation of former role players and permitting the arbitraging between rules
- the imperative of regulation following function.

1 Homer Homer-Dixon, T. The Ingenuity Gap: How can we solve the Problems of the Future?, Jonathan Cape, 2000, p.11.
The board of a 21st century corporation has the imperative to navigate the shoals of regulatory landmines without making a shipwreck of its entrepreneurial energy and strategic thrusts.

The board’s role in resolving the tensions between managing to ensure a creation of shareholder value and adhering to the demands of compliance is a daunting one. This includes:

- compliance monitoring
- managing regulatory risks
- communications between senior management
- communications and compliance with the regulatory regime
- market competitiveness and other stakeholders.

The Impetus for Reform

Just as the medieval ages gave way to reformation and enlightenment, which birthed modernity, so too did our individual and collective mindsets have to grope for fresh moorings in our corporate regulatory environment when we awoke to the failures of corporations.

Immediate calls for reform reverberated within both the legislative and executive arms of the government, often prompted by a naive sense of the efficacy of law. Even in the earlier period of perceived abuses of corporate power, a knee-jerk reform posturing can be seen.²

The Finance Ministry Report (Green Book) Committee for Law Reform met after the 1998 crisis and issued a clutch of reform proposals.³

The Impact of the Reform Agenda: Juridical and Legislative

Duty of Care of Directors: Conformance and Performance

Control mechanisms through legal means involved structural issues and an evaluation of management performance. The meeting of regulatory rules may be classifiable as the conformance aspect. In the competitive milieu that we are living in, the more intractable issue that is coming to the fore is not just conformance but performance. With the demise of the euphoria of the East Asian miracle, what is being reviewed is not just growth but the effectiveness of management. The performance of a cor-

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² See e.g. Section 132G (connected party transaction) and Section 67A (share buy-back) of Malaysian Companies Act.
³ The Subcommittee on Reform met less than five times and the final report appears to be the product of the Secretariat seeking to redress the perceived weaknesses in legislative provisions rather than an empirically driven institutional reform. The gap between 1998 and the realization of its suggested reforms in 2005 are a salutary reminder of the vicissitudes of law reform and the tortuous paths that it takes.
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Corporation as an enterprise means the measurement of the planning process and the implementation of business plans. Here, the control mechanisms being propounded emphasize the enhancement of stakeholders’ interests.

It must not be assumed that the conformance and performance roles of management are antithetical. Undoubtedly, it must be kept in mind that the promotion of sound practices and conformance activities must always be met with questions as to their achievability and that compliance costs must be kept to the minimum.

The law itself, whether judicial or statute-based, articulates society’s expectations of the proper conduct and standards of corporations. As corporate society grows more complex, so too does the expectations of the community of the corporation and its agents.

One Australian court decision puts it well:

“Foremost among (the difficulties in allocation of liability to directors, officers and auditors) is the failure to recognize and to admit that many companies today are too big to be supervised and administered by a board of directors except in relation to matters of high policy. The true oversight of the activities of such companies resides in the corporate bureaucracy. Senior management and, in the case of mammoth corporations, even persons lower down the corporate ladder exercise substantial control over the activities of such corporations involving important decisions and much money. It is something of an anachronism to expect non-executive directors, meeting once a month, to contribute anything much more than decisions on questions of policy and, in the case of really large corporations, only major policy. This necessarily means that, in the execution of policy, senior management is in the true sense of the word exercising the powers of decision and of management which in less complex days used to be reserved for the board of directors4.”

This decision was made in the context of the question of whether the duty of care of directors and officers of the company in the late twentieth century has been ‘quickened’ compared to the earlier decisions through to the mid-20th century.

The Australian judges emphasised that:

- directors must take reasonable steps to place themselves in a position to guide and monitor the management of a company
- the board should meet as often as it deems necessary to carry out its functions properly in the particular circumstances of the company

4 AWA Ltd v Daniels trading as DHS (1992) 7ACSR.
while it is unreasonable to expect every director to have equal knowledge and experience of every aspect of a company’s activities, courts have rejected the argument that a lower standard of care should apply to non-executive directors than to executive directors.

- the older authorities, suggesting that a director is justified in delegating and entrusting to the officers of the company unless there are circumstances so plain that this is not justified, do not now accurately state the law.

- a director may not rely on the judgment of others if there is notice of mismanagement or if an investment poses an obvious risk, and if the director knows or should know of facts which would awaken suspicion and put a prudent person on guard. The degree of care commensurate with the evil to be avoided is required, and

- directors are put under a continuing obligation to be kept informed about the activities and affairs of the corporation but this does not extend to a detailed inspection of day-to-day operations.

The above constitutes an admirable judicial statement of the quickening of management duty of care; it is infused with realism and commonsense.

It is also a clarion call to restate the older case authorities where directors were treated and accepted as sinecures. In the realm of fiduciary duties too, we see a heightened awareness of conflict situations tempered with a sober analysis of the transactions themselves, to distinguish between the entrepreneur who sought to exploit a corporate opportunity but has taken requisite steps to disclose the opportunity, and the company where the disclosure was less than forthright and the stringent duty is imposed. The no-conflict rule is also in the statute book.

**Fiduciary Duty**

The primary duty in law of a director is that a fiduciary duty is owed to the company. Legal orthodoxy recognizes that this means the corporation proper and not the shareholders individually, so that, in any breaches of duty, the proper plaintiff is the company and not the shareholder. The wider view that a corporation is made of multiple stakeholders of which the courts must take notice has not taken root. In cases of corporations going into near insolvencies, it has been noticed that the courts have, of late, taken note that there is a duty owed to the creditors. In Malaysia, there is an absence of an express statement that directors have to have regard to the interests of employees in their performance of their duties.

The primary duty articulated is that of loyalty to the company and the application of rules against self-dealing. The analogy of quasi-trustee duties was applied, which sits uneasily with commercial realities and in a situation where the company itself has difficulties or is disabled from exploiting the corporate opportunities (cf Canadian Aero Services v O’ Malley (1973) 65 DLR ed 235; Industrial Development Consultants v Cooley (1972) 2 AER 162).
The tension under a more expansive doctrine of corporate opportunities and the policy of encouraging entrepreneurial conduct in situations where a corporation is not able to exploit the opportunity is a real one. Reform and clarification in this area may also be forthcoming.

Liabilities of “Officers”


The decision by Ormiston J in Commr for Corporate Affairs v Bracht (1989) VR 821, 830 is instructive as to the scope of management in the definition of ‘officer’ under Australian law prior to 2000. His Lordship concluded that these terms should be regarded as encompassing:

Activities which involved policy and decision making, relating to the business affairs of a corporation, affecting the corporation as a whole or a substantial part of that corporation, to the extent that the consequences of the formation of those policies or the making of those decisions may have some significant bearing on the financial standing of the operation or the conduct of its affairs. The learned judge made pertinent rulings on the meaning to be given to such expressions as ‘concerned in’, and ‘takes part in’, and whether the officer’s degree of involvement is more than passing and not merely clerical or administrative. His Lordship ruled that the provision of advice to management, participation in decision-making processes and the execution of decisions going beyond the mere carrying out of directions as an employee would suffice to lead to the conclusion that the relevant person was concerned in management.

These remarks, if reform is made to have a more expansive definition of ‘officer’ under the Malaysian Companies Act, will be apposite for application. These reforms involve the following key areas:

- statutory clarification of directors’ duties of care and fiduciary duties
- issues on the scope of duties of nominees’ directors
- the scope of the ratification powers
- business judgment rule.
The following policy issues provide the basis for the CLRC Working Group’s proposal in relation to directors’ duties:

- ensuring accountability of directors within a flexible regulatory framework that promotes efficient risk-taking \(^5\) via codification of duties and available defenses for directors
- minimizing the agency cost attached to the director and shareholder relationship through disclosure obligation, and
- promoting a proper balance between government regulation and industry self-regulation.

Realism and the Corporation

It is important to be reminded that the corporation is a vehicle for wealth creation and a significant part of the democratic impulse in modern societies. Obviously, when an economic crisis occurs, it is in part a corporate governance crisis and issues of the continuing legitimacy of the corporation arise acutely. However, we must be wary of making scapegoats of directors for all the ills or weaknesses that attend to corporations.

Directors as part of the system do of course share in the responsibilities of maintaining a sound governance structure in a corporation, but it must be kept in mind that the overarching teleos of corporations is that of a vehicle for commercial adventure. The entrepreneurial energies that propelled the wealth of nations is in part realized as result of the pragmatism of the law.

The dominance of owner-shareholders, and the relative dissipated nature of minority shareholders, makes the challenge of ensuring the relative autonomy of directors, who are not owners, a real one.

On the one hand we do not desire a fractious board that gets bogged down in pettiness and time-consuming conflicts and that has no relationship with governance, but on the other hand there is the expectation that board members cast off their reticence and assert a check and balance to any overweening owner or CEO decision making.

The Structure and Composition of the Board

One of the issues that emerged in the debate on governance and the structure of the board is the independence of directors, more particularly the role and value of

\[^5\] Farrar, J. in Corporate Governance, Business Judgment and the Professionism of Directors (1993) 6 CBLJ 1, p 3 points out that neglect of this simple truth is the source of error in the contemporary debate about directors’ duties.
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independent directors. Throughout the Anglo-American jurisdictions, there has been a wave of recommendations on this issue.

The US would like the whole board, except the CEO, to be made up of independent directors.

In Australia, the Working Group on Corporate Practices and Conduct recommended that the boards of listed Australian corporations:

"Include sufficient directors who are generally independent in their views to carry significant weight on the board. Their numbers will vary with the size of the board but it is unlikely that less than two will be able to exercise sufficient influence, and it is desirable that at least one-third of the board should be genuinely independent."

It is worthwhile to set out the functions of a board of directors. In the main they are to:

- consider the proposals of the CEO or managing director and in some jurisdictions to appoint the CEO/MD and to set down their remuneration
- formulate a strategic business plan
- approve the annual budget and set down key management decisions on major capital expenditure, business acquisitions, restructuring and financing
- monitor business and management performance and approve the remuneration of key employees
- set down reporting to shareholders
- review various budgetary controls and also internal controls in respect of conformance to regulatory directives.

Reform Proposals and the Independent Director

A corporation is viewed more as a microcosm of a mini-state than as a competitive entity.

More and more proposals appear to be dedicated to the emasculation of management powers and a rejection of the model that businesses are more effectively disciplined by market forces. No attempt is made to ascertain, by empirical research, whether in fact independent directors can and do discharge their roles. In the US, a study conducted by Paul W MacAvoy, a Yale economist, tested proposals for independent directors and key committees. The study involved some 495 large corporations and tested corporate economic, legal and social performance. MacAvoy found that the independent director model had little or no success in ensuring compliance.6

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“Independent directors will always tend to be inefficient disciplinarians of incompetent management. They are by definition part-time directors, busy elsewhere with other concerns. That fact, in conjunction with their less than burning interests in profits, makes them ideal monitors of inefficiency in the corporation. They will always make the worst monitors for shareholders because they have no residual interest in the profits of the corporation. They therefore have no drive to be efficient monitors.”

Directors’ Independence and the Law

**Corporate law looks to the board to perform its duties.** The courts have increasingly been sensitive to the growing complexity of the corporations.

In AWA Ltd vs Daniels t/as DHS (1992) 7ACSR 759 Rogers J observed:

> “Foremost among the [difficulties which arise in the allocation of liability to directors, officers and auditors] is the failure to recognize and to admit that many companies today are too big to be supervised and administered by a board of directors except in relation to matters of high policy. The true oversight of the activities of such companies resides with the corporate bureaucracy.”

The law does not make any distinctions as to the type of directors and their duties under law. If a person is a director, then the law imposes both statutory and common law duties on them. There is authority that a ‘director’ includes someone who knowingly assumes the office of director without being duly appointed: CAC (NSW) v Drysdale (1978) 141 CLR 236; see PP v Yap Sing Hock.

Independence and the Various Types of Directors

De Facto Directors

**Statutory duties apply to a director and also to an officer.**

The definition of directors (s 4 of the Malaysian Companies Act) extends to:

> “any person occupying or acting in the position of director of a corporation, by whatever name called and whether or not validly appointed to occupy or duly authorized to act in the position.”

A person may be a de facto director even when he calls himself a consultant, or when the person undertakes tasks that would typically be expected of a director: see PP v Yap Sing Hock.
Shadow Directors

The definition in the Malaysian Companies Act also extends to:

“any person in accordance with whose directions or instructions the directors of the corporation are accustomed to act.”

The following Australian cases are instructive: Standard Chartered Bank v Antico; ASC v AS Ltd; Dairy Containers Ltd v NZI Bank Ltd and Hydro Dam (Corby) Ltd [1994].

In the Standard Chartered Bank case, the Supreme Court of NSW held that a company was a shadow director of another company, Pioneer International Ltd. Through two wholly-owned subsidiaries, 42% of Giant Resources Ltd, Pioneer had three nominee directors on the board of Giant Resources out of the total of 11 board members. There were several factors, which led Hodgson J to conclude that Pioneer was a director of Giant Resources.

In the relevant time in question, the board of Giant consisted of five executive directors and three nominees of Pioneer who were non-executive directors. The board of Pioneer consisted of these very same directors (Antico as Chairman of Pioneer, Quirk as Managing Director of Pioneer and Gardiner who became deputy Managing Director).

The mere fact of 42% ownership and their nominees on the board does not make Pioneer a shadow director of Giant. But the court referred to the following circumstances that led it to conclude that the usual position does not apply:

- Pioneer had effective control by virtue of its 42% equity where the other significant shareholders held about 10%, 6%, 6% and 3%
- Pioneer exercised management and financial controls over the affairs of Giant by virtue of the system of financial reporting
- Furthermore, three strategic decisions concerning Giant were effectively made by Pioneer, and the board of Giant was not consulted
- Although the three nominee directors maintained that they were at all times cognizant of their separate duties to Giant, the court held that on the facts they “simply accepted the decisions which had been effectively been made by Pioneer.”

Independent Directors and Nominee Directorship

The whole issue of the roles and duties of nominee directorship can be clouded by misapprehension and misconstruction.

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7 It is noteworthy this phrasing is used in s 122A of the Malaysian Companies Act.
In the Malaysian corporate set-up, it is not uncommon for family-based enterprises and government corporatised bodies to have a legitimate interest in maintaining nominee directors to oversee their interests. This expectation is legitimate and has commercial justification.

The expression ‘nominee director’ is best understood to describe a non-executive director who is appointed at the behest of a particular shareholder or class of shareholders. For example, in a conglomerate, the holding company may have nominees in their various subsidiaries or associate companies. A joint venture party will have a nominee director to safeguard its interest.

Anyone who holds a nominee directorship must bear in mind that they have all the basic duties of every director, each of which can be a trap for the unwary. The common law recognizes these arrangements and does not ipso facto strike them down as unlawful: see Boulting v ACTAT [1963] 2 QB 606; Bushell v Faith [1970] AC 1099; see also Danaharta Act where nominee directors can be appointed by a special administrator.

The nominee director must keep in mind that they owe a paramount duty to the company of which they are a board member and any matter under deliberation must be with this view of the interest of the company. The nominee director must not simply act on the behest of their appointer, disregarding the interest of the company. In the Scottish Co-operative v Meyer case, the House of Lords considered that nominee directors could be put under an impossible situation where they could not do their duty to two companies in a group. In a situation where the nominee directors subordinated the interests of a company to the Society that appointed them, it was construed as oppressive of the minority.

In this case, the Society that supplied raw materials to the company, which the nominee served, decided as a matter of corporate policy to starve the company of supplies of raw material, effectively damaging it commercially.

Lord Denning quipped:

“The question was asked: What could these directors have done? They could, I suggest, at least on behalf of the company, have protested against the conduct of the Society... But then it is said: What good would that have done?... the answer is that no one knows whether it would have done any good. They never did protest. And it does not lie in their mouths to say that it would not have done any good when they never put it to test.”

The Australian courts have also considered the impossible situation in which directors find themselves in a nominee situation. It was suggested that the realistic manner with
which to deal with this is to allow the director to take into account the wishes of the appointer, provided that the nominee director reasonably considers that those wishes are in the interest of the company and that following them will not be criticized; see RE Broadcasting Station2GB Ltd (1964-65) NSW 1662.

It is also important to take note that a nominee director is bound by rules of confidentiality and therefore cannot disclose unauthorized information. This article cannot examine the complexities of insider trading law as embodied in the Securities Industry Act. Suffice it to state that dealing with price-sensitive information that has not yet been made available in the public domain can be legally risky.

There can be a situation of price-sensitive information, which cannot be released without proper clearance.

**All the normal statutory and common laws are applicable to a non-executive director as the law makes no specific distinction between executive and non-executives**. The only distinction that courts and regulatory authorities may be willing to make will be in the nature and scope of the duty in application to the facts of the case.

It is incumbent, therefore, for every director to be cognizant of the legal regulatory framework and have a basic understanding of the legislative provisions that govern the discharge of their powers and duties.

It would appear that any reform initiative and search for a right solution requires the balancing of the interests of various stakeholders:

- investors: who wish to maintain the supply of competent, appropriately qualified individuals who are willing to lead the company
- directors: who want to be clear about their responsibilities and liabilities
- regulators: who are anxious to maintain efficient, well-ordered and transparent markets.

To the extent that reform initiatives can find solutions that reconcile these objectives, it will have been a worthwhile venture.
About the Author

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