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Market freedom or shareholders' protection? A comparative analysis of the duties of nominee directors

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Abstract

Purpose – The purpose of this paper is to examine the recent codification of the duties of nominee directors in Malaysia.
Design/methodology/approach – Comparative law and legal theory.
Findings – The paper finds that the Malaysian approach to the duties of nominee directors is overly prescriptive and inconsistent with commercial reality.
Practical implications – A review of the law on the duties of nominee directors in Malaysia is called for.
Originality/value – This paper highlights the need for clear law reform objectives and made comparisons of the law across jurisdictions.
Keywords Directors, Corporate governance, Law reform, Malaysia
Paper type Viewpoint

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1. Introduction

The question of whether a nominee director may act in the interests of his or her nominator when there is a conflict of interests between the nominator and that of the company in which the nominee serves as a director is a problem that is not easily solved.

The common law courts are divided in this issue. Most commentators have divided the approaches taken by the courts into (1) the strict or traditional approach (requiring directors to consider only the interests of the company and to avoid situations of actual or possible conflict, as advised by Lord Denning in *Scottish Co-operative Wholesale Society Ltd* v. *Meyer*[1]) or (2) the liberal or pragmatic approach (that the duties of nominee directors could be adjusted by the shareholders, see e.g. Re Broadcasting Station 2GB Pty Ltd[2] and *Levin* v. *Clark*[3])[4].

There were efforts to codify the fiduciary duties of nominee directors. The New Zealand Companies Act 1993 had ventured to codify the pragmatic approach by allowing for an adjusted fiduciary duty where this is allowed by the constitution of the company[5]. A more recent effort was a new provision in the Malaysian Companies Act 1965 which adheres to the more traditional approach of requiring a nominee director to act in the best interests of the company in the event of conflict between the interests of the company and his nominator[6]. The breach of this section attracts both civil and criminal penalties[7]. This follows the recommendation of the Malaysian High Level Finance Committee on Corporate Governance (1999)[8] and the Malaysian Corporate

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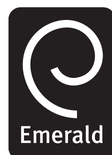

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Law Reform Committee (CLRC, 2006)[9]. Both the Finance Committee and the CLRC have recommended the strict approach to be inserted into the Malaysian Companies Act 1965.

We argue in this paper that the statutory duties of nominee directors in the Malaysian provision are untenable. There are few reasons for this. First, commercial reality dictates that nominee directors reserve their ultimate allegiance to their nominators. Second, market freedom requires that nominee directors should be allowed to adjust their fiduciary duties, especially where safeguards could be put in place (such as the requirement that the adjusted fiduciary duty is provided for in the company's constitution or where this has been unanimously agreed by the shareholders). Third, the position of nominee directors is fundamentally in negation of the fiduciary duty of loyalty. It has been suggested that the nominee directors' ultimate allegiance is to their nominators[10]. This is not solved by having an uncompromising approach in the other direction. Such inflexibility and unreasonableness will merely create evasion and/or creative compliance. Furthermore, in the Malaysian context, there are questions on the regulator's monitoring and enforcement capabilities[11], the limits on the resources and the incentive of minority shareholders to enforce directors' duties[12], and the existence of a management culture based on deference to persons in authority[13].

This paper is organised the following way. First we will discuss the meaning of nominee directors. This is followed by a discussion on the areas where there could be conflicts of interests. We will then discuss the approaches taken by the courts in Malaysia and several other common law countries, i.e. New Zealand, Australia, the United Kingdom and Singapore. We conclude by arguing that in the case of nominee directors, the combination of a number of factors dictates that nominee directors should be allowed to further the interests of their nominators, provided this has been unanimously agreed by shareholders or where the adjusted duty is clearly provided in the company's constitution. These factors are: the fundamental impossibility of the position of nominee directors, commercial reality, market freedom and enforcement issues. We argue, however, that in public companies, the interests of minority shareholders should not be sacrificed in the name of market freedom. In such companies directors should not be allowed to fetter his or her discretion by acting in the interests of the any third parties in preference to that of the company.

2. Who are nominee directors?

The Malaysian Companies Act 1965 defines the word "director" but not the phrase "nominee director"[14]. For guidance, we refer to the Australian Companies and Securities Law Review Committee (CSLRC, 1987) which stated that nominee directors may be directors nominated or elected to the Board of Directors by an individual shareholder, a class of shareholders or some other groups (e.g. a major creditors or the employees of the company), rather than by the general body of shareholders[15]. As nominee directors, they are expected, in the performance of their office, to "act in accordance with some understanding, arrangement or status which gives rise to an obligation (in the wide sense) to the appointor"[16]. This understanding may take a variety of forms, e.g. formal agreements as provided for in the company's constitution or shareholders agreements, as well as tacit understandings or expectations that nominees will be appointed to represent certain interests. The acceptance of the right of the nominator to remove and replace the nominee director is usually an indication of this understanding or expectation[17].

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Ford *et al.* (2001) said that a director is a nominee director if he or she is not merely appointed by some identified nominator, but also has an extraneous loyalty to the nominator or some interests other than the interests of the company[18].

Although the phrase nominee directors is not defined in the Malaysian Companies Act 1965, s. 132(1E) makes reference to a director appointed by virtue of his position as an employee of a company, or appointed by or as a representative of a shareholder, employer or debenture holder. The Act also tacitly recognise the existence of nominee directors in s. 176(10A)(d) in relation to the appointment of directors by majority creditors where the company is seeking to make an arrangement or compromise with its creditors[19].

From the above, the following observations may be made-

- a nominee director is usually appointed to represent certain shareholders, employees or creditors;
- independent of the method of their appointment, nominee directors usually acts in accordance with some understanding, arrangement or status which gives rise to an obligation to the nominator;
- the nominee director therefore has extraneous loyalty and may therefore be obliged to act in the interests of the nominator or at the very least to consider the interests of the nominator; and
- the arrangement for the nominee directors to act in the best interests of the nominator may be express or implied, formal or informal.

3. The duties of nominee directors

3.1 Duty to company or to the shareholders?

It is the trite law that directors owe fiduciary duties to the company and they must act bona fide in the best interests of the company. Lord Greene MR in Re Smith & Fawcett Ltd[20] said:

> [The directors] must exercise their discretion bona fide in what they consider, not what a court may consider, to be in the interests of the company, and not for any collateral purpose . . . It is beyond question that that is a fiduciary power, and the directors must exercise it bona fide in what they consider to be the interests of the company.

A similar position was taken in Re W.&M. Roith Ltd[21] where Plowman J rejected a plan entered into by the director which was not bona fide for the benefit of the company.

As mentioned, directors are under a duty to act bona fide in the best interests of the company. Because the duties are owed to the company, they are enforceable by the company and not individual shareholders[22]. However, the company is usually defined by reference to the shareholders as a whole and not by reference to the company as an entity distinct from its members[23]. In the case of *Percival* v. *Wright*[24], Swinfen Eady J referred to a string of old cases which established that the directors are regarded as trustee of the company. On the facts, Swinfen Eady J found that the directors were not in breach of their duties for non-disclosure of negotiation involving the company to the vendor shareholders when they entered into an agreement to purchase the company's shares. The directors must act bona fide for the interests of the company as a whole and not towards the members individually. This decision in *Percival* v. *Wright*[25] was severely criticised by the Cohen Committee (1945) and also rejected by the Jenkins Committee (1962)[26]. It was also criticised by

Mahon J in *Coleman* v. *Myers* as it conflicts with "commercial morality" and as being opposed to the "prevailing notions of correct commercial practice"[27]. However, on the facts the decision by Swinfen Eady J is not completely reproachable. He reached this decision after considering that there was no question of unfair dealing in this particular case. The directors did not approach the shareholders with the view of obtaining their shares; instead it was the shareholders who approached the directors and named the price at which they were desirous of selling[28].

Although it is a general rule that directors owe a primary duty to the company, the company's interests have traditionally been identified as the shareholders' interests, i.e. shareholders as a whole[29]. In a takeover situation, the interests of the shareholders may mean the interests of current shareholders[30].

In the UK today, the official stand appears to be that greater emphasis should be placed to the company's long term future instead of the shareholders as the ultimate focus of directors[31]. This is consistent with the "enlightened shareholder value" approach which embraces the stakeholder approach without sacrificing the interests of the shareholders as paramount. This is now reflected by s. 172 of the UK Companies Act 2006, which provides as follows:

> 172 Duty to promote the success of the company
> (1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to:
>
> - the likely consequences of any decision in the long term;
> - the interests of the company's employees;
> - the need to foster the company's business relationships with suppliers, customers and others;
> - the impact of the company's operations on the community and the environment;
> - the desirability of the company maintaining a reputation for high standards of business conduct; and
> - the need to act fairly as between members of the company.

The approach taken by the UK Companies Act 2006 in the provision above is not without critics. The Australian Parliamentary Joint Committee on Corporations and Financial Services (2006) and the Australian Corporations and Markets Advisory Committee (2006) have issued reports which included discussions of the UK approach[32]. The Parliamentary Joint Committee rejected the UK approach which it thought caused great uncertainty in the law and lacked guidance in relation to non-shareholders interests[33]. The Committee said that a law which imposes duties but fails to give clear guidance as to whom the duty is owed and how it is to be discharged magnifies the uncertainties faced by directors and is therefore bad law. The Committee instead preferred an enlightened self-interest interpretation of directors' duties under which the directors are permitted to consider and act upon the legitimate interests of stakeholders to the extent that these interests are relevant to the corporation. The Committee was however against the idea of incorporating this interpretation in the Corporations Act, primarily because directors' duties "as they currently stand have a focus on increasing shareholder value", but also because the other stakeholder protections is already regulated by a network of legislation[34].

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The Australian Corporations and Markets Advisory Committee (2006) also rejected the UK approach, saying[35]:

> The Committee considers that an amendment to the Corporations Act, either specifically to require or to permit directors to have regard to certain matters or the interests of certain classes of stakeholders, could in fact be counterproductive. There is a real danger that such a provision would blur rather than clarify the purpose that directors are expected to serve. In so doing, it could make directors less accountable to shareholders without significantly enhancing the rights of other parties.

It should be noted that the above does not mean that these Australian Committees have rejected the enlightened shareholder or even a wider stakeholder approaches, rather that the approach taken in the current UK legislation is unworkable.

In the Malaysian context it should be noted that although the Companies Act 1965 stipulates the duty of directors to act "in the best interest of the company"[36] the phrase is not defined, leaving its interpretation to the courts.

3.2 The company in a corporate group

It is very common that companies operate within a corporate group. The reasons for this include expansion purposes, tax benefits, risk management, financial reporting, administration and operational considerations[37]. In most cases companies within a group would have interlocking or common directors. Interlocking shareholding and directorships are common in Malaysia due to factors which include business culture[38].

The issue here is whether a director could take into account the interests of other companies within a corporate group[39]. This is relevant to the duties of nominee directors as very often the nominator being the holding or controlling company appoints its employees to sit on the board of the subsidiary company.

The common law courts have taken a strict approach on the issue. In *Charterbridge Corporate Ltd* v. *Lloyds Bank Ltd*, Pennycuick J said[40]:

> Each company in the group is a separate legal entity and the directors of a particular company are not entitled to sacrifice the interests of that company. This becomes apparent when one considers the case where the particular company has separate creditors. The proper test, I think, in the absence of actual separate consideration, must be whether an intelligent and honest man in the position of a director of the company concerned, could, in the whole of the existing circumstances, have reasonably believed that the transactions were for the benefit of the company.

The court considered the whole of the existing circumstances in this case, taking into account that the memorandum of the company expressly allowed the company to create a charge for the benefit of another company within the group. The court held that the company was carrying out the purposes expressed in its memorandum and did an act within the scope of power expressed in it. The memorandum of the company sets out its objects and proclaimed them to persons dealing with the company and it would be contrary to the whole function of a memorandum if the objects unequivocally set out in it should be subject to some implied limitation by reference to the state of mind of the parties concerned.

The High Court of Australia has also taken the similar position in *Walker* v. *Wimborne*[41]. Mason J in this case said:

> To speak of the companies as being members of a group is something of a misnomer... The word "group" is generally applied to a number of companies which are associated by common

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> or interlocking shareholdings, allied to unified control or capacity to control. In such a case the payment of money by company A to company B to enable company B to carry on its business may have derivative benefits for company A as a shareholder in company B if that company is enabled to trade profitably or realize its assets to advantage. Even so, the transaction is one which must be viewed from the standpoint of company A and judged according to the criterion of the interests of that company.

It should be noted that in a wholly-owned subsidiary the only directors will usually be the nominees appointed by the parent company, who are often chosen in their capacity as employees of the parent company. In such a company it might seem that the interests of the company as a whole will always coincide with those of the parent. But as Ford *et al.* (2001) pointed out, even wholly-owned subsidiaries can give rise to a dual loyalty in that the interests of the subsidiary can transcend those of the parent since the subsidiary may have their own creditors to consider[42].

In conclusion, nominee directors in performing their duties as directors of a company must act in the best interests of the company, judging from the standpoint of the company concerned. The nominee directors may take into account other circumstances (for example interests of other companies within a group) but the ultimate decision must be based on whether the proposed act is for the benefit of the company concerned.

3.3 Vicarious liability of the nominator

In *Kuwait Asia Bank EC* v. *National Mutual Life Nominees Ltd*[43], a Privy Council decision on appeal from New Zealand, the nominee directors were held to have breached their fiduciary duties to the company as they acted in the best interests of the nominator. However, the Council rejected the argument that the nominator is vicariously liable, saying that they acted as they did so as individuals and as directors of the company and not as nominees (and employees) of the nominator[44].

4. Fundamental conflict of interests: loyalty to the nominator

As mentioned, the traditional legal principle demands nominee directors to consider the interests of the company in preference to other interests, including those of the nominator. This in reality puts nominee directors in a position of inherent conflict. Justice Thomas (1997) has extra-judicially commented that the nominee directors' position is in fact a negation of the fiduciary obligation and its concomitant requirement of undivided loyalty. Their ability to carry out their duties as a director in good faith, and in the interests of the company as a whole, is at once compromised by their divided loyalty[45]. He suggested that nominee directors would breach their duties to the company in the following situations[46]:

(1) The nominee directors certainly breach the rule proposed by Lord Cranworth in *Aberdeen Railway Co* v. *Blaikie Bros*[47] which requires directors to avoid situations of actual or possible conflict.

(2) Directors are required to bring an independent judgment to bear in the exercise of their powers. Yet the very nature of the arrangement or understanding which brings directors within the definition of "nominee directors" means that they have fettered their discretion to act independently.

(3) Directors are obliged to shun extraneous ends, but the nominees' dutiful regard to the interests of their sponsors is collateral to the interests of the company

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(even where the interests coincide). In essence, good faith predicates the absence of a collateral purpose.

(4) The duty of directors not to disclose company information or use confidential information without the consent of the company is incompatible with the nominee directors' position. Indeed, in many cases, reporting back to their appointors may be their primary function. It is certainly essential to the control or supervision which the major shareholder or lender will wish to exercise.

With regards to confidential information, it is generally accepted that all directors, including nominee directors, owe a duty of confidentiality to the company[48]. However, this is a problematic issue as in many commercial and fiduciary situations a party will be in relationships giving rise to duties e.g. employees' duty of good faith and loyalty. Will these other duties be ancillary to the directors' fiduciary duty to the company? The conflict of duties is also heightened in the case where a director is appointed to the board in his capacity as a trustee, e.g. a trustee of a trust holding shares in a family company.

We suggest that more analysis of these conflicts in law and commercial reality is called for. It may be noted that in the UK, the Committee of Public Accounts (1985-1986) on the role and responsibilities of nominee directors emphasised that nominee directors could not assist government departments and non departmental public bodies directly in the monitoring process, or pass confidential company information to them, without the prior agreement of companies or unless special arrangements such as contractual conditions of financial assistance permitted them to do so[49].

5. The law in Malaysia

At common law nominee directors owe the same fiduciary duties to the company as any other directors. Nominee directors must therefore avoid situations of actual or possible conflicts (*Scottish Co-operative Wholesale Society Ltd* v. *Meyer*[50]). However, some common law courts have showed their appreciation to the commercial reality by dictating that nominee directors may cater to the interests of their nominators where this has been so agreed by the shareholders (e.g. *Re Broadcasting Station 2GB Pty Ltd*[51] and *Levin* v. *Clark*[52]).

There are three Malaysian cases on the duties of nominee directors. In Re Syed Ahmad Alsagoff[53], the Malaysian High Court held that a nominee director has a fiduciary duty to his principal as he is a "trustee" for his principal[54]. In *Industrial Concrete Products Bhd* v. *Concrete Engineering Bhd*[55], the Malaysian High Court found that the nominee director has allowed his duty to the company to conflict with those of his nominator and therefore has breached his fiduciary duties to the company. For authority, the court cited a Singapore decision, *Kumagai Gumi Co Ltd* v. *Zenecon Pte Ltd*[56] in which the Singapore Court of Appeal appeared to have been persuaded by the House of Lord's decision in *Scottish Co-operative Wholesale Society Ltd* v. *Meyer*[57] that the nominee must not let the interests of the nominator prevail over the interests of the company. *In Tan Guan Eng* v. *Ng Kweng Hee*[58] a shareholder attempted to sue the company's director on behalf of the company. Counsel for the plaintiffs submitted that directors of a parent company appointed by the parent company to act as the director in the subsidiary could not place themselves in the position of conflict and that they must at all times ensure that utmost good faith was observed between the parent and the subsidiary and vice versa. Unfortunately the court made no comment on this point.

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Malaysian courts have not had the opportunity to rule on the issue of whether nominee directors could be allowed to consider the interests of the nominators where this has been so agreed by the shareholders.

The duties of nominee directors in Malaysia were codified in 2007 with the insertion of a new s. 132(1E) in the Malaysian Companies Act 1965, which states:

> Responsibility of a nominee director
> 132(1E) A director, who was appointed by virtue of his position as an employee of a company, or who was appointed by or as a representative of a shareholder, employer or debenture holder, shall act in the best interests of the company and in the event of any conflict between his duty to act in the best interests of the company and his duty to his nominator, he shall not subordinate his duty to act in the best interests of the company to his duty to his nominator.

There was no explanation on this provision. The Explanatory Statement of the relevant Companies Amendment Bill merely provided a general statement that the proposed section seeks to "clarify further on the existing provisions regarding the duties and liabilities of a director of a company". The Malaysian High Level Finance Committee on Corporate Governance (1999) had earlier recommended that "there should be statutory clarification of the fact that a nominee director's primary obligation is to act in the best interests of the company and that his duty to his principal is always subject to his duty to act in the best interests of the company"[59]. Similarly, the CLRC (2006) took the view that nominee directors must be held to a strict fiduciary duty to act in the best interests of the company[60]. The CLRC noted the arguments that this position is not in line with commercial reality and may not be facilitative to the business needs of companies, but took the view that facilitation of business should not be at the expense of good corporate governance. Therefore, nominee directors should be allowed to act in the interests of his nominator only if the interests of the nominator do not conflict with the interests of the company. The CLRC gave two reasons for this:

- this will assist directors to understand the nature and extent of their duty; and
- since it may be difficult to determine or define with certainty the identity of the nominee directors, the adjusted fiduciary duty may not be capable of being properly enforced[61].

The CLRC, however, conceded that any adjusted fiduciary duties should only be allowed in the case of a wholly-owned subsidiary since there would be no minority shareholders' interests which need protection[62].

The breach of s. 132(1E) carries both civil and criminal penalties[63]. Apart from these penalties, the practice of adjusting the fiduciary duties of directors may also be invalid for being opposed to the law[64].

5.1 Disclosure of confidential information

The Malaysian Companies Act 1965 is silent on the issue of whether the nominee directors can disclose confidential information belonging to the company to his nominator. This may be compared with another provision in the Act relating to schemes of arrangement or compromise with creditors. Section 176 allows the majority of creditors to nominate a director in the company. Section 176(10B) provides that the director shall have a right of access at all reasonable times to the accounting and other records (including registers) of the company, and is entitled to require from any officer of the company such information and explanation as he may require for the purposes of his duty. However, the section is also silent regarding the use of the confidential

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information, i.e. whether the nominee can disclose to his nominator such information he obtains in the position of a director of the company concerned.

Section 132(2)(b) of the Companies Act 1965 prohibits a director or officer from using any information acquired by virtue of his position as director or officer of the company to gain directly or indirectly, a benefit for himself or any other person, or cause detriment to the company, without the consent of the general meeting. This is an area of great difficulty as in many cases a nominee director would be expected to report back to their nominator, especially where the nominees are employees of the nominator.

5.2 Vicarious liability of the nominator

Another issue which has not been addressed in Malaysia is whether the nominator may be made vicariously liable for the nominee's breach of duties as a director. As mentioned, the Malaysian High Court in Re Syed Ahmad Alsagoff[65] has held that a nominee director is a "trustee" for his principal. This appear to be a good ground for holding the nominator vicariously liable as principal for the breach of duty of the nominee, especially where the nominee has breached his duties in the course of performing his obligations to his nominator. However this decision should be read in the light of a more recent *Privy Council decision in Kuwait Asia Bank EC* v. *National Mutual Life Nominees Ltd*[66]. Privy Council's decision, although not necessarily binding, is usually treated with utmost respect in Malaysia; therefore the possibility of the decision in this case being applied in Malaysia when the opportunity arises should not be underestimated[67].

6. Comparative legislation

In this part we consider how the legislation in other selected common law countries deals with the issue of the duties of nominee directors.

6.1 New Zealand

New Zealand has the most liberal approach with regards to the duties of nominee directors. The New Zealand Companies Act 1993 addresses the issue of conflict of interest and provides for requirements to be fulfilled before the interests of the nominator can be considered.

Section 131(1) of the New Zealand Companies Act 1993 reiterates the duties of directors to "act in good faith and in what the director believes to be the best interests of the company". Sections 131(2), (3) and (4) address the issue of conflicts of interest situations in a wholly-owned subsidiary, a subsidiary which is not wholly-owned, and joint venture between shareholders. They read as follows:

> 131(2) A director of a company that is a wholly-owned subsidiary may, when exercising powers or performing duties as a director, if expressly permitted to do so by the constitution of the company, act in a manner which he or she believes is in the best interests of that company's holding company even though it may not be in the best interests of the company.
>
> 131(3) A director of a company that is a subsidiary (but not a wholly-owned subsidiary) may, when exercising powers or performing duties as a director, if expressly permitted to do so by the constitution of the company and with the prior agreement of the shareholders (other than its holding company), act in a manner which he or she believes is in the best interests of that company's holding company even though it may not be in the best interests of the company.
>
> 131(4) A director of a company that is carrying out a joint venture between the shareholders may, when exercising powers or performing duties as a director in connection with the

carrying out of the joint venture, if expressly permitted to do so by the constitution of the company, act in a manner which he or she believes is in the best interests of a shareholder or shareholders, even though it may not be in the best interests of the company.

Section 145(2)(a) of the New Zealand Companies Act 1993 deals with the disclosure of information by nominee directors. It allows a director of a company, unless prohibited by the board, to disclose information to a person whose interests the director represents.

The duties of nominee directors especially in s. 131(4) may seem innovative, although they actually reflect the progressive approach taken by the courts in New Zealand, following their counterparts in Australia. The first is *Berlei Hestia (NZ) Ltd* v. *Fernyhough*[68], a decision by the Supreme Court of Auckland. In this case, an Australian company held 40 per cent of the shares in a New Zealand company. The articles of the New Zealand company authorised the Australian company to appoint directors of the New Zealand company. Dispute arises between these two companies resulting to a breakdown in relations. The nominee directors of the Australian company were refused access to the company's premises and records. The reason given for this was because these directors were in a position to act in derogation of their duty to the company. Mahon J said that the right of a director to access to corporate records is necessary for him to perform his duties as a director. On the facts, Mahon J found no evidence that the Australian directors intended to act in breach of their fiduciary duty towards the company[69]. The judge then referred to English decisions including *Scottish Co-Operative Wholesale Society Ltd* v. *Meyer*[70]. He however said[71]:

> But despite the width of that proposition [in the English cases], there have been attempts to bring this theoretical doctrine of undivided responsibility into harmony with commercial reality, upon the basis that when Articles are agreed upon whereby a specified shareholder or group of shareholders is empowered to nominate its own directors, then there may be grounds for saying that in addition to the responsibility which such directors have to all shareholders as represented by the corporate entity, they may have a special responsibility towards those who nominated them. Such a view proceeds on the basis that the articles were so constructed with the intent and belief that the institution of such a special responsibility towards one class of shareholders was conducive to the interests of the company as a whole.

For the justification for this "adjusted form of fiduciary duty", the learned Judge cited two Australian cases, *Levin* v. *Clark*[72] and Re Broadcasting Station 2GB Pty Ltd[73]. Mahon J concluded[74]:

> [T]his business undertaking, stripped of its corporate shell, is a trading partnership between two organisations operating in different countries. They agreed, when the company was incorporated, that each partner nominate three directors, and they impliedly agreed, as the Articles show, that one class of directors was at liberty to bring the Board's functions to a stand-still when a disagreement arose, and that disagreement would almost certainly have its origin in a dispute between the two sets of shareholders. These consequences were all well known to the corporators when the Articles were drawn. As a matter of legal theory, as opposed to judicial precedent, it seems not unreasonable for all the corporators to be able to agree upon an adjusted form of fiduciary liability, limited to circumstances where the rights of third parties vis-a-vis the company will not be prejudiced. The stage has already been reached, according to some commentators, where nominee directors will be absolved from suggested breach of duty to the company merely because they act in furtherance of the interests of their appointors, provided that their conduct accords with a bona fide belief that the interests of the corporate entity are likewise being advanced.

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6.2 Australia

It could be argued that Australia, or more specifically the Supreme Court of New South Wales, is the birth place for the adjusted fiduciary duties of nominee directors. The New Zealand case of *Berlei Hestia (NZ) Ltd* v. *Fernyhough*[75] as discussed above followed two decisions of the Supreme Court, *Levin* v. *Clark and Re Broadcasting Station 2GB Pty Ltd*[76].

Tomasic and Bottomley (1995) said that the role of nominee directors raises significant issues for the law on directors' duties. They quoted Henry Bosch (1992), the former chairman of the Australian National Companies and Securities Commission, who said that nominee directors are common in Australia and there is good reason to think that some of them contributed in large measure to the damage done to Australian investors in the 1980s[77]. There were far too many cases in which part of the wealth of the public companies was siphoned off to other companies in which the controllers of the listed companies had a personal interest[78]. Such concerns have led to the preparation of a report dealing with nominee directors by the CSLRC (1989). The CSLRC called for legislative clarification of the duties of nominee directors and noted that in practice the principle that a nominee director should have loyalty to the company to whose board they have been appointed is widely disregarded in practice[79].

Despite the recommendations, the Australian legislation has no provision which deals specifically with the duties of nominee directors. The only relevant provision now is s. 187 of the Corporations Act 2001 reads:

> 187 Directors of wholly-owned subsidiaries
> A director of a corporation that is a whollyowned subsidiary of a body corporate is taken to act in good faith in the best interests of the subsidiary if:
>
> (a) the constitution of the subsidiary expressly authorises the director to act in the best interests of the holding company; and
>
> (b) the director acts in good faith in the best interests of the holding company; and
>
> (c) the subsidiary is not insolvent at the time the director acts and does not become insolvent because of the director's act.

6.3 The United Kingdom

Case laws in the UK have maintained the traditional approach that directors must avoid actual or possible conflicts of interests. These cases include *Scottish Co-operative Wholesale Society Ltd* v. *Meyer*[80], *Boulting* v. *Association of Cinematograph, Television and Allied Technicians*[81], *Charterbridge Corporate Ltd* v. *Lloyds Bank Ltd*[82] and *Selangor United Rubber Estates Ltd* v. *Cradock* (No. 3)[83].

In *Burmah* v. *Hedges and Butler*[84], in rejecting the argument of the Inland Revenue that a subsidiary was merely the agent of its parent, Walton J said:

> It is of course of the essence of any subsidiary company that, broadly speaking, it should conform to the wishes of its parent company. The parent company, of necessity, appoints its directors, directly or at a remove; the parent company is often its main, and frequently its sole, source of finance; its directors are often directors of the parent company who thus carry the policy of the holding company directly into the board room of the subsidiary. All these factors may, and indeed sometimes do, lead to the board of the subsidiary company pursuing policies which commend themselves to the parent company but which, reviewed objectively, ought not to commend themselves to an independent board of directors. None of these factors, however, whether separately or in conjunction, leads to the conclusion that, in thus obeying,

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> or indeed possibly being made to obey, the whims and caprices of the board of the parent company, the subsidiary company is in any manner acting otherwise than on its own behalf: it is not thereby acting as an agent or nominee for its parent company.

In a joint consultation paper, the Law Commission (1998) commented on the strict view of the duties of nominee directors taken by the English courts and noted the more liberal approach taken by the Australian courts. However, they declined to address this issue, suggesting that this should be tied up with the question of corporate groups[85].

The UK Companies Act 2006 has not addressed the issue of nominee directors specifically. It, however, provided for a general provision on directors' conflicts of interests. The relevant part of s. 175 of the UK Companies Act 2006 reads:

> 175 Duty to avoid conflicts of interest
>
> (1) A director of a company must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company.
>
> (4) This duty is not infringed—
>
> (a) if the situation cannot reasonably be regarded as likely to give rise to a conflict of interests; or
>
> (b) if the matter has been authorised by the directors.
>
> (5) Authorisation may be given by the directors—
>
> (a) where the company is a private company and nothing in the company's constitution invalidates such authorisation, by the matter being proposed to and authorised by the directors; or
>
> (b) where the company is a public company and its constitution includes provision enabling the directors to authorise the matter, by the matter being proposed to and authorised by them in accordance with the constitution.
>
> (6) The authorisation is effective only if—
>
> (a) any requirement as to the quorum at the meeting at which the matter is considered is met without counting the director in question or any other interested director, and
>
> (b) the matter was agreed to without their voting or would have been agreed to if their votes had not been counted.

To summarise, the situation as regards to nominee directors in the UK is as follows. Nominee directors may act in the interests of the nominator instead of the company if this has been authorised by the board of directors. Two additional safeguards are put into place to protect minority interests: the first is that interested directors will not be counted for purposes of quorum and their voting will be excluded. The other safeguard is for the protection of minority shareholders in public companies, by requiring that the company's constitution must specifically allow for such authorisation to be given by the board.

6.4 Singapore

Singapore courts have adopted the traditional approach: *Raffles Hotel Ltd* v. *Rayner*[86] *Kumagai Gumi Co Ltd* v. *Zenecon Pte Ltd*[87] and *Oversea-Chinese Banking Corp Ltd* v. *Justlogin Pte Ltd*[88]. It was also held that a director of a company are not entitled to

sacrifice the interests of that company concerned in favour of the group: *Golden Village Multiplex Pte Ltd* v. *Phoon Chiong Kit*[89].

Woon (2005) commented on the traditional approach as commercially unrealistic. He said[90]:

> . . . there is a large amount of commercial unrealism in Winslow J's *dicta* [in *Raffles Hotel Ltd* v *Rayner* [1965] 1 MLJ 60], especially when the learned judge asserts that the nominee should be left free to exercise his best judgment in the interests of the company he serves and not in accordance with the directions of his patron. In practice, nominee directors usually are employees of the principal. Often, they are not paid any extra for being nominee directors; it is part of their job as senior executives of the principal to sit on boards of investee companies to keep an eye on the investment. Their salary continues to be paid by the principal.

In a recent decision the Singapore High Court in *Jenton Overseas Investment Pte Ltd* v. *Townsing Henry George*[91] revealed a readiness to consider the more liberal view in line with the Australian approach, but in the end opted to stick to the traditional approach. This issue was not considered at the Court of Appeal[92]. Koh (2007) lamented on the "missed opportunity" and suggested that the solution to the issue should be a legislative one[93].

The Singapore Company Legislation and Regulatory Framework Committee (2002) suggested that a provision be introduced in the Companies Act to recognise the reality underlying the appointment of nominee directors and, in particular, the issue of nominee directors making available corporate information to their nominators[94]. The Committee said that they are inclined to follow the approach taken in s. 145(2)(a) the New Zealand Companies Act 1993 in relation to disclosure of information by directors[95]. The Committee did not however make any recommendation in respect to the codification of the duties of nominee directors.

7. Conclusions

Is corporate law mandatory or enabling? Should it be made mandatory or enabling? Mandatory rules refer to rules that are imposed to persons who do not have the ability or discretion to opt out or vary them. Enabling rules, on the other hand, refer to rules which can be varied by the parties to suit their particular circumstance.

It is generally accepted that systems of corporate law should have a combination of both mandatory and enabling rules. As Ogus (2004) said, in all industrialised societies there is a tension between two systems of economic organisation. The first is the market system where individual and groups are left free to pursue their own welfare goals subject only to certain basic restraints. The second is the collectivist system where the state seeks to direct or encourage behavior which would not occur without such intervention. The objective of regulation is to correct perceived deficiencies in meeting collective or public interests goals[96].

There is the same tension in corporate law. On one hand there is the so-called market freedom philosophy which supports the shareholder primacy value. On the other hand the stakeholder value theory requires the company to be managed for the benefit of a wide range of corporate constituents. In between these two opposite theories, there are others such as the enlightened shareholder value and team production theory[97]. Notwithstanding what the law actually says, these theories may have a certain effect on behavior (how directors perceive their duties) as well as influencing the direction of the law. A good example is the current s. 172 of the UK Companies Act 2006 which adopted the enlightened shareholder value. This requires companies to be managed for

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the benefit of the shareholders but with considerations to the wide range of corporate constituents[98].

As regards nominee directors, the current legislative trend, represented by the New Zealand Companies Act 1993 and the UK Companies Act 2006, appears to be that corporate participants should be allowed to dictate the rules that may be applicable to organise themselves, subject only to certain basic principles to ensure the integrity of the market and the protection of minority shareholders. This is consistent with the trend in the USA. As Romano (1993) observed[99]:

> Modern corporation codes tend to be enabling rather than mandatory statutes: they are standard form contracts specifying the rights and obligations of managers and shareholders, which can often be altered by private agreement to suit the circumstances of particular firms. The enabling approach is a function of the contractual nature of a corporation. Participation in a firm is voluntary; common stock is one of a vast array of available investment vehicles.

Market freedom and investor protection appears to be the two most important bases for corporate governance regulation. An example is the Australian Corporate Law Economic Reform Program (CLERP, 1997) which adopted an economic approach to corporate regulation. It was based on five key principles; the first two are market freedom and investor protection[100]. In the UK, the Company Law Review Steering Group (1999) stated its reform objectives as follows[101]:

> The objective is modern law supporting a competitive economy, in a coherent and accessible form, providing maximum freedom for participants to perform their proper functions, but recognising the case for high standards and for ensuring appropriate protection for all interested parties.

Indicating its cognisance of the modern approach to regulation, the Steering Group proposed that there should be presumptions (1) against interventionist legislation and in favour of facilitating markets and (2) against creating criminal offences unless the subject matter demands it[102].

The Malaysian legislature have taken a contrasting approach in s. 132(1E) of the Companies Act 1965. This provision requires nominee directors to give undivided loyalty to the company where there is a conflict of interest situation. It is a mandatory rule for the simple reason that a breach of the section attracts both civil and criminal penalties. Shareholders therefore do not have the discretion to vary the application of the rule. It could be argued that there could be little justification for having the inflexible mandatory standard in s. 132(1E). There are few reasons for this:

(1) The mandatory standard is not commercially realistic as the practice of appointing nominee directors are a fact of corporate life in both private and public companies. As mentioned above, the very position of nominee directors is a negation of the fiduciary obligation of undivided loyalty. The conflict of duties can be more prominent where parties are in relationships which give rise to a conflict of duties e.g. employees' duty of good faith and loyalty or a director appointed to the board in his capacity as a trustee of a trust.

(2) Shareholders should be allowed to make their own arrangement in relation to the corporate structure, provided that the interests of minority shareholders and other stakeholders are not prejudiced. Where, for example, the shareholders have agreed in a shareholders or joint venture agreement to adjust the fiduciary duties of directors so that the directors may act in the best interests of the nominator, there is no reason why this should not be allowed.

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There could be additional safeguards to protect shareholders, especially minority shareholders, for example:

- the arrangement is incorporated in the company's constitution or unanimously agreed by shareholders;
- that to act in the interests of the nominators does not mean that the directors may blatantly disregard the interests of other corporate constituents especially employees and creditors;
- the rights of minority shareholders to commence an action for oppression or unfair conduct should be mandatory and incapable of being contracted out; and
- the adjustment of the directors' fiduciary duties may not apply in public or public listed companies.

The exception in (d) is necessary in the Malaysian context because in most public listed companies in Malaysia the presence of controlling shareholders is still pervasive. In many of these companies, the non-executive directors nominated by controlling shareholders may easily outnumber independent non-executive directors.

(3) Where the company operates as part of a group and there is no minority interests there could be a case for allowing the directors to act in the interests of the holding company. However, as in (1) above, considerations should be made to the interests of the other stakeholders especially employees and creditors.

As mentioned, the breach of s. 132(1E) carries with it both civil and criminal penalties and the practice of adjusting the fiduciary duties of directors may also be invalid for being opposed to the law. Therefore common law cases which permit the adjustment of fiduciary duties in Australia and New Zealand have no application in Malaysia. Furthermore, if the assertion that the very position of nominee directors is itself a negation of the fiduciary obligation is correct, one wonders whether the very practice of appointing nominee directors may in itself be illegal as it would defeat the law.

Notes

1. [1959] AC 324.
2. [1964-65] NSWR 1648.
3. [1962] NSWR 686.
4. Tomasic and Bottomley (1995, p. 408).
5. New Zealand Companies Act 1993, s. 131(2)-(4).
6. The Malaysian Companies Act 1965, s. 132(1E).
7. The Malaysian Companies Act 1965, s. 132(3).
8. High Level Finance Committee on Corporate Governance (1999). This report was prepared soon after the Asian financial crisis of 1997 hit Malaysia.
9. CLRC (2006). The CLRC was established pursuant to powers given to the Companies Commission pursuant to the Companies Commission of Malaysia Act 2001.
10. This was also argued by Justice Thomas (1997, p. 151).
11. These were among the problems associated in the traditional forms of regulation: Parker (2000).

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12. An example is the very small number of shareholder suits in Malaysia: see e.g. Salim and Lawton (2008).
13. See, for example Salim (2006); Lawton (1996).
14. Section 4 of the Malaysian Companies Act 1965 defines "director" to include "any person occupying the position of director of a corporation by whatever name called and includes a person in accordance with whose directions or instructions the directors of a corporation are accustomed to act and an alternate or substitute director".
15. Companies and Securities Law Review Committee (1987, para. 101).
16. Companies and Securities Law Review Committee (1987, para. 101).
17. For a case concerning a dispute over the appointment of nominee directors, see Re A & BC Chewing Gum Co Ltd [1975] 1 WLR 579.
18. Ford *et al.* (2001, para 9.420).
19. Section 176(10A)(d) of the Malaysian Companies Act 1965 provides:
    The Court may grant a restraining order . . . to a company for a period of not more than ninety days or such longer period as the Court may for good reason allow if and only if – (d) it approves the person nominated by a majority of the creditors in the application by the company under subsection (10) to act as a director or if that person is not already a director, notwithstanding the provisions of this Act or the memorandum and articles of the company, appoints the person to act as a director".
20. [1942] Ch 304, p.306. Lord Greene MR's judgment was unanimously concurred by Luxmoore LJ and Asquith J.
21. [1967] 1 WLR 432.
22. (1843) 2 Hare 461.
23. Morse (1992, para 8.505).
24. [1902] 2 Ch 421.
25. [1902] 2 Ch 421.
26. Cohen Committee (1945, paras 86-87); Jenkins Committee (1962, paras 89 and 99(b)); see Davies (1997, p. 600).
27. In *Coleman* v. *Myers* [1977] 2 NZLR 225 Mahon J stated:
    The decision in *Percival* v. *Wright* has been criticized on numerous occasions as being not only in conflict with commercial morality but as also being inconsistent by analogy with the fiduciary duty of directors not to use the property or confidential information of the company for personal profit, and I shall refer later to various aspects of those criticisms . . . The Cohen and Jenkins Committees on Company Law in the United Kingdom each recommended the enactment of legislation in abrogation of the decision in *Percival* v. *Wright* . . . Applying such considerations to the problem in hand, I reach the unhesitating conclusion that the decision in *Percival* v. *Wright*, directly opposed as it is to prevailing notions of correct commercial practice, and being in my view wrongly decided, ought no longer to be followed in an impeached transaction where a director dealt with identified shareholders." [emphasis added]
28. This case was however distinguished in *Allen* v. *Hyatt* (1914) 30 TLR 444 in which Viscount Haldane V.C. said:
    The appellants appear to have been under the impression that the directors of a company are entitled under all circumstances to act as though they owed no duty to individual shareholders. No doubt the duty of the directors is primarily one to the company itself . . . But the facts as found in the present case are widely different from those in *Percival* v. *Wright*, and their Lordships think that the directors must here be taken to have held themselves out to the individual shareholders as acting for them on the same footing as they were acting for the company itself, that is as agents.

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29. *Richard Brady Franks Ltd* v. *Price* (1937) 58 CLR 112.
30. *Heron International Ltd* v. *Lord Grade* [1983] BCLC 244.
31. The Company Law Review Steering Group (1999).
32. Parliamentary Joint Committee on Corporations and Financial Services, Commonwealth of Australia (2006); Corporations and Markets Advisory Committee (2006).
33. Corporations and Markets Advisory Committee (2006, pp. 52-6).
34. Corporations and Markets Advisory Committee (2006, pp. 59-60).
35. Corporations and Markets Advisory Committee, above note 32, pp. 111-2.
36. References to the directors duty to act in the "best interest of the company" is made in s. 132(1) (general duties of directors), 132(1B) (business judgment rule) and 132(1E) (duties of nominee directors) of the Malaysian Companies Act 1965.
37. See, for example, Ramsay and Stapledon (2002).
38. See references in note 13 above.
39. It should be noted that the word "group" is not defined in the Malaysian Companies Act 1965 or the Listing Requirements of the Bursa Malaysia Securities Berhad. The Malaysian Companies Act provides the definition of holding company, subsidiary company, ultimate holding company, wholly-owned subsidiary (Sections 5, 5A & 5B of the Malaysian Companies Act), but is silent on the definition of associated company.
40. [1970] 1 Ch 62, p. 74.
41. [1975-1976] 137 CLR 1, p. 6.
42. See Ford *et al.*, above note 18, para 9.420.
43. [1990] 3 NZLR 513.
44. The Privy Council decision has been criticised: see Justice Thomas, above note 10. For further discussion of these issues see Carroll (1997).
45. Justice Thomas E.W., above note 10, p. 151.
46. Justice Thomas E.W., above note 10, p. 151.
47. (1854) 1 Macq 461, pp. 471-2; [1843-1860] All ER Rep 249, p. 252.
48. For cases on disclosure of information, see generally *Carrian Investments Ltd* v. *Wong Po* [1986] HKLR 945; *North & South Trust* v. *Berkely* [1971] 1 WLR 470, [1971] 1 AER 980; *Supasave Retail Ltd* v. *Coward Chance* [1991] 1 All ER 668; Re a firm of Solicitors [1991] NLJ 746; *Kelly* v. *Cooper* [1992] WLR 936.
49. House of Commons, cited by Lawton, above note 13, pp. 53-4.
50. [1959] AC 324.
51. [1964-1965] NSWR 1648.
52. [1962] NSWR 686.
53. [1960] MLJ 147.
54. See however *Kuwait Asia Bank EC* v. *National Mutual Life Nominees Ltd*. [1990] 3 NZLR 513.
55. [2001] 2 MLJ 332.
56. [1995] 2 SLR 297.
57. [1959] AC 324.
58. [1992] 1 MLJ 487.
59. Above note 8, p.120.
60. CLRC, above note 9.

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61. CLRC, above note 9, para 4.35.
62. CLRC, above note 9, para 4.36.
63. Section 132(3) provides:
    An officer or agent or officer of the Stock Exchange who commits a breach of this section shall be:
    (a) liable to the company for any profit made by him or for any damage suffered by the company as a result of the breach; and
    (b) guilty of an offence against this Act.
    Penalty: Imprisonment for five years or thirty thousand ringgit.
64. Section 24(b) of the Contracts Act 1950 provides:
    The consideration or object of an agreement is lawful, unless:
    (b) it is of such a nature that, if permitted, it would defeat any law.
65. [1960] MLJ 147.
66. [1990] 3 NZLR 513.
67. See Salim and Lawton, above note 12.
68. [1980] 2 NZLR 150.
69. [1980] 2 NZLR 150, pp. 163-5.
70. [1959] AC 324.
71. [1980] 2 NZLR 150, pp. 165-6.
72. [1962] NSWR 686.
73. [1964-1965] NSWR 1648.
74. [1980] 2 NZLR 150, p. 166. Cf. *Ryde Holdings Ltd* v. *Sorenson* [1988] 2 NZLR 157 where the court found that there was no arrangement between the parties for a nominee director to take a certain action.
75. [1980] 2 NZLR 150.
76. *Levin* v. *Clark* [1962] NSWR 686; Broadcasting Station 2GB Pty Ltd [1964-1965] NSWR 1648.
77. Tomasic and Bottomley, above note 4, p. 407.
78. Tomasic and Bottomley, above note 4, p. 407, citing Bosch (1992, p. 34).
79. Tomasic and Bottomley, above note 4, p. 407, citing CSLRC (1989). See also CSLRC, above note 15.
80. [1959] AC 324.
81. [1963] 2 QB 606.
82. [1970] 1 Ch 62.
83. [1968] 2 All ER 1073; [1968] 1 WLR 1555.
84. [1979] 1 WLR 160.
85. The Law Commission and the Scottish Law Commission (1998, pp. 315-6).
86. [1965] 1 MLJ 60.
87. [1995] 2 SLR 297.
88. [2004] 2 SLR 675.
89. [2003] 2 SLR 307. The court applied the decision in *Charterbridge Corporation Ltd* v. *Lloyds Bank Ltd* [1970] Ch 62.
90. Woon (2005, p. 306).
91. [2006] SGHC 31.

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92. Reported as *Townsing Henry George* v. *Jenton Overseas Investment Ltd* (in creditors' voluntary liquidation) [2007] SGCA 13.
93. Koh (2007, pp. 155, 161).
94. Company Legislation and Regulatory Framework Committee (2002, Chapter 3, para 4.4).
95. Section 145(2)(a) of the New Zealand Companies Act 1993 allows a director of a company, unless prohibited by the board, to disclose information to a person whose interests the director represents.
96. Ogus (2004, pp. 1-2).
97. For enlightened shareholder value, see Committee on Corporate Governance (Hampel Committee) (1998). For team production theory, see Blair and Stout (1999). There are assertions that the enlightened shareholder value is a repackaged shareholder primacy value and the team production theory an extension of the stakeholder theory. It could also be argued that these theories bridge the gap between the shareholder primacy and stakeholder approaches.
98. For further discussion and critiques on the UK legislation see references in note 32 above. See also Keay (2007).
99. Romano (1993, p. 85). Ian Ramsay however argued that Australia corporate law has a core mandatory rules: Ramsay (1998, pp. 215-70). Note that this comment was made before the major revision of the Australian Corporations Law in 2001 which has now provided in numerous provisions a default or default or "replaceable rules" which gives shareholders the option of opting out. For the categories of mandatory corporate rule, see Buxbaum (2002); Eisenberg (1989); Gordon (1989). Black argued that some mandatory rules are actually trivial: Black (1990); Whincop (1997).
100. The five listed principles are: (1) market freedom; (2) investor protection; (3) information transparency; (4) cost effectiveness; (5) regulatory neutrality and flexibility; and (6) business ethics and compliance: CLERP (1997), Policy Framework, Australia. CLERP was itself a replacement for the Corporate Law Simplification Program, which has as its central objective "to simplify the Corporations Law and make it capable of being understood so that users can act on their rights and carry out their responsibilities: Commonwealth Attorney-General's Department, (1993, p. 1).
101. The Company Law Review Steering Group, above note 31, p. v.
102. The Company Law Review Steering Group, above note 31, p. v.

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