

A Consultative Document

On Clarifying and Reformulating
the Directors' Role and Duties

by the Corporate Law Reform Committee
for the Companies Commission of Malaysia



SURUHANJAYA SYARIKAT MALAYSIA
COMPANIES COMMISSION OF MALAYSIA

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COMPANY LAW
CORPORATE LAW REFORM COMMITTEE
A CONSULTATIVE DOCUMENT
CLARIFYING AND REFORMULATING THE DIRECTORS' ROLE AND DUTIES
AUGUST 2006

The Corporate Law Reform Committee invites comments, by **14 November 2006** on the issues set out in this consultative document.

You are invited to send comments, together with any supporting evidence on any part of this consultation. We would be grateful if you could refer to the recommendation number(s) and/or paragraph number(s) in your feedback, preferably by email, to:

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Section A
FOREWORD

SECTION A - FOREWORD

In reviewing the existing framework on directors, their role and duties and in formulating the questions for public consultation purposes, the Corporate Law Reform Committee (CLRC) is mindful that its review and its recommendations, if any, must:

- improve the legal and regulatory structure that will facilitate business in Malaysia;
- protect the interest of shareholders whilst taking into account the interest of other stakeholders;
- ensure the accountability of directors within a flexible regulatory framework which promotes efficient risk-taking via the codification of duties and available defences for directors;
- minimise the agency costs attached to the director / shareholder relationship through the disclosure obligation; and
- promote an appropriate balance between the legal prescriptions and the self-regulation by the industry.

In preparing this paper, reference was made to international developments for comparative analysis. Further, the CLRC referred to the High Level Finance Committee Report on Corporate Governance (1999) (the CG report) and where appropriate, draws upon and develops the views of the Finance Committee in so far as it coincides with the objectives of the Corporate Law Reform Programme. The recommendations of the CLRC are also based to some extent on current initiatives by Companies Commission of Malaysia to implement the recommendations of the CG report which are reflected in proposed amendments to the Companies Act 1965.

This consultation paper is made up of five (5) parts:

- Part I focuses on the definition of 'directors', directors' qualifications, appointment, removal and compensation;
- Part II focuses on clarifying and reformulating the roles and functions of the company and the board of directors.

- Part III focuses on the duty of care, skill and diligence of directors. It also addresses the need for the enactment of a Business Judgment Rule (BJR);
- Part IV focuses on the directors' fiduciary obligations and conflict of interest; and
- Part V focuses on the exemption and indemnification of Directors' and Officers' Liability.

We hope to receive views and comments on the recommendations stated in this Consultation Paper. Please reply to Nor Azimah Abdul Aziz at the Companies Commission of Malaysia (SSM) by **14 November 2006**.

Thank you.

Yours truly,

Dato' K.C. Vohrah

Chairman

Corporate Law Reform Committee

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Section B

Executive Summary

SECTION B - EXECUTIVE SUMMARY

1. Background

- 1.1 In reviewing the existing framework on directors, their role and duties and in formulating the questions for public consultation purposes, the CLRC is mindful that its review and its recommendations, if any, must:
- improve the legal and regulatory structure that will facilitate business in Malaysia;
 - protect the interest of shareholders whilst taking into account the interest of other stakeholders;
 - ensure the accountability of directors within a flexible regulatory framework which promotes efficient risk-taking *via* the codification of duties and available defences for directors;
 - minimise the agency costs attached to the director/shareholder relationship through the disclosure obligation; and
 - promote an appropriate balance between the legal prescriptions and self-regulation by industry.
- 1.2 In preparing this paper, reference was made to international developments for comparative analysis. Further, the CLRC referred to the High Level Finance Committee Report on Corporate Governance (1999) (the CG report) and where appropriate, draws upon and develops the views of the Finance Committee in so far as it coincides with the objectives of the Corporate Law Reform Programme.
- 1.3 This consultation paper is made up of five (5) parts:
- Part I focuses on definition of 'directors', directors' qualifications, appointment, removal and compensation;
 - Part II focuses on clarifying and reformulating the roles and functions of company and the board of directors.

- Part III focuses on the duty of care, skill and diligence of directors. It also addresses the need for the enactment of a Business Judgment Rule (BJR);
- Part IV focuses on the directors' fiduciary obligations and conflict of interest;
- Part V focuses on exemption and indemnification of Directors' and Officers' Liability.



Section C

Clarifying and Reformulating the Directors' Role and Duties

SECTION C - CLARIFYING AND REFORMULATING THE DIRECTORS' ROLE AND DUTIES

PART I - DIRECTORS, DIRECTORS' QUALIFICATIONS, APPOINTMENT, REMOVAL AND COMPENSATION

A. DEFINITION OF 'DIRECTOR' AND 'SHADOW DIRECTOR'

1.1 Under section 4(1) of the Act, unless the contrary intention appears, the term 'director' is defined in an inclusive manner. It reads:

A director 'includes any person occupying the position of a director of a corporation **by whatever name called** and includes a person in accordance in whose directions or instructions the directors of a corporation are accustomed to act and an alternate or substitute director¹.

1.2 The current definition encompasses the following categories of directors:

- (a) a person who is lawfully appointed as a director and whose tenure of office is continuing;
- (b) a person lawfully appointed as an alternate or substitute director;
- (c) a person who was appointed as a director but whose appointment was defective for whatever reasons;
- (d) a person who was never appointed as a director but occupies the position of a validly appointed director;
- (e) a person in accordance with whose directions and instructions the directors of a company are accustomed to act upon.

¹ In terms of legislative history, the words in bold were taken from section 455(1) of the UK Companies Act 1948. Except for the words underlined, the definition is taken from section 5 of the Australian Uniform Companies Act 1961.

The underlying statutory purpose for the extended meaning is to attach statutory liabilities and fiduciary obligations onto persons who occupy the position of that of a director in circumstances where such persons:

- were never appointed; or
- were defectively appointed; or
- whose term in office has expired but they carry on to act as, or persons held out by companies to be directors.

1.3 The extended meaning given to the word 'director' in the Act is obvious – to impose sanctions and liabilities against persons who, in defence to allegations of breaches of duties, etc, claim that they are not directors².

1.4 Since the definition of a 'director' under section 4(1) was primarily intended to impose sanctions and liabilities against persons who, in defence to allegations of breaches of duties, etc, claim that they are not directors, persons who were never appointed as directors (as opposed to defectively appointed directors) are not entitled to any benefits nor defences available under the Act³. The acts of these individuals are also invalid except in the case of a person whose appointment was defective⁴. The CLRC is of the view that it needs to be clarified that the definition is for purposes of liability and does not entitle such a person (i.e., those who were never appointed as directors) to any rights or benefits under the Companies Act.

² *Coventry v Dickson* (1880) 14 Ch D 660; see also *Corporate Affairs Commission v Drysdale* [1978] 141 CLR 236, a case which traced the entire history of the legislation behind the word 'director'.

³ *Ibid.*

⁴ See section 127 of the Companies Act 1965.



- 1.5 One of the issues requiring consideration is whether or not there is a need to propose an express statutory provision for the definition of a 'shadow director'. Although the UK Companies Act 1985 has a separate categorisation of *de facto* and shadow directors⁵, a review of the relevant sections shows that the definition of shadow directors under the UK Companies Act 1985 is similar to the current definition found under section 4(1) of the Companies Act 1965. In Singapore, the Company Legislation and Regulatory Framework Committee (CLRFC) recommended that there should not be a separate statutory definition of 'director' and 'shadow director' as is currently found in sections 149(8) and 149A of the Companies Act (Cap 50). The view of the CLRFC is that there is no need for any refinement or extension of the word 'director' as the definition of 'director' in sections 4(1) and 4(2) of the Companies Act (Cap 50) effectively encompasses nominee and shadow directors.
- 1.6 The CLRC is of the view that it is not necessary to introduce a separate definition for 'shadow director'. However, the CLRC noted that it is in line with public policy that a person who is able to give instructions to the board on how it should act, should not hide behind the excuse that he is not a member of the board and therefore should be subject to the same duties and responsibilities as the directors. The current definition under section 4 of the Companies Act 1965 makes it practically impossible to hold such persons accountable to the company since it must first be proven that the *entire board* is accustomed to act in accordance to the person's instructions or directions. Therefore, the definition of 'director' under section 4 of the Companies Act

⁵ The words used to define 'shadow director' first appeared in section 63 of the UK Companies Act 1967. It was for the purposes of governing provisions contained in Part I of the UK Companies Act 1967. This was subsequently abolished and now appears in section 741(2) of the UK Companies Act 1985. It is to be noted that the definition of 'shadow director' in the UK statutes (see also section 22(5) Directors Disqualification Act 1986, section 251 Insolvency Act 1986 and section 207(1) Financial Services Act 1980) are expressly made applicable to specified provisions of the UK statutes: see sections 309, 317, 318, 319, 320, 323, 324, 325, 330 and 346 of the UK Companies Act 1985. See also sections 206, 208, 210, 211, 213, 214 and 216 of the UK Insolvency Act 1986.

1965 should be amended to state as follows (by adding the words in italics) 'includes any person occupying the position of a director of a corporation by whatever name called and includes a person in accordance with whose direction or instructions the majority of the board of directors of a corporation is accustomed to act and an alternate or substitute director.'

- 1.7 Nevertheless, the CLRC is aware of the existence of nominee directors who are appointed under genuine commercial circumstances where there could be undue burden to business if the duties of a director are easily extended to the principal or nominator who appointed a nominee to the board of a company. There are also concerns that by amending the definition of a director, any holding company of a subsidiary or a wholly-owned subsidiary will be held to be a director of the subsidiary. The CLRC noted that there is sufficiently clear case law stating that there must be 'a pattern of behaviour in which the board did not exercise any discretion or judgment of its own but acted in accordance with the directions of others. In the case of a subsidiary or wholly-owned subsidiary, no liability is imposed on the holding company as a director *merely* due to the existence of a holding-subsidary relationship. There could be liability imposed on the holding company if the board of the holding company is accustomed to giving instructions to the subsidiary's directors and the board of the subsidiary is 'accustomed to act' under the instructions of the holding company as this effectively means that the holding company is managing the subsidiary's affairs⁶. There is also a possibility of the individual director of the holding company being held liable as a shadow director provided the director gave instructions or directions to the board of the subsidiary who is 'accustomed to act' under the instructions of the individual directors⁷. The CLRC is of the view that the

⁶ *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180.

⁷ *Ibid.*



definition will only cover a person who is shown to be able to instruct or direct a *majority* of the board and not just any one director of the board. Amending the definition does not mean that the nominator (or a holding company as the case may be) will *ipso facto* be held liable as a *de facto* or shadow director due to the requirement of having to prove that the majority of the board did not exercise any discretion or judgment of its own but is accustomed to act in accordance with the directions of others.

RECOMMENDATIONS

- 1.8 The CLRC recommends that section 4(1) be amended to state that:
- ‘a director’ includes, any person occupying the position of a director of a corporation by whatever name called and includes a person in accordance with whose direction or instructions the majority of the board of directors of a corporation is accustomed to act’.
- 1.9 The CLRC does not recommend a separate statutory definition of the term ‘shadow director’.

Question for Consultation

Question 1:

Do you agree that the definition of the word 'director' should be amended to be stated as follows:-

'any person occupying the position of a director of a corporation by whatever name called and includes a person in accordance with whose direction or instructions the majority of the board of directors of a corporation is accustomed to act'?

B. SHARE QUALIFICATION

1.10 Where share qualification is concerned, the CLRC recommends the deletion of section 124. The Companies Act 1965 does not make it mandatory that a person who seeks to be appointed as a company director must hold share qualifications although if the company's Articles of Association does impose a share qualification requirement, section 124 of the Companies Act 1965⁸ will be applicable to stipulate the time for the person to obtain his share qualification and the criminal liability for non-compliance. The CLRC noted that most companies do not require for share qualifications in the present business environment and thus believes that there is no need for a statutory provision regulating share qualification. Even if the Articles of Association of some companies still require directors to have share qualifications, this should be left to each company's Articles to resolve and should not be dealt with via statutory provision.

⁸ Section 124 of the Companies Act 1965 is similar to section 155 of the Hong Kong Company Ordinance (Cap 32), section 147 of the Singapore Companies Act (Cap 50) and section 291 of the UK Companies Act 1985. The company legislations for Australia, the Corporations Act 2001 and New Zealand Companies Act 1993 are silent on this matter.

RECOMMENDATIONS

1.11 The CLRC recommends the deletion of section 124 of the Companies Act 1965.

C. AGE AND RESIDENCY REQUIREMENT

1.12 The CLRC noted that whilst the Companies Act 1965 does not provide for a maximum age limit, section 129 of the Companies Act 1965 provides that a director of a public company who has reached 70 years of age can only be appointed to the board on an annual basis supported by not less than a 75 per cent vote of the shareholders at the general meeting. The statutory provision that a director of a public company who has reached a certain age must be appointed annually to the board and that the resolution must be supported by not less than 75 per cent vote of the shareholders at the general meeting is also found in other jurisdictions including Hong Kong, New Zealand and Australia.

1.13 The CLRC is of the view that what is more important is ensuring that shareholders are able to decide who is to be appointed as directors and whether such persons are competent to carry out their role and functions as a director. Based on this view, the CLRC believes that there is no reason why a special resolution is required for the appointment. Thus, it is recommended that section 129 of the Companies Act 1965 should not be retained and that no maximum age is to be statutorily imposed. However, the director's age is to be disclosed at the general meeting before that

person is to be appointed as a director⁹. The CLRC is also of the view that the Companies Act should clarify that a director must not be less than 18 years of age.

- 1.14 The CLRC is of the view that the residency qualification imposed on directors should be retained. Whilst the residency qualification imposed on directors can be a cost barrier for foreign investment, the residency qualification is an important mechanism for the regulatory authorities in enforcing compliance with the law.

RECOMMENDATION

- 1.15 The CLRC recommends that:
- (a) section 129 of the Companies Act 1965 should not be retained and that there should be no statutory maximum age limit for a person to be appointed as a director.
 - (b) that the Companies Act should clarify that a director must not be less than 18 years of age.
 - (c) the residency requirement imposed on directors should be retained.

Questions for Consultations

Question 2:

Do you agree that section 129 of the Companies Act 1965 should not be retained whereby there should be no statutory maximum age-limit for a person to be appointed as a director?

⁹ Currently, section 135(1)(d) of the Companies Act 1965 imposes a mandatory obligation on a director of public company or of a subsidiary of a public company to inform the company the date on which he attains or will attain the age of 70. Further, the company is also required to lodge Form 49 with Companies Commission of Malaysia (CCM). The contents of Form 49 also includes among other things, the date of birth of persons who are appointed as a director. Form 49 is subject to the doctrine of constructive notice. However, the Companies Act 1965 does not have a provision that requires the company to disclose the age of the person prior to the appointment of that person as a director to the shareholders at the general meeting. The company however indirectly is required to disclose the age of such persons to the shareholder by virtue of section 129 as discussed above and this may in itself explain the rationale behind the enactment of section 129 and the reason for its retention.

Question 3:

Do you agree that the Companies Act 1965 should clarify that a director must not be less than 18 years of age?

Question 4:

Do you agree that the residency requirement imposed on directors should be retained?

D. APPOINTMENT OF DIRECTORS

1.16 Whilst the first directors are usually appointed by subscribers to the Memorandum, new or additional directors may be appointed by shareholders¹⁰. In addition, the Articles of Association of a company often include various provisions in relation to directors' appointment. For example, article 68 of Table A allows the board to appoint any directors when there is a casual vacancy¹¹ in the board as long as the maximum board membership number, if any, as specified in the Articles has not been reached. The CLRC has reviewed the above issues and is of the view that the present position should be retained. This approach is in line with the view that the law should not seek to micro-manage the internal governance structure of a company, in view of the diversity of companies.

¹⁰ *Worcester Corsetry Ltd v Witting* [1956] 1 CH 640.

¹¹ Casual vacancy means a vacancy in the board of directors arising by death, resignation or bankruptcy: *York Tramways Co v Willows* (1882) 8 QBD 685.

1.17 The CLRC also reviewed section 126 which states that the appointment of directors of a public company must be voted on individually. The section thus prohibits the election of two or more persons as directors of a public company by a single resolution i.e., a practice known as the bundling of resolutions for the appointment of directors. The CLRC is of the view that section 126 which prohibits bundled resolution for directors' appointment ensures that shareholders have the right to accept or reject any particular individual and therefore promotes democracy within the election process of company directors.

RECOMMENDATIONS

1.18 The CLRC recommends:

- (a) there should not be any statutory provision restricting how directors are appointed to the board; and
- (b) retaining section 126 of the Companies Act 1965.

Question for Consultation

Question 5:

Do you agree that the appointment of directors of a public company must be voted on individually?

E. REMOVAL OF DIRECTORS

- 1.19 Whilst there are views that a director may not be removed unless the Articles allows for it, there are also views that just as shareholders at the general meeting have the right to appoint directors they also have the right to remove persons they have appointed. The issue raised by the views above, is that, the method of removal of directors in the absence of a specific provision in the Articles of Association may not be clear. There are views that if a method of removal is specified in the Articles, the director may not be removed except in accordance with that procedure. Nonetheless, section 128 of the Companies Act 1965 provides that the shareholders of a public company may remove a director by passing an ordinary resolution at the general meeting. This power is exercisable notwithstanding anything in the company's Memorandum or Articles of Association or in any agreement between the company and that person.
- 1.20 Section 128(1) only applies to public companies¹². In the case of a private company, the right of its shareholders to remove a director from office is dependent upon the Articles of that private company. Whilst, most Articles of Association of private companies may provide for the termination of office of the directors before his term expires, this is not always the case¹³.

¹² See section 152 of the Singapore Companies Act (Cap 50) which provides that members of a public company can remove its director before the completion of his tenure in office notwithstanding any provisions in the company's Memorandum or Articles or in any contract between the company and that director which provides to the contrary. Removal is to be effected by passing an ordinary resolution. However, prior to the purported removal of that said director, special notice must be served on to the company concerned. As with Malaysia, a director who is to be removed pursuant to this section has the right to defend himself and can also claim compensation from the company if his removal results in a breach of contract between the company and that director. Under section 185, the duration of service of special notice to the company is not less than 28 days.

¹³ A private company may adopt article 69 of Table A of the Companies Act 1965 and if so its shareholders will have the power to remove a director prematurely from office.



- 1.21 The CLRC noted that company legislation of Hong Kong¹⁴, United Kingdom¹⁵, Australia¹⁶ and New Zealand¹⁷ contain provisions which allows the general meeting of both private and public companies to remove a director by passing an ordinary resolution. However, in Australia and New Zealand, the right of the general meeting of a private company to remove a director is subject to the company's Constitution and this means that the Articles of a private company would prevail over the statutory provisions.
- 1.22 The CLRC is of the view that section 128(1) should not be extended to private companies. This is in line with the Strategic Framework which seeks to promote laws that are facilitative to business especially for private companies. The CLRC noted that even in jurisdictions which allows the director of a private company to be removed by shareholders at general meeting, the applicability of the statutory provision is subject to the company's Constitution.

¹⁴ Pursuant to section 157B of the Hong Kong Companies Ordinance (Cap 32), members of *any type of company* can remove its director before the completion of his tenure in office notwithstanding any provisions in the company's Memorandum or Articles or in any contract between the company and that director that provides to the contrary. Section 157B does not however permit the removal of a director of a private company where it is provided for in the company's Constitution that that director holds office for life. Removal is to be effected by passing an ordinary resolution. However, prior to the purported removal of the director, special notice must be served on to the company concerned. As with Malaysia, a director who is to be removed pursuant to this section has the right to defend him or herself and can also claim compensation from the company if his removal results in a breach of contract of employment. Under section 116C, the duration of service of special notice to the company is not less than 28 days.

¹⁵ Pursuant to section 303 of UK Companies Act 1985, members of *any type of company* can remove its director before the completion of his tenure in office notwithstanding any provisions in the company's Memorandum or Articles or in any contract between the company and that director that provides to the contrary. Removal is to be effected by the passing of an ordinary resolution. However, prior to the purported removal of that said director, special notice must be served on to the company concerned. As with Malaysia, a director who is to be removed pursuant to this section has the right defend him or herself and can also claim compensation from the company if his removal results in a breach of contract between the company and that director. Under section 379, the duration of service of special notice to the company is not less than 28 days. These principles are being retained by the United Kingdom Company Law Reform Bill 2005 (HL Bill 34) sections 152 and 153.

¹⁶ Section 203C and 204D the Australian Corporations Act 2001 makes a distinction between the removal of directors of a private company and that of a public company. In the case of a private company unless provided otherwise by the company's Constitution a company director can be removed by an ordinary resolution. In the case of a public company, the right to remove a director by passing an ordinary resolution is entrenched in that notwithstanding any provisions in the company's Memorandum or Articles or in any contract between the company and that director or between any member and that director that provides to the contrary, a director of public company can be removed by the passing of an ordinary resolution. However, before removing a director of a public company, prior notice of the intended removal of that director must be served onto the company at least 2 months before a meeting can be convened to remove that director. Further, the director who is intended to be removed has the right to defend him or herself against his purported removal.

¹⁷ Pursuant to section 156 of the Companies Act 1993, members of a company can remove a director by passing an ordinary resolution to that effect. The application of this statutory right is, however, made subject to the company's Constitution. There is no requirement that prior special notice must be served on to the company before that director is removed.

1.23 However, it was noted by the CLRC that one issue which requires clarification is whether the removal of a director which is done in accordance with the company's Articles of Association would still require a special notice to be served on the company. In *Soliappan v Lim Yoke Fan & Others*¹⁸, the court decided that section 128 is an independent source for the power of removal that can be relied on in the absence of provisions in the Articles empowering the removal of a director. However, subsequent to this case, section 128(2) was amended where the words 'under this section' were removed, leading to arguments that whilst directors of a public company may be removed by a simple resolution passed at a general meeting irrespective of anything stated in the Articles, a special notice must still be given to the company in respect of the resolution to remove a director even if the removal is in accordance with procedures specified in the Articles and even in the case of a director of a private company. The CLRC is of the view that special notice to the company is only required when the director of a public company is to be removed at a shareholders' general meeting. This is because the special notice is to be served by shareholders who want to propose for the removal of the director and as such, the special notice is to provide a reasonable opportunity to the directors of public companies to make their representations to the shareholders at the general meeting in relation to their removal. If the director is not removed at a shareholders' general meeting, a special notice will be irrelevant as no meeting will be called to consider the removal.

¹⁸ [1968] 2 MLJ 21.



RECOMMENDATIONS

1.24 The CLRC recommends that:

- (a) where the right of the shareholders at a general meeting to remove a director (as reflected in section 128 of the Companies Act 1965) is concerned, this right should be made applicable to public companies only and should not be extended to private companies; and
- (b) where a director of a public company is to be removed, special notice is required when the director is to be removed in accordance with section 128 of the Companies Act 1965.

Questions for Consultation

Question 6:

Do you agree that section 128 of the Companies Act 1965 which provides for the right of members of a public company to remove its directors should be retained and that the section should not be extended to private companies?

Question 7:

If yes, do you agree that the requirement to serve special notice in relation to the director's removal should be applicable if the removal is made under the section only?

F. RESIGNATION OF DIRECTORS

1.25 The Articles of Association of a company usually confers a right on a director to resign from office. Article 72(e) of Table A also provides for this right and pursuant to the

article, a director's resignation takes effect with him giving written notice of his resignation to the company. There is no need for any other further acts, such as acceptance by the company, unless the Articles provide otherwise. However, a problem faced by directors is that the resignation is not made public and in some cases, the necessary information or documents are not lodged by the company with the Registrar¹⁹. In some instances, the company will not proceed to give this required notification and this may cause difficulties to the director who still remains on record as a director although he has resigned. This problem arises because the Companies Act 1965 only allows the company and not the director who has resigned to file the Form 49 with the Companies Commission of Malaysia.

- 1.26 The CLRC noted that some jurisdictions have resolved this problem by providing in their respective company legislation, a provision that enables the director who has resigned from office to serve notice to the Regulator²⁰. The CLRC is of the view that a director who has resigned should be allowed to lodge the fact of his resignation with the Regulatory Authority. To clarify the law on this, the CLRC is of the view that the effective date of resignation should be the date the notice was sent to the registered office or any other date as specified in the letter of resignation.

¹⁹ Upon receiving this notice the company is under a statutory duty to notify Companies Commission of Malaysia of that director's resignation within one month's time. This notice will be affected by lodging Form 49 with Companies Commission of Malaysia.

²⁰ See section 157D(2) of the Hong Kong Companies Ordinance and section 173(6A) of the Singapore Companies Act (Cap 50) which provides that the resigning person can give notice to the Registrar, if he has reasonable grounds for believing that the company will not give the required notice. Section 157D of the Hong Kong Companies Ordinance states that unless provided otherwise in the company's Constitution or in a contract between the company and that director, a company director can resign at any time. The Act does not specify that the notice of resignation must be in writing. The company upon receiving that notice is under a statutory duty to inform the Registrar of the resignation of that director but that director who has served notice is empowered by the Act to inform the Registrar of his resignation, if there are reasonable grounds to believe that the company would not do so. Section 157(2) of the New Zealand Companies Act 1993 states that a director has the statutory right to resign by serving written notice to that effect to the company and the resignation is effective when that written notice is received at the address for service of the company or at a later time specified in that notice. Section 203A of the Australian Corporations Act 2001 states that unless provided otherwise by the company's Constitution, a company director can resign by serving written notice of that effect at the registered office of the company.

RECOMMENDATION

1.27 The CLRC recommends that the Companies Act should incorporate a provision that will enable a person who has resigned from the office of director to give notice of his resignation to the Regulators in the event the company does not do so.

Question for Consultation

Question 8:

Do you agree that the Companies Act should incorporate a provision that will enable a person who has resigned as a director to give notice of his resignation to the Regulators in the event the company does not do so?

G. DIRECTORS' COMPENSATION

1.28 At common law, the directors would have no authority to approve their own remuneration as this would amount to a conflict of interest and this means that it is the shareholders who have the authority to approve directors' remuneration. Whilst the Companies Act 1965 does not contain any specific provision as to the manner or quantum of any remuneration to directors, the Articles of Association often allows for remuneration to be determined by shareholders at the general meeting²¹. Whilst the court has set aside excessive remuneration on the basis that this is a sham transaction²² or on the basis of oppressive conduct²³, the court does not decide the quantum of the remuneration.

²¹ Article 70 of Table A amongst other things provides that the remuneration of the directors (in the form of fees) shall from time to time be determined by the company in the general meeting.

²² *Re Half Garage (1964) Ltd* [1982] 3 All ER 1016.

²³ See *Low Tien Sng & Sons Holdings Sdn Bhd v How Kern Hin & Ors* [2000] 2 MLJ 334.



- 1.29 The CLRC also noted that various corporate governance reports have recommended the use of best practice and non-legal provisions in relation to directors' remuneration. Common best practices on directors remuneration includes:-
- having in place proper procedures and process to determine the quantum of remuneration, for example, by the establishment of a remuneration committee and benchmarking the quantum against the company's performance, and
 - disclosure of directors' remuneration.
- 1.30 Where Malaysia is concerned, the best practices in relation to directors' remuneration can be found in the Listing Requirements of Bursa Malaysia Securities Berhad (BMSB). Whilst there may be a need to revise the appropriateness of the best practices, the CLRC is of the view that there should not be any statutory intervention in relation to the quantum of remuneration of a director. This should be left to the internal management of the company and market forces.
- 1.31 Nonetheless, the CLRC is of the view that there is a role to be played by legislation to minimise the conflict of interest where the director's remuneration is concerned. This may be achieved by requiring that directors' remuneration be approved by shareholders at the general meeting. The CLRC also recommends that company members should have the right to inspect the director's service contract which provides the basis for contractual remuneration (salary) received by the director in his capacity as an employee of the company²⁴.

²⁴ See section 318 of the United Kingdom Companies Act 1985 which provides that a company is required to keep a copy of any written contract of service that the company has entered into with its director. The holding company is also required to keep a copy of any written contract of service that the company's subsidiary has entered into with its director. Where the contract of service is not in writing, the company is under a statutory duty to keep a written Memorandum of its terms. The copy of the above mentioned contract or Memorandum must be kept either in the company's registered office or the place where its register of members is kept. The company is also required to inform the Registrar of the place where the copy of that contract or Memorandum is kept. Members of the company have the statutory right to inspect that contract or Memorandum. Contravention of the above duty by the company or denial of the right of inspection by members shall result in the company and its officers being liable to a fine and default fine. Further, where inspection is refused, the court may by order, compel an immediate inspection of the contract of service. The above requirements must also be complied with where there is a variation of the contract of service.

- 1.32 Currently, the disclosure of the terms of employment and directors' remuneration is found in the notes to the accounts laid before the shareholders at the annual general meeting. The Ninth Schedule of the Companies Act 1965 requires that the profit and loss accounts of a company must set out:-
- fees and emoluments paid to or received by directors as remuneration for their services to the company;
 - the profit and loss accounts must set out by way of note or otherwise, the estimated monetary value of any other benefits received or receivable by directors otherwise than in cash from the company or from any of its subsidiary companies.
- 1.33 There are views that since details of directors' remuneration must be included in the notes to the accounts, the members' approval is *obtained* when members approve the company's accounts that are laid before the general meeting. However, this is not correct since the company's accounts need not be approved by shareholders.
- 1.34 The CLRC noted that there are several jurisdictions which require for directors' remuneration to be approved by shareholders. The Australian Corporations Act 2001 for example states that unless provided otherwise by the company's Constitution, remuneration for directors of a private company must be approved by a company resolution²⁵. The remuneration can also include directors travelling expenses and other expenses incurred by a director whilst attending any director's meeting, the company's general meeting and in connection with the company's business. The Australian Corporations Act 2001 also requires a company to disclose the

²⁵ Section 202A of Australian Corporations Act 2001. In the case of a company that has only one director/shareholder, the Corporations Act provides that remuneration of that single director must be approved by a company resolution. Disclosure as provided for by section 202B does not, however, extend to genuine payments of pension and lump sums paid in accordance with section 202G or to benefits which must be given to a person in accordance to the general law of Australia.

remuneration paid to each director of the company or a subsidiary (if any) by the company or by an entity controlled by the company if the company is directed to disclose that information by:

- (a) members with at least 5 per cent of the votes which may be cast at a general meeting of the company; or
- (b) at least 100 members who are entitled to vote at a general meeting of the company (section 202B).

- 1.35 The legal position in Singapore with respect to directors' remuneration and payment for the loss of office is similar to that found in Malaysia. Hence, the payment of directors' remuneration is regulated by the company's Articles whilst the payment for the loss of office is regulated by statute. As with Malaysia, in Singapore any payment made to directors for the loss of office must first be approved by the company members²⁶. However, unlike Malaysia, the Singapore Companies Act also provides that the company is under a duty to disclose its directors' emoluments and any other benefits if the company is served with a notice sent by or on behalf of —
- (a) at least 10 per cent of the total number of members of the company; or
 - (b) the holders in aggregate of not less than 5 per cent in nominal value of the company's issued share capital, requiring the emoluments and other benefits received by the directors of the company or of a subsidiary to be disclosed (section 164A).

Further, in Singapore, a company shall not at any meeting or otherwise provide emoluments or improve the emoluments for a director of a company in respect of his

²⁶ Section 168 of the Singapore Companies Act.



office as such unless the provision is approved by a resolution that is not related to other matters and any resolution passed in breach of this rule is void (section 169). An emolument is defined to include fees and percentages and any sum paid by way expense or allowance.

- 1.36 In contrast, the New Zealand Companies Act 1993 confers powers to the board of directors of a company to make payments for remuneration or any other benefits receivable to a director for services as a director or in any other capacity, subject to any restrictions that are provided for by the company's Constitution²⁷.
- 1.37 The UK Companies Act on the other hand requires that directors' contract of employment for more than 5 years must first be approved by shareholders at the general meeting²⁸. In addition, the UK Companies Act 1985 also requires a company to keep a copy of any written contract of service that the company has entered into with its director. The holding company is also required to keep a copy of any written contract of service that the company's subsidiary has entered into with its director. Members of that company have the statutory right to inspect that contract or Memorandum²⁹. The UK Company Law Reform Bill 2005 is retaining the existing principles embodied in the UK Companies Act 1985³⁰. The Hong Kong Companies Ordinance (Cap 50) under sections 163, 163C and 163D places emphasis on the

²⁷ Section 161 of the New Zealand Companies Act 1993. In exercising this power, the board is required to act fairly to the company and particulars of any payment must be entered into the company's interest register. Further, directors who authorised such payments must sign a certificate stating that such payment is fair to the company.

²⁸ Section 319 of the Companies Act 1985 (Director's contract of employment for more than 5 years) states that any contract of service entered into by a company with its director which provides that the said director is to be employed for a period in excess of five years and that the contract cannot be terminated by the company by notice or can only be terminated in specified circumstances is void unless it was first approved by a members resolution.

²⁹ Section 318 of the UK Companies Act 1985.

³⁰ See sections 195-202 and sections 205-208 of the UK Company Law Reform Bill 2005 (HL Bill 34). This section has been the subject of review in the United Kingdom. The United Kingdom Law Commission 'Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties' (Law Commission Report No 261 – 1999 and the Scottish Law Commission Report No 173 – 1999) has been subsumed within the United Kingdom Company Law Review. See United Kingdom Company Law Review, *Modern Company Law for a Competitive Economy*, Final Report 2001. In June 2003, the United Kingdom DTI published a consultative document on directors' remuneration seeking views on the appropriate measures to further reform the best practices and legislations on directors' remuneration. See United Kingdom DTI, 'Rewards for Failure' *Directors' remuneration-Contracts, Performance and Severance* Company Law Consultative Document, (June 2003).

issue of the disclosure of directors' emoluments and pension in the company's accounts which is found under section 161.

- 1.38 The CLRC is of the view that the directors' remuneration should be made subject to shareholders' approval. The fact that a resolution is required would also necessitate the company to include a copy of that proposed resolution in the notice convening that meeting that will pass that proposed resolution. The need to pass a members' resolution to approve the directors' emoluments will promote greater transparency which in turn will promote accountability of directors. The company may also pay the directors' travelling and other expenses which are incurred³¹ legitimately.
- 1.39 In addition, the CLRC also recommends that the definition the 'remuneration' be included in the Companies Act. The CLRC recommends that the term 'remuneration' in relation to a director should include fees, any sum paid by way of expenses allowances in so far as those sums are charged to income tax in Malaysia, any contribution(s) paid in respect of a director under any pension scheme and any benefit(s) received by him otherwise than in cash in respect for his services rendered as a director³².

RECOMMENDATIONS

- 1.40 The CLRC recommends that:
- (a) directors' remuneration should be made subject to shareholders' approval.

³¹ This is the legislative text of section 202A of the Australian Corporations Act 2001.

³² This is the legislative text of section 169 of the Singapore Companies Act (Cap 50). It should be noted that Table A under the Singapore Companies Act (Cap 50) also includes a provision similar to that found under our current article 70 of Table A of the Companies Act 1965.

- (b) to define the term 'remuneration' in relation to a director to include fees, any sum paid by way of expenses allowances in so far as those sums are charged to income tax in Malaysia, any contribution paid in respect of a director under any pension scheme and any benefit received by him otherwise than in cash in respect for his services as a director.
- (c) directors' contract of service should be made available for inspection by shareholders.

Questions for Consultation

Question 9:

Do you agree that the Companies Act should incorporate a provision that requires directors' remuneration to be approved by shareholders at the general meeting?

Question 10:

Do you agree that the Companies Act should incorporate a provision that will provide company members with a statutory right to inspect its directors' contracts of service?

H. PAYMENT FOR LOSS OF OFFICE

1.41 Section 137 of the Companies Act 1965³³ prohibits directors from making any payment to themselves by way of compensation for the loss of office as an officer of the company or of a subsidiary or as consideration for or in connection with their retirement from any such office³⁴. Further, directors cannot make payments to

³³ Historical links exist between our current section 137 and sections 191-194 of the United Kingdom Companies Act 1948. Sections 191-194 of the United Kingdom Companies Act 1948 were enacted at the recommendation of the Cohen Committee (1945). Other comparative jurisdictional sections include section 168 Singapore Companies Act, section 129 of the Australian Uniform Companies Act, section 191 of the New Zealand Companies Act 1955 and sections 163, 163A, 163B, 163C of the Hong Kong Companies Ordinance.

³⁴ Section 137(1)(a) of the Companies Act 1965.

themselves in connection with the transfer of the whole or any part of the undertaking or property of the company³⁵. Such payments can only be made to directors provided the prior approval of the company's members' has been obtained.

- 1.42 Section 137 emphasises transparency in that the proposed payment that is to be made to the director concerned must first be disclosed to the members. Further, section 137 promotes accountability in that directors can only receive that proposed payment provided it has been approved by the members of the company making that payment³⁶.
- 1.43 The use of the word 'officer' in section 137 of the Companies Act 1965 has the effect of requiring that any payment made by way of contractual or non-contractual compensation to a director for the loss of office as an officer of the company must also be disclosed to and approved by the company's members. Hence, the intentional inclusion of the words '*loss of office as an officer*' within section 137 prevents a director, who is an employee, from taking benefits under his contract of service upon his resignation from the company unless that payment has first been disclosed and approved by the company's members³⁷. Contractual/covenanted payment can, however, be made to a director for the loss of office as an officer if it has been approved by the members of the company³⁸.

³⁵ Section 137(1)(b) of the Companies Act 1965.

³⁶ Where a director receives payment in contravention section 137 the payment received by the director shall be kept in trust for the company.

³⁷ Thus, the inclusion of the words '*loss of office as an officer*' within section 137 has therefore circumvented the application of the decision of *Taupo Tofara Co Ltd v Rowe* [1997] 3 All ER in Malaysia. This case involved a New Zealand company having to make contractual/covenanted payment made to its managing director for loss of his office as managing director. This payment was provided for in his contract of service. The Privy Council held that section 191 of the New Zealand Companies Act 1953 did not apply to contractual payments made by way of a contract of service.

³⁸ Approval can either be by way section 137(1) itself or by section 137(5)(b) of the Companies Act 1965.

- 1.44 However, *bona fide* severance payment which is part of the directors contractual remuneration package shall not be caught by section 137(1) as this payment is not made with the intention to compensate the director for the loss of office but is in fact part of the director's contractual remuneration package which is given to the director concerned to get him to provide his valuable services to the company³⁹.
- 1.45 The CLRC noted that there are practices which do not coincide with the spirit of section 137 i.e. to ensure transparency and accountability. These practices may involve the interested director, to whom the proposed payment is to be made, also voting as a shareholder in the meeting which was convened to approve the proposed payments made to that director pursuant to section 137⁴⁰. The CLRC recommends that such persons should not be allowed to vote at such a meeting and a provision to that effect must be included as part of section 137. On this point, the CLRC noted that section 163D(3) of the Hong Kong Companies Ordinance provides that in any meeting summoned for the purposes of approving payments made pursuant to section 163⁴¹, any director to whom it is proposed to make any payments, and any person who holds any shares in the company in trust for him, shall not be entitled to vote on any resolution to approve such payment. Hence, the inclusion of this type of provision within section 137 will have the effect of ensuring that disinterested shareholders will give the necessary approval required by section 137.

³⁹ *Grinsted v Britannia Brands Holdings Pte Ltd* [1996] 2 SLR 97. In practice, the court will examine the character of the payment made to the director. The court will usually look for a nexus between payment made and director's loss of office as an officer before the court holds that the payment made is compensation for loss of office as an officer. This was also the approach that was used in *Grinsted v Britannia Brands Holdings Pte Ltd* [1996] 2 SLR 97 and in the Australian decision of *Lincoln Mills (Australia) Ltd v Gough* [1964] VR 193.

⁴⁰ Currently section 137 does not prohibit a director who is also a shareholder from voting in the meeting that is convened to approve the proposed payments made to a director pursuant to section 137.

⁴¹ Similar to section 137 of the Companies Act 1965.

1.46 The CLRC also noted that another practice that defeats the spirit of section 137 is the use of a subsidiary company to make compensation payments or 'golden handshakes' to directors of its holding company. In most cases, this will involve a wholly-owned subsidiary of the holding company where as sole member of that wholly-owned subsidiary, the holding company will appoint a corporate representative to attend the subsidiary's general meeting which is convened to approve the proposed payment made to its director. The corporate representative who is appointed in this situation will more likely than not vote at that meeting to approve that proposed payment made to the director. There is no contravention of the black letter of the law as the director's compensation for the loss of office has been approved by the shareholders of the subsidiary company, although in reality there is only one shareholder who is the holding company. Thus, section 137 should be amended to address this concern by stating that where a subsidiary is going to make a payment to its director (whether or not that director is also a director of its holding company) pursuant to section 137, that payment must be approved by the shareholders of the holding company in addition to the shareholders of the subsidiary company.

RECOMMENDATIONS

1.47 The CLRC recommends the retention of section 137 of the Companies Act with the following amendments;

(a) an interested director (who is a shareholder) to whom the proposed payment is to be made to should not be allowed to vote in that meeting which was convened to approve the proposed payments; and

- (b) the section should prevent situations where a group structure is used to enable compensation payments or 'golden handshakes' to directors so that where a subsidiary is going to make a payment to its director (whether or not that director is also a director of its holding company) pursuant to section 137, that payment must be approved by the shareholders of the holding company in addition to the shareholders of the subsidiary company.

Questions for Consultation

Question 11:

Do you agree that interested directors or their agents or trustees should be prohibited from voting in the meeting which is convened to approve the proposed payments made to the directors pursuant to section 137?

Question 12:

Do you agree that where a subsidiary is going to make a payment to its director (whether or not that director is also a director of its holding company) pursuant to section 137, that payment must be approved by the shareholders of the holding company in addition to the shareholders of the subsidiary company?

PART II - CLARIFYING AND REFORMULATING THE ROLE AND FUNCTIONS OF COMPANY DIRECTORS AND THE BOARD OF DIRECTORS

- 2.1 The Companies Act 1965 does not contain any provisions specifying the role and functions of the board. However, provisions specifying the board's powers and duties can be found in Table A of the Companies Act 1965. Article 70 of Table A states that

the business of the company shall be managed by the directors. The key benefit of the current approach is that it enables flexibility to be maintained considering that the governance structure and the role and functions of the board may vary from one company to another. Since the board's powers and duties are found in the Articles of Association, this gives flexibility to companies and their boards to structure the roles and functions of boards according to the needs of the company.

- 2.2 However, the CLRC also recognises that there is an educational role to be played by legislation and that there are views that corporate governance failures are partly attributable to the lack of knowledge of what is to be expected of directors and boards of directors. Furthermore, in companies with large operations, be it public or private companies, company's affairs are managed by senior employees i.e., the management team whilst the board of directors often supervise management and set policies for the companies.
- 2.3 The CLRC noted that the Finance Committee on CG Report recommended that:
- that there should be a statutory clarification of the responsibilities of the board to supervise and monitor management; and
 - there should be a statutory clarification of the minimum functions to be performed by the board of directors of public companies.

At the same time, the CG Report maintained that the provisions must be flexible to cater to the wide variations of relationships which can exist between the board and management in the various types and sizes of companies regulated by the Companies Act 1965.

- 2.4 The CLRC noted that section 128 of the New Zealand Companies Act 1993 provides that the business and the affairs of the company are to be managed by or be directed or supervised by the board. Further, the board has all power to carry out the above functions. The restatement of the board's role is, however, made subject to the company's Constitution. Section 198A of the Australian Corporations Act 2001 provides that the business of the company is to be managed by the board or under the directions of the board. Further, the section also provides that the board can exercise all the powers of the company except those powers reserved for the general meeting by this Act or by the company's Constitution. The United Kingdom, on the other hand has no equivalent provision within the United Kingdom Companies Act 1985, nor is there any intention to enact a similar provision in the United Kingdom Company Law Reform Bill 2005⁴².
- 2.5 The CLRC noted that the roles and functions of a board may differ from one company to another. In the case a private company, the board is most likely to be involved in the day-to-day management of the company. Whilst in the case of a larger and more specifically in the case of a public listed company, it is an accepted fact that the board exercises a supervisory function as opposed to actually managing the day-to-day operations of the company. The CLRC is of the view that if a statutory restatement of the board's role and functions is to be incorporated in the Companies Act 1965, that restatement must be sufficiently flexible to cover all the possible variations of the board's role as discussed above.

⁴² See the Code of Best Practices of the Cadbury Committee. See also the Higgs Report, *The Role of Non-Executive Directors* (2003).

- 2.6 The CLRC recommends that there should be incorporated in the Companies Act 1965, a general statement of the board's role and function, to manage and supervise the affairs of the company. However, that statutory restatement must:
- be couched in general terms so as to enable the general statement to cover all possible variations in the perceived roles and functions of the board. The statutory provision, if any, should allow the board to either manage or supervise the company's affairs as this will acknowledge the different roles and functions carried out by the board that exists between private and public companies⁴³; and
 - not impose additional duties and sanctions on directors but must have an informative effect in that the statutory statement which will have the effect of informing directors what is expected of them in respect to their role and functions.

In addition, if there is a need to elaborate on the role and function of the board as in the case for public listed companies, that elaboration can be dealt with by providing for it in the listing requirements or by way of codes of best practices⁴⁴.

RECOMMENDATION

- 2.7 The CLRC recommends that there should be incorporated in the Companies Act 1965, a general statement of the board's role and function, to manage the affairs of the company.

⁴³ The extent of supervision that the board should exercise over management is discussed later in this consultation paper under the heading of 'delegation and supervision of the person/persons to whom power has been delegated to'.

⁴⁴ The Malaysian Code of Corporate Governance provides a detail list of the principal responsibilities/functions of the board. This includes, amongst others:

- reviewing and adopting a strategic plan for the company;
- overseeing the conduct of the company's business;
- identifying and managing principal risk; and
- reviewing the adequacy and the integrity of the company's internal control system.

Question for Consultation

Question 13:

Do you agree that the Companies Act should provide that the board of directors' role and function is to manage the affairs of the company?

PART III - DIRECTORS' DUTY OF CARE, SKILL AND DILIGENCE AND ENACTING A BUSINESS JUDGEMENT RULE

A. DUTY OF CARE, SKILL AND DILIGENCE

- 3.1 The Companies Act 1965 includes a statutory prescription of a director's duty to act honestly and use reasonable diligence whilst, being a director of a company⁴⁵. That statutory provision is, however, silent with respect to the care and skill that is expected of a director when carrying out his stewardship function. However, this does not mean that a company director is not required to act with care and skill. These obligations are imposed upon a company director by virtue of the common law⁴⁶.
- 3.2 The CLRC noted that Finance Committee on CG recommended that section 132(1) should not be amended to clarify that the standard of care imposed is with reference to the particular circumstances of the director⁴⁷. However, the CLRC is of the view that the recommendation of the Finance Committee on CG was intended to avoid the codification of the subjective standard of care that was expounded in

⁴⁵ Section 132(1) Companies Act 1965.

⁴⁶ *Re City Equitable Fire Insurance* [1924] All ER Rep 485.

⁴⁷ *Report of the Finance Committee on Corporate Governance* (1999) Chapter 6, at p 131. The Finance Committee had proposed 'that section 132(1) should not be amended to clarify that the standard of care imposed is with reference to the particular circumstances of the director'. In making this recommendation the Finance Committee had amongst other things referred to *Daniels v Anderson* (1995) 37 NSWLR 438 and section 232(4) of Australian Corporations Act 2001.

the case of *Re City Equitable Fire Insurance*⁴⁸. This was because whilst the subjective assessment of a directors' standard of care and skill as laid out in *Re City Equitable Fire Insurance* provides a flexible standard of care and skill whereby the standard varies according to the skill that a director brings to his office, a director who has no specific skill or expertise will be able to avoid being made accountable merely because there is no minimum objective standard required of him.

- 3.3 It was noted that the *Cooney Committee Report (Australia) 1989* which prompted the codification of the common law duty of care in Australia was very critical of the common law standard of care and skill as laid down in *Re City Equitable Fire Insurance*⁴⁹. However, it was mentioned by the *Cooney Committee* that the early case law on directors' standard of care no longer met the needs of contemporary business and therefore, recommended changes in the legislation to impose elements of an objective standard of care.
- 3.4 The CLRC noted that there has been case law development in other Commonwealth jurisdictions where the trend is moving towards imposing an objective standard of care and skill on a company director⁵⁰. For example, the modern judicial restatement by *Rogers J* in *AWA Ltd v Daniels t/as Deloitte Haskins & Sells*⁵¹ (1992) has observed that the duty of directors and any other officers depends upon the size of the company, and whether they are full – time senior managers or non-executive directors. Account is also taken into as to the variety of positions which may exist in a large corporation. In addition, legislative reforms in other jurisdictions have codified the standard of care

⁴⁸ [1924] All ER Rep 485.

⁴⁹ There is no objective common law standard of the reasonably competent director, as there are objective standards for other professions.

⁵⁰ *Daniels v Anderson* (1995) 13 ACLC 614; *Fletcher v National Mutual Nominees Ltd* [1990] 3 NZLR 641 and *Lim Weng Kee v PP* [2002] 4 SLR 327.

⁵¹ [1992] 7 ACSR 759.

expected of directors⁵². However, where Malaysia is concerned, the CLRC noted that there has not been any case law development on the modern approach to directors' standard of care and skill⁵³.

3.5 Section 137 of the New Zealand Companies Act 1993 provides that a company director must carry out his directorial functions with such care, skill and diligence that would be exercised by a reasonable director in the circumstances of the former⁵⁴. The section also provides that in determining what would be an appropriate standard of care, skill and diligence that would have been exercised by the reasonable director, attention should be given to:

- The nature of the company to which the former is a director of;
- The nature of decision made by the former; and
- The position and responsibility of the former.

3.6 The CLRC noted that the United Kingdom Law Commission⁵⁵ proposed three options in relation to the standard of care required of company directors:-

- The first option specified a subjective standard where the director's duty is measured against a reasonable person having the director's skill and experience.
- The second option specified a mixed test of an objective and subjective standard.

⁵² See for instance section 232(4) of Australian Corporations Act, section 180 of the Australian Corporations Act, section 137 of the New Zealand Companies Act 1993. Section 180 of the Australian Corporations Act provides that in determining what standard of care will be exercised by a reasonable person, regard will be given to the corporation's circumstances and the directors responsibilities in that corporation. Section 137 of the New Zealand Act 1993 provides that in determining what standard of care will be exercised by a reasonable person regard will be given to the nature of the company, nature of the decision; and the position and the responsibilities undertaken by that director.

⁵³ See *Abdul Mohd Khalid v Dato Haji Mustapha Kamal* [2003] 5 CLJ 85, where the court cited obiter *Re City Equitable Fire Insurance* as the applicable authority for directors' duty of care and skill and did not refer to recent development in other jurisdictions on this point.

⁵⁴ It should be noted that although our Corporate Governance report had recommended that section 132(1) be clarified to include care and skill, it did however also recommend that section 132(1) should NOT be amended to clarify that the standard of care imposed is with reference to the particular circumstances of the director.

⁵⁵ United Kingdom Law Commission 'Company Directors: Regulating Conflicts of Interests and Formulating A Statement of Duties' Consultation Paper No 153 and Scottish Law Commission Consultation Paper No 105, the Stationery Office, London (1998).

- The third option specified an objective standard where any of the director's skill or experience will be ignored.

3.7 The United Kingdom Company Law Review in its Final Report⁵⁶ (Final Report) proposed a statement of directors' duty of care which requires a company director to exercise reasonable care, skill and diligence⁵⁷. The Final Report also recommended the implementation of the double threshold - the objective and subjective standard as had been advocated by the United Kingdom Law Commission. This proposal has been adopted by the United Kingdom Company Law Reform Bill 2005⁵⁸.

3.8 It is the view of the CLRC that there should be an objective statement of the standard of care expected of directors similar to that proposed by the United Kingdom CLR as was reflected in the United Kingdom Company Law Reform Bill⁵⁹. The United Kingdom CLR proposed that the director is required to exhibit a degree of care and skill which, would be exercised by a reasonable person who is a director. However, unlike the Australian⁶⁰ and New Zealand provisions, in the event that the director has any additional knowledge, skill and experience, the director will be assessed against a

⁵⁶ The Company Law Review Steering Committee, *Modern Company Law for a Competitive Economy*, Final Report 2001, Annex C, Statement of Directors' Duties - Draft clause and schedule and explanatory notes (June 2001) United Kingdom, at 353. This proposal has been accepted by the United Kingdom government in its White paper, *Modernising Company Law*, June 2002.

⁵⁷ The United Kingdom Companies Act 1985 has no statutory provision dealing with the standard of care and skill expected of a company director. Hence, currently in the United Kingdom, the standard of care and skill expected of a director is determined with reference to the common law. Case law development in the United Kingdom also suggests that there is a move by the judiciary to impose some element of an objective assessment in respect to the standard of care and skill expected of directors: *Norman v Theodore Goddard (A firm)* [1991] 1 BCLC 1028, *Re D'Jan of London Ltd* [1994] 1 BCLC 561. However, it has also been said that this development by the English judiciary was prompted by the Company Directors Disqualification Act 1996 as these cases were decided under this particular legislation.

⁵⁸ See United Kingdom Company Law Reform Bill 2005 (HL Bill 34) -

'158, Duty to exercise reasonable care, skill and diligence

(1) A director of a company must exercise reasonable care, skill and diligence.

(2) This means the care, skill and diligence that would be exercised by a reasonably diligent person with—

(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and

(b) the general knowledge, skill and experience that the director has.'

⁵⁹ The Singapore CLRFC has also proposed to adopt the United Kingdom CLR proposal if and when the proposal becomes law. See Company Legislation and Regulatory Framework Committee (CLRFC) Oct 2001.

⁶⁰ Section 180(1) of the Australian Corporations Act 2001 states that:

'A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:

(a) were a director or officer of a corporation in the corporation's circumstances; and

(b) occupied the office held by, and had the same responsibilities within the corporation as, the director or officer'.

reasonable person who has that additional knowledge, skill and experience⁶¹. This approach proposes that the actual knowledge and experience of a director be taken into consideration as an *addition* to the minimum standard. This approach will not enable directors, who lack the necessary skill and experience, to use this as a defence. This approach will also encourage directors not to become or remain passive. This will enable the standard to be adjusted upward but will not enable it to be adjusted downward.

RECOMMENDATION

3.9 The CLRC recommends that:

- (a) the Companies Act should incorporate the directors' obligation to exercise care and skill; and
- (b) The standard of care and skill expected of directors should reflect a mixed test of an objective and subjective standard of care and skill. It is proposed that the duty of care, skill and diligence is to be stated in the following manner:

'Duty to exercise reasonable care, skill and diligence

- (1) A director of a company must exercise reasonable care, skill and diligence.
- (2) This means the care, skill and diligence that would be exercised by a reasonably diligent person with—
 - (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and
 - (b) the general knowledge, skill and experience that the director has.'

⁶¹ This therefore requires the company director to be at least conversant with any practices of the industry within which his company operates and with any relevant best practices that may regulate that director of that position.

Question for Consultation

Question 14:

Do you agree that the reformulation of a directors' standard of care and skill should be as follows:

'Duty to exercise reasonable care, skill and diligence

- (1) A director of a company must exercise reasonable care, skill and diligence.
- (2) This means the care, skill and diligence that would be exercised by a reasonably diligent person with—
 - (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and
 - (b) the general knowledge, skill and experience that the director has'?

B. DELEGATION, RELIANCE ON AND SUPERVISION OF THE PERSON(S) TO WHOM POWER HAS BEEN DELEGATED

3.10 The CLRC is of the view that the Companies Act should contain provisions that shall have the effect of:

- imposing a statutory obligation on company directors to effectively supervise those to whom power has been delegated to, in managing the affairs of the company; and
- allowing company directors to rely on information given by others if the reliance is made in good faith, after proper inquiry and if there is no knowledge that reliance is unwarranted.

- 3.11 In the earlier part of this Consultation Paper, the CLRC proposed that there should be recognition of the management and supervisory functions of company directors and the board. In large companies, directors do not manage the affairs of the company but merely supervise. The day-to-day operations of the company may be left to others⁶². Further, directors also rely on information provided by others when making corporate decisions. The CLRC is of the view that the Companies Act 1965 must recognise this practise of delegation and reliance by clarifying the right of directors to rely on others as well as the responsibility of directors when there is delegation to and reliance on others.
- 3.12 In respect to directors' right to rely on information provided by others, a provision similar to section 138 of the New Zealand Companies Act should be adopted. Section 138 of the New Zealand Companies Act 1993 expressly provides that company directors can rely on information provided by the company's employees, professional advisers or by another director or by a directors' committee provided reliance by a director on that information is made in good faith and the director concerned has made proper inquiry of that information before relying on it, if the need for inquiry is warranted by the circumstances. Further, a director shall not rely on the information provided for by the delegate if the director has knowledge that such information is unreliable.
- 3.13 Where the directors' right to delegate to others is concerned, the CLRC is of the view a provision similar in line to that of sections 190 and 198D of Australian Corporations Act 2001 should be adopted. Section 198D of the Australian Corporations Act 2001 expressly provides that unless provided otherwise by the company's Constitution, company directors may delegate any of their powers to a

⁶² These persons can include employees of the company or even external persons who provide such services to the company.

committee of directors, a director, an employee or any other person. The person delegated to must exercise power in accordance with any of the directions laid down by the directors. Further, the provision also provides that the exercise of that power by a delegate in the above circumstance is to be treated as if the directors have exercised that power. It is submitted that this provision has two effects, which are:

- it expressly empowers company directors with the right to delegate their powers to others; and
- makes the company directors accountable for the actions of their delegate.

3.14 However, section 190(2), provides the necessary protection to the company director in that the director will not be liable for the acts of the delegate if that director can satisfy the following two conditions:-

- (i) that at all times the director believed on reasonable grounds, that the delegate would exercise his power in conformity with the duties imposed on directors by Corporations Act and the company's Constitution; and
- (ii) that the company director believed on reasonable grounds, in good faith and after making proper inquiry, if the circumstances warrant an inquiry, that the delegate was reliable and competent in relation to the power delegated to him⁶³.

3.15 The proposals put forward by the CLRC are also in tandem with the recommendations made by the Finance Committee in the CG Report. The CG Report had recommended that the Act incorporates a provision which enables

⁶³ In other words, reliance would only be unreasonable where the director was aware of the circumstances of such a character, so plain, so manifest and so simple of appreciation that no such person, with any degree of prudence, acting on his behalf, would have relied on the particular judgment, information and advice of the officers.

directors to rely on others to perform their functions as a defence under the law but subject to the necessary safeguards so as to ensure that this right to rely on others is not abused.

RECOMMENDATION

3.16 The CLRC recommends that:

- (a) the Companies Act should contain an express provision which allows for company directors to rely on information provided it is made in good faith and the director concerned has made proper inquiry of that information before relying on it, if the need for inquiry is warranted by the circumstances and if there is no knowledge that reliance is unwarranted;
- (b) the Companies Act should contain an express provision which enables the board of directors to delegate authority to others but subject to reasonable supervision by the directors.
- (c) the Companies Act should contain an express provision that the director will not be liable for the acts of the delegate if that director can satisfy the following two conditions:
 - (i) that at all times the director believed on reasonable grounds, that the delegate would exercise his power in conformity with the duties imposed on directors by the Corporations Act 2001 and the company's Constitution; and
 - (ii) that the company director believed on reasonable grounds, in good faith and after making proper inquiry, if the circumstances warrant an inquiry, that the delegate was reliable and competent in relation to the power delegated to him.

Questions for Consultation

Question 15:

Do you agree that the Companies Act should incorporate an express provision that :

- (a) enables company directors to rely on information provided by the company's employees, professional advisers or by another director or by a directors' committee; and
- (b) that reliance by a director on that information should be made in good faith and only where the director has made proper inquiry of that information before relying on that information, if the need for inquiry is warranted by the circumstances? and
- (c) that a director shall not rely on the information provided for by the delegate if the director has knowledge that the information is unreliable?

Question 16:

Do you agree that the Companies Act should incorporate an express provision stating that:

- (a) company directors may delegate any of their powers to a committee of directors, a director, an employee or any other person? and
- (b) the delegate must exercise his power in accordance with any of the directions laid down by the directors?

Question 17:

Do you agree that the exercise of power by a delegate in the above circumstance is to be treated as if the directors have exercised that power?

Question 18:

Do you agree that the director will not be liable for the acts of the delegate if that director can satisfy the following two conditions:

- (i) that at all times the director believed on reasonable grounds, that the delegate would exercise his power in conformity with the duties imposed on directors by the Corporations Act and the company's Constitution; and**
- (ii) that the company director believed on reasonable grounds, in good faith and after making proper inquiry, if the circumstances warrant an inquiry, that the delegate was reliable and competent in relation to the power delegated to him.**

C. BUSINESS JUDGMENT RULE (BJR)

3.17 The Australian Corporate Law Economic Reform Program 'Proposals for Reform: Paper No: 3' explains why there is a need to incorporate the BJR in the Company legislation: -

'The fundamental purpose of a business judgement rule is to protect the authority of directors in the exercise of their duties, not to insulate directors from liability. In the absence of an express statutory acknowledgement of a business judgement rule, companies and their shareholders will inevitably incur costs as a result of the failure by the company and its directors to take advantage of opportunities that involve responsible risk-taking'.

3.18 The CLRC agrees with the reason for the introduction of a BJR as stated above and proposes that the BJR should be incorporated into the Companies Act 1965 in line with the legislation enacted in Australia. There must be a clear statement of law in

relation to the directors' responsibilities and protection/immunity given to reasonably diligent directors in the exercise of their duties as directors.

3.19 Section 180(2) of the Australian Corporations Act 2001 provides for the BJR. The Australian BJR extends immunity to company directors who make business judgments in good faith and for a proper purpose, having acted on an informed basis without material personal interest and who have rational belief that the decision is in the best interest of the corporation against potential liability in the event that director is sued for having failed to exercise care.

3.20 The immunity provided to company directors under the BJR only applies provided the company director can satisfy the following 4 conditions:

- that the director has made a business judgment: in that the director must have made a decision. The BJR does not extend to cover situations where the company directors failed to make a decision or has abdicated his responsibilities and failed to exercise any judgment;
- that the business decision was made in good faith, for a proper purpose and in the interest of the company;
- that the company director has no material conflict of interest in that decision; and
- that the director was reasonably informed of the company's circumstances when making that decision on behalf of the company⁶⁴.

⁶⁴ The American Law Institute has suggested that the director must be informed of the business reasons for the transaction; the impact of the transaction on the stakeholders of the company, management view as to price and factors affecting the price including forecast, if any, and the fairness of the transaction.

RECOMMENDATION

3.21 The CLRC recommends that:

- (a) the Companies Act should incorporate a provision that has the effect of extending immunity to company directors who make business judgments; and
- (b) that the business judgment must be made:
 - (i) in good faith and for a proper purpose, and
 - (ii) by directors who must have acted on an informed basis, without material personal interest and must have rational belief that the decision is in the best interest of the corporation.

Question for Consultation

Question 18:

Do you agree to the introduction of the business judgment rule in the Companies Act?

PART IV - CLARIFYING AND REFORMULATING DIRECTORS' FIDUCIARY DUTIES

A. INTRODUCTION

4.1 At common law, a director owes the fiduciary duty of loyalty⁶⁵ to the company and this duty encompasses:

- the duty of a director to act *bona fide* in the interest of the company and to use his powers for its proper purpose; and

⁶⁵ In *Board of Trustees of Sabah Foundation & Ors v Datuk Syed Kechik bin Syed Mohamed & Anor* [1999] 6 MLJ 497, Ian Chin J said that 'The distinguishing obligation of a fiduciary is the obligation of loyalty. The principal is entitled to the single-minded loyalty of his fiduciary. This core liability has several facets. A fiduciary must act in good faith; he must not make for his own benefit or the benefit of a third person without the informed consent of his principal. This is not intended to be an exhaustive list'.

- the duty of a director to avoid a conflict of interest where he must not place himself in a situation where his personal interest is or may be in conflict with his duty to the company.
- 4.2 The above common law propositions of directors' fiduciary duties are subsumed within sections 132(1) and 132(2) of the Companies Act 1965. Section 132(1) provides that a director must act 'honestly' whilst section 132(2) provides that a company officer⁶⁶ shall not make use of any information acquired by virtue of his office to benefit himself or someone else or to cause detriment to the company. However, it is the view that the current drafting of section 132(1) does not assist a director in appreciating and understanding his obligations as a company director.
- 4.3 Hence, the CLRC is proposing to clarify and restate the directors' fiduciary duties found at common law. This will be achieved by codifying the common law fiduciary duties of a company director within the company legislation. Codification will clarify the law which in turn will promote better governance of companies.
- 4.4 In line with the Strategic Framework of the Corporate Law Reform Programme, the proposals, if any, of the CLRC in relation to directors' duties, proceeds on the premise that the reform and restatement of company law will be guided by the shareholder theory whilst taking into account the interests of other stakeholders.

⁶⁶ 'Officer' as defined by section 4 of the Companies Act 1965 includes company directors but is not limited only to company directors.

- 4.5 The common law, as well as section 132(1) of the Companies Act 1965 places emphasis on the shareholders theory where directors' duty and accountability are concerned. This is because, both common law as well as section 132(1) requires company directors to act in the interest of the company and interest of the company is usually taken to mean the collective interest of the company's shareholders or at least the interest of the majority of the company's shareholders⁶⁷. It has been held that section 132(1) does not require company directors to act in the interest of individual shareholders or company creditors (except when the company is insolvent)⁶⁸.
- 4.6 However, a rigid application of this common law rule which requires company directors to only act in the interest of the company can at times result in decisions that do not conform with public expectations and the company's social obligations⁶⁹.
- 4.7 Whilst the CLRC supports the proposition that a company must be a good corporate citizen and for the long-term, sustainability of a company must foster a relationship with its stakeholders, the CLRC is of the view that social obligations of the company should not be incorporated in the Companies Act 1965. The CLRC noted that there are jurisdictions which have expressly provided that company directors are empowered to make provisions for company employees on the cessation of the

⁶⁷ *Greenhalgh v Aderne Cinemas Ltd* [1951] Ch 286. Members whose interests are not served by a director can seek judicial intervention by resorting to a section 181 application. See also the Australian case of *Peter's American Delicacy Co Ltd v Heath* (1939) 61 CLR 457. Though this is so, it must be noted that the common law also recognises that the company can also have interest that is separate from the collective interest of its shareholders: *Introco Ltd v Multi-Pak Singapore Pte Ltd* [1995] 1 SLR 313.

⁶⁸ See *Percival v Wright* [1902] 2 Ch 42. See also *Lum Sow Kuen v Chuah Choong Heong & Ors* [1998] MLJU 39. These cases are cited as authorities for the proposition that the duty imposed on company directors pursuant to section 132(1) is owed to the company alone and not to an individual shareholder. It is to be noted that common law is prepared to recognise that company directors may owe fiduciary obligations to individual shareholders in special circumstances as was illustrated in the Australian case of *Glavanics v Brunninghausen* (1996) 14 ACLC 34 and in the New Zealand case of *Coleman v Meyers* [1977] 2 NZLR 297. The case of *Double Acres Sdn Bhd v Tiara Setia Sdn Bhd* Civil Suit S5-22-116-99 can be cited as authority in support of the proposition that section 132(1) does not require company directors as a general rule to act in the interest of an individual creditor.

⁶⁹ See *Hutton v West Cork Railway* (1883) 23 Ch D 654 and see also *Parke v Daily News Ltd* [1962] Ch 927.

company's business⁷⁰, are allowed to consider employees' interest when exercising their powers⁷¹, or are required to consider, amongst other things, the impact of its operations on the community and the environment⁷², these statutory provisions do not replace the fundamental rule that requires company directors to act in the interest of the company i.e. the members collectively.

4.8 The CLRC also noted that in respect to employees' interests, the Companies Act 1965 already contains provisions empowering company directors to establish and support various facilities calculated to benefit employees and past employees and their various dependents and to provide for pensions and benefits⁷³. On this point, the CLRC is inclined to adopt the approach advanced by the New Zealand Law Commission. The New Zealand Law Commission in its report⁷⁴ recommended that social obligations such as looking after the environment and engaging in fair dealings with its customers should be imposed by particular statutes and not be reflected in the Companies Act 1965. This approach has been adopted by the New Zealand Companies Act 1993⁷⁵.

⁷⁰ Section 24 of the Singapore Companies Act (Cap 50) and section 132 of the New Zealand Companies Act 1993.

⁷¹ Section 159 of the Singapore Companies Act (Cap 50); see section 155 of the UK's Company Law Reform Bill (HL Bill 34).

⁷² See the United Kingdom Companies Bill, (HL Bill 34) -

156. Duty to promote the success of the company for the benefit of its members

- (1) A director of a company must act in a way you consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as whole.
- (2) Where or to the extent that the purposes of the company consists of or include purposes other than the benefit of its members, his duty is to act in the way he considers, in good faith, would be most likely to achieve those purposes.
- (3) In fulfilling the duty imposed by this section a director must (so far as reasonably practicable) of -
 - (a) the likely consequences of any decision in the long,
 - (b) interests of the company's employees,
 - (c) the need to foster the company's business relationships with suppliers, customers and others,
 - (d) the impact of the company's operations on the community and the environment,
 - (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
 - (d) the need to act fairly as between members of the company.
- (4) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

⁷³ Paragraph 7 of Third Schedule of the Companies Act 1965.

⁷⁴ *Company Law Reform and Restatement*' Report No 9 (1993) at p 66.

⁷⁵ Section 132 of the New Zealand Companies Act reads as follows:

'Exercise of powers in relation to employees

- (1) Nothing in section 131 of this Act limits the power of a director to make provision for the benefit of employees of the company in connection with the company ceasing to carry on the whole or part of its business.
- (2) In subsection (1) of this section-
'Employees' includes former employees and the dependants of employees or former employees; but does not include an employee or former employee who is or was a director of the company;
'Company' includes a subsidiary of a company'.

4.9 Thus, the CLRC is of the view that whilst company directors may consider the interests of stakeholders, for example, employees when managing and/or supervising the company's affairs, the recognition of employees' interest does not mean that a *duty* should be imposed on company directors to act in the best interest of employees. The CLRC is of the view that the relationship between a company and its creditors and employees are sufficiently dealt with and should not be regulated under the Companies Act 1965.

RECOMMENDATION

4.10 The CLRC recommends that the relationship between a company and its creditors and employees should not be regulated under the Companies Act 1965.

Question for Consultation

Question 19:

Do you agree that the relationship between a company and its creditors and employees should not be regulated under the Companies Act 1965?

B. CLARIFYING DIRECTORS' DUTY TO ACT 'HONESTLY' PURSUANT TO SECTION 132(1) OF THE COMPANIES ACT 1965

- 4.11 Under section 132(1), directors are required to act honestly⁷⁶. However, the term 'honestly' as is used in section 132(1) is not currently defined by the Companies Act 1965. The case of *Marchesi v Barnes*⁷⁷ is accepted as the definitive case in interpreting the meaning of the statutory duty to act honestly where a director is required to act 'bona fide in the interests of the company in the performance of functions attaching to the office of a director'⁷⁸. The court also decided that there is a need to prove that the director knows or is aware that the conduct is not in the company's best interest⁷⁹. Because of this, there are views that the section requires proof of mental element of dishonesty before a person may be held liable for contravention of the section.
- 4.12 As decided in *Marchesi v Barnes*⁸⁰, there is criminal liability for the contravention of the section only if the director is aware that he is not acting in the best interest of the company so that if he genuinely believes that he is acting in the best interest of the company but nonetheless, exercise his powers for an improper purpose, he will not be held liable⁸¹.
- 4.13 At common law, the duty to act *bona fide* in the interest of the company includes the exercise of power for a proper purpose and not for any collateral or improper purpose⁸². A director may be in breach of the common law duty to act honestly if he exercises his powers for an improper purpose even though he genuinely believes that he is acting in the best interest of the company⁸³. Thus, at common law, a director

⁷⁶ This section is derived from and is *in pari materia* with section 124(1) of the Australian Companies Act 1961.

⁷⁷ *Marchesi v Barnes* [1970] VR 434.

⁷⁸ *Ibid* at p 438.

⁷⁹ *Ibid*.

⁸⁰ *Marchesi v Barnes* [1970] VR 434.

⁸¹ *Chew v R* (1992) 10 ACLC 816 at 824. However, in another case *Australian Growth Resources v Van Reseema* [1988] 13 ACLR 261, it was decided that a director who exercised his powers for an improper purpose contravenes the statutory duty even though he may be acting in the best interest of the company. Nonetheless, this case has been criticised and the majority view is that the decision in *Marchesi v Barnes* [1970] VR 434 is the correct approach.

⁸² *Re Smith & Fawcett Ltd* [1942] Ch 304.

⁸³ *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 82; *Lee Panavision Ltd v Lee Lighting Ltd* [1992] BCLC 22; *Bishopgate Investment Management Ltd v Maxwell (No 2)* [1993] BCLC 1281.

must comply not only with the best interest of the company requirement but also with a proper purpose test. Nonetheless, there is no requirement that the director had acted *fraudulently or dishonestly or with deliberate intent to obtain personal advantage*⁸⁴.

- 4.14 The CLRC noted that the United Kingdom Company Law Reform Bill 2005 and the New Zealand Companies Act 1993 clearly provides that there is a duty to act in the best interest of the company and to exercise power for the benefit of the company⁸⁵. The Australian Corporations Act 2001, on the other hand provides that whilst a director has a duty to act in the best interest of the company and to exercise powers for a proper purpose, he will only be held liable to a criminal offence for breach of the duty if there is intent to deceive or defraud⁸⁶. If the contravention is without intent to deceive or defraud, there will only be civil liability for contravention.

⁸⁴ Ibid. Per Gowans J. 'If the term fraud is applicable in this situation, it is only so in the sense of a 'fraud on the power'. See *Industrial Concrete Engineering Products v Concrete Engineering Products Bhd* [2001] 2 MLJ 332, citing *Multi-Pak Singapore Pte Ltd (In Receivership) v Intraco Ltd* [1994] 2 SLR 282 per James Foong J 'Regarding the extent of the meaning "honestly", the case of *Multi-Pak Singapore Pte Ltd (In Receivership) v Intraco Ltd* [1994] 2 SLR 282 explains that this does not mean that the director had acted fraudulently; it means that he must act *bona fide* in the interest of the company and that in exercising his discretion, the director should act only to promote and advance the interest of the company'.

⁸⁵ See the United Kingdom Company Law Reform Bill 2005 (HL Bill 34).

¹⁵⁵ Duty to act within powers

As a director of a company you must –

- (a) act in accordance with the company's Constitution, and
 - (b) only exercise powers for the purposes for which they are conferred.
156. Duty to promote the success of the company for the benefit of its members
- (5) A director of a company must act in a way you consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as whole.
 - (6) Where or to the extent that the purposes of the company consists of or include purposes other than the benefit of its members, his duty is to act in the way he considers, in good faith, would be most likely to achieve those purposes.
 - (7) In fulfilling the duty imposed by this section a director must (so far as reasonably practicable) of –
 - (a) the likely consequences of any decision in the long,
 - (b) interests of the company's employees,
 - (c) the need to foster the company's business relationships with suppliers, customers and others,
 - (d) the impact of the company's operations on the community and the environment,
 - (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
 - (d) the need to act fairly as between members of the company.
 - (8) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company'

See also section 131 of the New Zealand Companies Act 1993 - '131(1) Subject to this section, a director of a company, when exercising powers or performing duties, must act in good faith and in what the director believes to be the best interests of the company'.

⁸⁶ See sections 182 and 184 of the Australian Corporations Act 2001

- 4.15 It was also noted by the CLRC that the CG report recommended that the duty to act honestly should be rephrased so as to expressly state that:
- there is a duty to act *bona fide* in the best interest of the company; and
 - there is a duty to exercise powers for a proper purpose.

However, the CG Report also proposed that the phrase 'best interest of the company' should not be statutorily clarified.

- 4.16 The CLRC noted that the differences in views of the content of the statutory duty could be attributed to the ambiguity posed by the use of the word 'honestly'. The CLRC agrees with the views expressed in the CG Report and recommends that the Companies Act should incorporate the recommendations of the CG report as set out above. By replacing the word 'honestly' with the phrase 'to act in the best interest of the company and to exercise powers for a proper purpose', a director will be informed of the fact that the duty requires directors to be aware that his conduct and decision must be made in the best interest of the company and that powers conferred on him must be exercised for a proper purpose. Furthermore, this approach clarifies that there is no need to prove dishonest intent as would be required if the statutory provision is drafted to require directors to 'act honestly'.

RECOMMENDATIONS

- 4.17 The CLRC recommends:
- (i) that the term 'honestly' appearing in section 132(1) of the Companies Act 1965 should be replaced with an express statement requiring directors to act in the best interest of the company and to use powers for a proper purpose.
 - (ii) however, the phrases 'in the best interest of the company' should not be statutorily clarified by the Act.

Questions for Consultation

Question 20:

Do you agree that the term 'honestly' appearing in section 132(1) should be replaced with an express statement requiring directors to act in the best interest of the company and to use their powers for a proper purpose?

Question 21:

Do you agree that the express inclusion of the phrase 'to act in the best interest of the company' into section 132(1) should not be statutorily clarified and hence what is in fact 'the interest of the company' should be left to judicial decision to develop?

C. CLARIFYING DIRECTORS' DUTIES TO AVOID CONFLICT OF INTEREST

4.18 Directors owe a strict duty of loyalty to the company. This duty of loyalty imposes on the directors, a positive duty to avoid situations where the directors can have direct or indirect interests that conflict with the directors' duty to act in the interest of the company⁸⁷.

4.19 In common law, 'conflict' situations can arise in the following situations:

- when the company enters into a contract, arrangement or transaction in which a director has direct or indirect interest in and that company director does not disclose his interest to the company⁸⁸.
- when a director makes personal profit while acting in his position⁸⁹.

⁸⁷ Ibid.

⁸⁸ *Aberdeen Railway Co v Blaikie Bros* (1854) 1 Macq 461.

⁸⁹ *Regal (Hastings) Ltd v Gulliver* [1942] 1 ALL ER 378 and see also *PJT V Denson (M) Sdn Bhd v Roxy (M) Sdn Bhd* [1980] 2 MLJ 136. This proposition of law arises from the fact that common law regards the company director as a fiduciary and as fiduciary the company director is not allowed by equity to profit from his position. This is a strict rule and the fact that the company has no funds or did not lose a corporate opportunity has no bearing on the application of this rule.

- where a director uses or exploits an asset (including a business opportunity, and corporate information) which is to be treated properly as belonging to the company, for his own purposes or the purpose of any one else (other than the company)⁹⁰.
- where a director receives a benefit in some other way in connection with the exercise of his powers as a director (such as a bribe)⁹¹; and
- where a director competes with the company⁹².

4.20 The CLRC noted that the current legislative text of section 132(1) of the Companies Act does not expressly refer to the abovementioned situations of conflict. There are also contradictory case laws within the common law jurisdictions on whether a director may exploit an opportunity where the company cannot avail itself of that opportunity⁹³ or where there is no possibility of the company benefiting from such an opportunity⁹⁴. Whilst the Companies Act 1965 provides for an example for conflict of interest situation under section 132(2), that a company officer (who also includes a director) shall not use any information acquired by virtue of his position in the company to benefit himself or a third party, section 132(2) only addresses one specific 'conflict' situation in that it deals with company directors abusing corporate information which he has acquired by virtue of his position in the company.

⁹⁰ *Avel Consultants Sdn Bhd v Mohd Zain Yusof* [1995] 4 MLJ 146. See also *the Board of Trustees of Sabah Foundation & Ors v Datuk Syed Kechik bin Syed Mohamed & Anor* [1999] 6 MLJ 497.

⁹¹ *Mahesan v Malaysian Government Officers' Co-operative Housing Society* [1978] 1 MLJ 149.

⁹² *Yukilon Manufacturing Sdn Bhd v Dato' Wong Gek Meng & Ors* [1998] 7 MLJ 551. See also *Canadian Aero Services Ltd v O'Malley* (1973) 40 DLR (3d) 371. In this Canadian case the court held that company directors who had resigned from the plaintiff company and set a competing company to take over an opportunity that belonged to the plaintiff company which the plaintiff company was actively pursuing through those directors themselves had acted in breach of their duty to the company. Further, in *Industrial Development Consultants Ltd v Cooley* [1972] 2 ALL ER 162, the English High Court held that a company director who had resigned from his company on a false pretence to exploit a corporate opportunity although the plaintiff company itself would not have succeeded in getting that opportunity had acted in breach of his duty to the company.

⁹³ The Canadian case of *Peso Silver Mines v Cropper* (1966) 58 DLR (2d) 1, suggest that should the company's board reject an opportunity, its company director can exploit that opportunity so as to benefit his or herself. However, this view is to be contrasted with the view that was expressed in the English case of *Regal (Hastings) Ltd v Gulliver* [1942] 1 ALL ER 378, which suggested that the exploitation of an opportunity by a company director must be preceded with the informed consent of the company's shareholders.

⁹⁴ *Industrial Development Consultants Ltd v Cooley* [1972] 2 ALL ER 162.

- 4.21 To promote clarification of what is expected of directors and to assist them in appreciating situations of conflict which may cause them to act in breach of their duty to the company, the CLRC proposes that the Companies Act 1965 incorporates a provision which sets out in general terms what are the conflict situations that should be avoided by the directors⁹⁵. This new provision will be a restatement of the conflict of interest situations and will state that a director must:
- not misuse corporate information, property or corporate opportunity;
 - not engage in business in competition with the company;
 - avoid taking any benefit from a third party,
- to gain advantage (whether direct or indirect) for himself or to cause detriment to the company.
- 4.22 The CLRC also reviewed sections 132A and 132B. The CLRC is of the view that these sections attempt to codify the misuse of corporate information as well as being directed at various insider trading conduct. In view of the proposal to codify the duty to avoid a conflict of interest of which misuse of corporate information is one example, as well as the existence of adequate insider trading provisions under the Securities Industries Act 1983, the CLRC is of the view that sections 132A and 132B of the Companies Act 1965 are redundant and should be deleted. It should be noted that the Companies Act 1965 already includes specific provisions which provides for the need to obtain the shareholders' prior approval before a company can carry out certain transactions for example, as stated under section 132E of the Companies Act 1965⁹⁶. The CLRC is of the view that whilst this section is still relevant, it is insufficient

⁹⁵ See Clause 159 of the United Kingdom Company Law Reform Bill 2005 (HL Bill 34).

'159. 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.

(2) This applies in particular to the exploitation of any property, information or opportunity (and it is immaterial whether the company could take advantage of the property, information or opportunity)'.

⁹⁶ These sections are discussed in Part V of this consultation paper.

to protect shareholders' interest in cases other than for the disposal or acquisition of asset or shares of a substantial value to or from a director or person connected to the director.

4.23 The CLRC also noted that at common law, whilst there is a strict fiduciary duty in relation to avoiding a conflict of interest, directors would not be in breach of the duty to avoid a conflict of interest if the director disclosed the conflict of interest to shareholders and shareholders have either approved the transaction involving the conflict of interest prior to it being entered into by the director or if shareholders have ratified the transaction. To be valid, shareholders approval must be given after full and frank disclosure has been made by the relevant directors.

4.24 As was previously discussed, the common law permits a director to enter into a conflict situation and benefit from that situation without being made accountable to the company provided the director concerned has obtained the informed consent of the company where the conflict of interest may be ratified or consented to by shareholders at a general meeting⁹⁷. There are differing views as to the appropriate organ to approve a conflict of interest transaction. One view is that the appropriate organ is the shareholders at the general meeting as they are the residual owners of the company's assets. On the other hand, there are also views that the requirement that only shareholders may approve the transaction is not cost-efficient to business and that if a director has disclosed to the board and he obtains the benefit with informed consent of the board of directors he should not be held liable for breach of the fiduciary duty⁹⁸. There are also views that provided the interested director has disclosed to the board under section 131 of the Companies Act 1965, no further disclosure to shareholders is required. There is some uncertainty as to whether

⁹⁷ *Regal (Hastings) Ltd v Gulliver* [1942] 1 ALL ER 378.

⁹⁸ *Queensland Mines Ltd v Hudson* [1978] 52 ALJR 399.



disclosure to the board pursuant to section 131 enables a company director to take up a corporate opportunity which had previously been rejected by the board. A view has been expressed that compliance with section 131 only protects a director from incurring criminal liability as is imposed by section 131 but does not protect the director from being held liable at common law for accounts of profits to the company⁹⁹.

4.25 The CLRC noted that the United Kingdom Company Law Reform Bill 2005 states that the duty to avoid a conflict of interest is not infringed if the matter has been authorised by the directors. Authorisation may be given by the directors:

- 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
- where the company is a public company and its Constitution includes provisions enabling the directors to authorise the matter, by the matter being proposed to and authorised by them in accordance to the Constitution¹⁰⁰.

Where the approval is made by the board of directors, the approval is valid only when the interested director is not counted towards the quorum for the meeting to consider the matter and the matter was decided without the interested director's votes.

⁹⁹ See Walter Woon, *Company Law* (2nd Edn, 1997) FT Law & Tax Asia Pacific, at p 283.

¹⁰⁰ Clause 159(a) and (b) of the Company Law Reform Bill 2005 (HL Bill 34).



- 4.27 The Australian Corporations Act 2001 provides that if a director has an interest in a contract entered into or to be entered into by a company, the director has a duty to disclose the interest and in the case of a public company, the director must abstain from voting on the transaction. However, the directors' failure to disclose the interest does not affect the validity of the transaction although the director may be held liable for breach of fiduciary duty at common law¹⁰¹. The Australian Corporations Act 2001 is silent as to the appropriate organ to approve the transaction.
- 4.28 The CLRC is of the view that a conflict of interest transaction should be approved by the shareholders. Obtaining the shareholders' consent should be the responsibility of the director. Failure to obtain such consent may result in the director being held liable for breach of fiduciary duty. A conflict of interest transaction is not an ordinary commercial decision which is within the directors' powers to approve or disapprove. Because the conflict of interest involves directors, the directors' decision may be tainted with self-interest. Whilst there is already a duty to disclose to the board under section 131, the duty is not always observed as is reflected in numerous case-law involving the non-disclosure of a conflict of interest situation where directors deliberately do not disclose their interest. If the strict fiduciary duty is retained, there is an incentive for directors to voluntarily disclose the conflict of interest since failure to do so will result in the director having to make an account of profit to the company. The CLRC also noted that whilst the UK Company Law Reform Bill 2005 allows authorisation to be made by the board, this is only possible if the company's Constitution allows this to be done. Hence, in the absence of an authorisation clause in the company's Articles, arguably approval can only be given by a shareholders' resolution.

¹⁰¹This is because section 193 of the Australian Corporations Act 2001 provides that the statutory duty of disclosure applies in addition to any general rule about conflicts of interest.

RECOMMENDATIONS

- 4.28 The CLRC recommends that the Companies Act 1965:
- (i) should incorporate a provision which sets out the common law conflict of interest situations to be avoided by a company director;
 - (ii) should include a provision that a company director will not be held liable if there is approval or ratification of the conflict of interest by the appropriate organ of the company i.e. the shareholders at the general meeting.

Questions for Consultation

Question 22:

Do you agree that the Companies Act should incorporate a provision which sets out the common law conflict of interest situations (as stated above) to be avoided by a company director?

Question 23:

Do you agree that the Companies Act should include a provision that a company director will not be held liable if there is approval or ratification of the conflict of interest by the appropriate organ of the company i.e the shareholders at the general meeting?

D. CLARIFYING THE POSITION OF A NOMINEE DIRECTOR

- 4.29 Whilst the phrase 'nominee director' has no legal definition¹⁰², the term 'nominee director' is accepted as referring to an individual who 'independent of the method of their appointment, in the performance of their office, act in accordance with some understanding, arrangement or status which gives rise to an obligation to the appointor'¹⁰³.
- 4.30 The CLRC noted that there are two key issues in respect to nominee directors which requires the consideration of this Committee. These are:
- (i) whether a nominee director when acting in the interest of the company may consider the interest of his appointor; and
 - (ii) whether a nominee director may disclose confidential corporate information to his appointor.
- 4.31 The CLRC noted that the CG report had proposed that there should be a statutory clarification of the fact that a nominee director's primary obligation is to act in the interest of the company and that his duty to his principal (appointor) is always subject to his duty to act in the best interest of the company.
- 4.32 The CLRC noted that there are nonetheless, different views within the common law jurisdictions in relation to nominee directors' duties and obligations. There are:
- the strict approach which provides that a director, nominee or otherwise, is required to act in the best interest of the company which they serve¹⁰⁴. This does

¹⁰²Despite the lack of formal recognition as to the existence of a nominee director, section 128(1) which empowers shareholders of a public company to remove its director, provides that a director who has been appointed to look after the interest of a class of shareholders cannot be removed unless his successor has first been appointed.

¹⁰³Australian Companies and Securities Law Review Committee, *Nominee Directors and Alternate Directors Discussion Paper No 7* (1987) paragraph 101.

¹⁰⁴*Industrial Concrete Products Bhd v Concrete Engineering Products Bhd* [2001] 2 MLJ 332; *Kumagai Gui Co Ltd v Zenecon Pte Ltd* [1995] 2 SLR 297; see also *Overseas-Chinese Banking Corp Ltd & Anor v Justlogin Pte Ltd & Anor* [2004] 2 SLR 675.

not mean that a nominee director must act against the interests of his appointor but that he is allowed to act in the interest of his appointor if the interest does not conflict with the interest of the company¹⁰⁵. However, in a corporate group structure the best interest of the company may include the interest of the members of the corporate group or the holding company¹⁰⁶.

- the adjusted fiduciary duty approach allowing a nominee director to act in the best interests of the nominator, in some cases with the shareholders' prior approval¹⁰⁷ or if it does not affect the company's ability to pay its creditors¹⁰⁸.

4.33 The CLRC also noted that in some jurisdictions, the adjusted fiduciary duty is applicable to a corporate group structure (irrespective of whether or not that company is a wholly-owned subsidiary) and is extended to a joint venture company. The New Zealand Companies Act 1993, for example provides that where directors are appointed to the board of a wholly-owned subsidiary, they are allowed to act in the interest of the holding company even if it is not in the best interest of the wholly-owned subsidiary provided that the wholly-owned subsidiary's Constitution permits such conduct. Where the company is not a wholly-owned subsidiary, the nominee director may act in the interest of the holding company provided that the subsidiary company's Constitution allows for this and that the prior approval of the shareholders of the subsidiary company (other than the holding company) was obtained. The same allowance is given in the case of a joint venture company where the nominee director is allowed to act in the best interest of the person whose interest he represents. Further, in the case of a subsidiary that is not wholly-owned, the holding company shall not be allowed to vote in the subsidiary's general meeting which was

¹⁰⁵*Overseas-Chinese Banking Corp Ltd & Anor v Justlogin Pte Ltd & Anor* [2004] 2 SLR 675.

¹⁰⁶*Walker v Winborne* (1976) 50 AJLR 446; *Charterbridge Corp Ltd v Lloyds Bank Ltd* [1970] Ch 62.

¹⁰⁷Section 131(2) and (3) of the New Zealand Companies Act 1993.

¹⁰⁸Section 187 of the Australian Corporations Act 2001, which is based on section 131(2) the New Zealand Companies Act 1993.

convened to give the necessary approval for the nominee director to act in the interest of his appointor (the holding company). The New Zealand approach also requires the establishment of an 'interests' register. This is to enable particulars of the nominee's appointment and the extent of the interest of the nominee's appointor to be publicly disclosed. The New Zealand legislation also enables the nominee director to disclose information to the appointor provided prior approval of the board is obtained¹⁰⁹.

4.34 Nonetheless, in Australia, the adjusted duty only applies to a wholly-owned subsidiary. Section 187 of the Australian Corporations Act 2001¹¹⁰ provides that a director of a wholly-owned subsidiary can act in the interest of the holding company and will be taken to have acted in the best interest of the subsidiary if the Constitution of the subsidiary expressly authorises the director to act in the best interest of the holding company and the director acts in good faith in the best interest of the holding company; and the subsidiary is solvent or will not become insolvent because of that director's act. Section 187 came into being as a result of the CSLRC's¹¹¹ report which proposed that nominee directors may have regard to their appointor's interest without breaching their duty towards their company. However, the protection applies only when there is a shareholders' agreement or where shareholders had given their prior informed consent and only whilst the company is solvent¹¹². In contrast, the Ghana Companies Code 1973 provides that a

¹⁰⁹Section 145 of New Zealand Companies Act 1993 also provides that information acquired by a director in the capacity as a director may be disclosed to the appointor unless it is prohibited by the board. In addition, the director must have been authorised to do so by the board, the particulars of the use of the information is entered into the interest register and the company's interest must not be prejudiced.

¹¹⁰Section 187 of the Australian Corporations Act 2001 states that –

'A director of a corporation that is a wholly-owned subsidiary of a body corporate is to be 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.'

¹¹¹Companies and Securities Law Review Committee Report No 8 *Nominee Directors and Alternate Directors* (1989).

¹¹²Companies and Securities Law Review Committee Report No 8 *Nominee Directors and Alternate Directors* (1989) at 28; see also Companies and Securities Advisory Committee, *Corporate Group Final Report* (2000).

nominee director may give consideration to the interest of the nominator without requiring that there must be a group structure or joint-venture in place¹¹³.

4.35 The CLRC is of the view that directors, whether nominee or otherwise, must be held to a strict fiduciary duty to act in the best interest of the company. In spite of views that this position is not in line with commercial reality and may not be facilitative to the business needs of companies, the CLRC is of the view that facilitation of business should not be at the expense of good corporate governance. This does not mean that a nominee director *must act* against the interests of his appointor but that he is allowed to act in the interest of his appointor if the interest does not conflict with the interest of the company. Whilst the law should take into account the commercial aspect, the CLRC believes that by clarifying that a director should act only in the best interest of the company and not any other person; this will assist directors to understand the nature and extent of their duty. Since it may also 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. Where disclosure of corporate information by a nominee director to the appointor is concerned, the CLRC noted that such disclosure is currently prohibited under securities law and allowing for such disclosure may have unintended consequence of reducing the effectiveness of insider dealing provisions.

4.36 Nevertheless, the CLRC is of the view that if the strict fiduciary duty is to be adjusted *vis-à-vis* nominee directors, this would only be possible in the case of a wholly-owned subsidiary since there would be no minority shareholders' interests which needs protection.

¹¹³The Ghana Companies Code 1973 provides that 'In considering whether a particular transaction or course of action is in the best interest of the company as a whole, a director, when appointed by, or as representative of, a particular class of members, employees or creditors, may give special, but not exclusive, consideration to the interest of that class'.

RECOMMENDATION

4.37 The CLRC recommends that a director's primary obligation is to act in the interest of the company and if he represents the interest of other persons due to some understanding, arrangement or status which gives rise to an obligation to the appointor, his duty to his principal (appointor) is always subject to his duty to act in the best interest of the company.

Questions for Consultation

Question 24:

Do you agree to the strict approach which provides that the company legislation should incorporate a provision that clearly states that the primary duty of a director (even if he is a nominee director) is to act in the interest of the company that he has been appointed to?

Question 25:

What are your views in allowing for the adjusted duty in relation to nominee directors, in respect of –

- (a) a wholly-owned subsidiary only?**
- (b) companies within a corporate group structure as long as there is a holding-subsidiary relationship ?**
- (c) a joint-venture company?**

PART V - EXEMPTION AND INDEMNIFICATION OF DIRECTORS' AND OFFICERS' LIABILITY

5.1 Section 140(1) of the Companies Act 1965¹¹⁴ voids any provision provided for in the company's Articles or in any contract entered between the company and its officer or otherwise that:

¹¹⁴Section 140(1) of the Companies Act 1965 is based on section 152 of the United Kingdom Companies Act 1929 which was then re-enacted as section 203 of the United Kingdom Companies Act 1948. Section 203 of the United Kingdom Companies Act 1948 is now re-enacted as section 310 of the United Kingdom Companies Act 1985.

- has the effect exempting its officer or auditor from any breach of duty in relation to the company; or
- has the effect of indemnifying its officer or auditor against any liability in relation to the company.

5.2 The section originated from section 152 of the United Kingdom Companies Act 1929. Section 152 of the United Kingdom Companies Act 1929 was enacted on the recommendation of the Greene Committee (1925-1926). The Greene Committee was of the view that any provision, whether contained in the company's Articles or in any contract with a company or otherwise, that had the effect of exempting or indemnifying an officer or auditor in respect any liability in respect of negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company should be void as such provisions went against public expectation. The Greene Committee's recommendation was a response to the decisions in *Re Brazilian Rubber Plantations and Estates Ltd*¹¹⁵ and *Re City Equitable Fire Insurance Co Ltd*¹¹⁶ where the company's Articles included provisions that had the effect of exempting its officers from liability to the company arising from the breach of their duty to the company.

5.3 Section 140(1) prevents the company from using its property to indemnify the directors who are duty bound to protect the company's interest. However, there is also the view that section 140(1) may also discourage able persons from taking on the office of a director especially in view of the more onerous responsibilities and regulatory obligations which are being imposed on the company directors and/or managers although this argument has been refuted by the Greene Committee itself¹¹⁷ and more recently by the Higgs Committee Report¹¹⁸.

¹¹⁵[1911] 1 Ch 425.

¹¹⁶[1925] Ch 407.

¹¹⁷Greene Committee on Company Law (1929, Cmnd 2657).

¹¹⁸The United Kingdom DTI, *Review of the Role and Effectiveness of Non-Executive Directors* (January 2003) (Higgs Committee).

A. SECTION 140(1) AND EXEMPTION FROM LIABILITY

- 5.4 As discussed section 140(1) strikes down any provision which has the effect of exempting or indemnifying an officer of the company in respect of his liability to the company which arises by virtue of that officer having breached his duty to his company. The provisions dealing with the exemption of liability which are invalidated are provisions which provide relief from liability in advance of any breach of duty¹¹⁹. The rationale is that such advance relief from liability should not be allowed because the effect is to basically remove any requirement for directors to exercise their duty. The CLRC is of the view that there should not be any advance relief from liability given to directors.
- 5.5 The CLRC noted that most of the Commonwealth company legislations invalidate any provisions in the company's Articles or in any contract entered between the company and its officer or otherwise that has the effect of exempting or indemnifying its officer in respect of his liability to the company which arises by virtue of that officer having breached his duty to his company. This includes, amongst others, the United Kingdom¹²⁰, Australia,¹²¹ Singapore¹²² and Hong Kong¹²³. Although New Zealand¹²⁴ does not have an express provision dealing with exemption of liability, the New Zealand Companies Act 1993 defines indemnity as including

¹¹⁹In *Re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 425 and *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407 this relief came in the form provision that had been included in the company's Articles that had the effect of exempting its officers from liability to the company arising from breach of their duty to the company. This type of provision in the company's Articles shall now have no effect as it is struck down by section 140(1) of the Companies Act 1965.

¹²⁰Under section 310 of the United Kingdom Companies Act 1985, a company may not, by its Articles or otherwise, exempt a director or officer from, or indemnify him against, any liability for any negligence, default, breach of duty, or breach of trust in relation to the company.

¹²¹Section 199A(1) of the Australian Corporations Act 2001.

¹²²Section 172(1) of the Singapore Companies Act (Cap 50).

¹²³Section 165 of the Hong Kong Companies Ordinance (Cap 32).

¹²⁴Under section 162 of the New Zealand Companies Act 1993, insurance is allowed for an officer of a company or a related company if there is authorisation in the company's Constitution and obtain board's prior approval where the board must certify that the cost is fair to the company. Insurance is allowed for:

- Non-criminal liability;
- Costs in defending or settling civil claim;
- Costs incurred in defending criminal proceedings where there is acquittal.

provisions to relieve or excuse officers from liability, whether before or after the liability arises¹²⁵. On the contrary, Canada does not have any express provision prohibiting provisions exempting directors from liability for breach of duty.

- 5.6 There is some uncertainty as to whether section 140(1) applies to the shareholders ratification of officers' breach of duty in respect to his company. At common law, shareholders of a company can excuse the director's or officer's breach of duty after that breach has occurred. Ratification of breach of duty or authority by the company's shareholders at a general meeting is an established principle of company law. The CLRC is of the view that the rationale for section 140 is to prevent the director from being exempted from any liability as a result of a breach of duty in advance of the occurrence of the breach. It is, therefore, submitted that section 140(1) was not enacted to strike down the effective ratification of the officers' breach of duty or authority by the company's shareholders. Thus, ratification of the director's breach of duty should not be prohibited.

RECOMMENDATION

- 5.7 The CLRC recommends that the effect of section 140(1) that 'a provision, whether in a contract with the company or in the company's Articles which provides for exempting directors from any liability is void' should be preserved.

¹²⁵Section 162 of the New Zealand Companies Act 1993. See also section 177 of the New Zealand Companies Act 1993 in relation to ratification by shareholders of director's exercise of power.

Question for Consultation

Question 26:

Do you agree that the effect of section 140(1) that 'a provision, whether in a contract with the company or in the company's Articles that provides for exempting directors from any liability is void' should be preserved?

B. SECTION 140 (2) AND DIRECTORS' INDEMNITY

- 5.8 Section 140(2) provides that a company pursuant to its Articles¹²⁶ or otherwise can indemnify any of its officers or auditors for the costs and expenses which the officer or auditor has incurred in relation to the legal proceedings whether civil or criminal but provided that the officer or auditor has been successful in defending the legal proceedings or in legal proceedings in which he has been acquitted. Further, indemnity is also available when the officer has been successful in any application where the court grants relief¹²⁷.
- 5.9 Under section 140(2), an indemnity can only be given to the officer or auditor concerned at the end of the trial provided he has been successful in defending the legal proceedings or he has been acquitted. There are views that since the trial process can be long and expenses may be incurred through out the trial process, it should be considered whether or not trial expenses and cost can be disbursed in advance of the trial process.

¹²⁶Refer to article 113 Table A.

¹²⁷Comparative jurisdictional sections include section 310(3)(b) of the United Kingdom Companies Act 1985, section 162(3) New Zealand Companies Act 1993, section 172(2)(b) of the Singapore Companies Act Chapter 50 and section 165(2) of the Hong Kong Company Ordinance. For example section 162(4) of the New Zealand Companies Act 1993 provides a company may, 'if expressly authorised by its Constitution, indemnify a director or employee of the company or a related company in respect of—
(a) Liability to any person other than the company or a related company for any act or omission in his capacity as a director or employee; or
(b) Costs incurred by that director or employee in defending or settling any claim or proceeding relating to any such liability,—
not being criminal liability or liability in respect of a breach, in the case of a director, of the duty specified in section 131 of this Act or, in the case of an employee, of any fiduciary duty owed to the company or related company'.

5.10 In Australia, the company or a related body corporate cannot indemnify liabilities (other than for legal costs) incurred by a person as officers or auditors of the company in relation to liability owed to the company or related body corporate, liability for a pecuniary civil penalty order or a compensation order or liability arising out of the conduct which is not in good faith owed to someone other than the company or related body corporate¹²⁸. The United Kingdom Company Law Review has also recommended amendments to section 310 of the Companies Act 1985 to allow for the advance against the cost of defending proceedings provided the decision is made by disinterested members of the board based on appropriate legal advice that there is the prospect for success; however, the director will have to reimburse the company if he loses the case. A company is also permitted, although not required, to indemnify directors in respect of proceedings brought by third parties except for the unsuccessful defence in criminal proceedings, fines imposed in criminal proceedings and penalties imposed by regulatory bodies such as the Financial Services Authority¹²⁹.

5.11 Whilst the CLRC acknowledges that indemnity should be able to be given by a company for cost and expenses incurred by that director, officer or auditor in defending an action commenced by a third party (the third party refers to persons other than the company), an advance should not be possible as this involves potential breach of directors' duties that are owed to the company. Although there

¹²⁸Section 199A(2) of the Australian Corporations Act 2001. However, indemnity for legal costs cannot be given for costs incurred by the officer or auditor:

- in defending proceedings is found liable under circumstances not covered by 199A(2);
- in defending criminal proceedings when they are found guilty;
- in defending proceedings by ASIC or a liquidator if the grounds for making an order are established;
- in proceedings for relief where the court denies relief.

In addition the company may be able to give a person a loan or an advance in respect of legal costs, although the amount will have to be repaid if the case is not successful.

¹²⁹In December 2003, the Department of Trade and Industry published a consultation paper '*Directors' and Auditors' Liability*' which built on the recommendations of the Company Law Review and the Higgs Report. In September 2004, the Secretary for Trade and Industry announced that amendments to the Companies (Audit, Investigation and Community Enterprise) Bill will be tabled.

are some jurisdictions which allows advance provided the director must reimburse the company if he fails in the proceedings, the CLRC is of the view that it may not be practical to allow this.

RECOMMENDATION

5.12 The CLRC recommends that:

- (a) a company may be allowed to provide indemnity for any costs of defending legal proceedings, whether civil or criminal, only when the director is successful (whether by a judgment in his favour, an acquittal or by a discontinuance);

- (b) section 140 should be clarified to provide that the company may indemnify its officer or auditor for costs and expenses incurred by that officer or auditor in defending an action commenced by a third party (the third party being a person other than the company).

Question for Consultation

Question 27:

Do you agree that a company may be allowed to provide indemnity for any costs of defending legal proceedings, whether civil or criminal, only when the director is successful (whether by a judgment in his favour, an acquittal or by a discontinuance)?

Question 28:

Do you agree that a company may be allowed to provide indemnity for the costs of a successful claim to the court for relief from liability?

Question 29:

Do you agree that section 140 should be clarified to provide that the company may indemnify its officer or auditor for costs and expenses incurred by that officer or auditor in defending an action commenced by a third party (the third party being a person other than the company)?

C. SECTION 140 AND DIRECTORS AND OFFICERS' INSURANCE (D&O INSURANCE)

5.13 The CLRC believes that the D&O insurance is a means of mitigating potential personal liabilities for directors and officers. One issue that the CLRC considered was whether an insurance contract taken by the company or by the director is void under section 140 of the Companies Act 1965.

5.14 In the United Kingdom, the Higgs Committee identified that exposure to liabilities from legal action against directors by third parties; and the cost of lengthy legal proceedings are affecting the recruitment and behaviour of directors and recommended the relaxation of the prohibition on companies in relation to exempting or indemnifying directors¹³⁰. As a result of the Higgs Committee Report, the Combined Code has been amended to refer to the need for companies to arrange for appropriate insurance cover in respect of legal actions against directors. The United Kingdom Institute of Chartered Secretaries and Administrators (ICSA) has also published guidance for companies on what type of insurance is to be provided for the directors¹³¹. The United Kingdom Company Law Review, however, recommended amending section 310(3)(a) to allow a company to indemnify a director against reasonable *bona fide* excess of loss requirement on a liability insurance policy¹³².

¹³⁰The United Kingdom DTI, *Review of the Role and Effectiveness of Non-Executive Directors* (January 2003) (Higgs Committee).

¹³¹http://www.icsa.org.uk/pdfs/guidance/030925_Dir_Offinsurance.pdf

¹³²Paragraph 6.4, p 133, Company Law Review Steering Group, *Modern Company Law for A Competitive Economy: Final Report* (2001).

5.15 In Australia, the Australian Corporations and Market Advisory Committee stated that - *'The D&O Insurance is a means by which companies and their office holders may seek to mitigate potential personal liabilities of those officeholders. The directors and officers of companies are exposed to considerable potential personal liability arising out of the performance of their roles. They are exposed to personal financial liability for any breach of common law and statutory duties as well as sanctions for offences, ranging from imprisonment to fines or other pecuniary penalties. There is an increasing trend to impose personal liability on corporate officeholders for the shortcomings of companies'*¹³³.

5.16 The CLRC noted that in jurisdictions where D&O insurance is valid:

- It may be taken by a company where the company purchases and maintains insurance to insure against any loss or damage suffered by the company as a result of claims *taken by third parties* arising out of an officer's or a director's act or omission¹³⁴;
- It may be taken by a company to reimburse the company for losses it has suffered as a result of indemnifying the insured person where the company is obliged to indemnify the officer or director¹³⁵;
- It may be taken by the company where the company purchases and maintains insurance to insure against any loss or damage suffered by the company due to a director's breach of any duty that he owes to the company;
- It may be taken by the director to insure against personal liabilities in relation to his duties as a director that he owes towards the company¹³⁶.

¹³³Australian Corporations and Market Advisory Committee, *Directors and Officers Insurance*, Report, June 2004, at p 1.

¹³⁴Section 199A of the Corporations Act 2001 expressly states that a company or a related corporate body cannot pay the insurance premium for a person who is or has been an officer or auditor of a company in relation to liability (other than legal costs) for :

- Wilful breaches of duty;
- Contravention of section 182 (liability for improper use of position) and section 183 (liability for improper use of information)

¹³⁵Under section 310(3)(a) of the United Kingdom Companies Act 1985 the company is allowed to buy a director liability insurance and indemnify him against the costs of successfully defending proceedings and the costs of a successful claim to the court for relief from liability under section 727.

¹³⁶*Ibid.*

5.17 In deciding whether or not to recommend allowing D&O liability insurance, the CLRC is aware of the existence of other statutes which imposes personal liability on directors. In addition, it is an accepted fact that legal proceedings in Malaysia often take a long time to be settled so as to affect the legal cost of any proceedings. It is also noted that the normal D&O insurance does not cover claims by the company against the directors, although insurance against claims by third parties are provided and this does not cover fraudulent or other illegal conduct. Thus, the CLRC recommends that it should be clarified in the Companies Act that the company may be allowed to purchase or maintain insurance for directors (and officers) in relation to liability owed to someone other than the company. However, a company should not be allowed to purchase or maintain insurance for officers in relation to any liability or breach of duty owed to the company. The CLRC is also of the view that shareholders should be informed of the insurance or indemnity given.

RECOMMENDATIONS

The CLRC recommends that:

- (a) a company should not be allowed to purchase or maintain insurance for officers in relation to liability owed towards the company;
- (b) section 140 should be clarified to allow a company to purchase or maintain insurance or to indemnify its officer or auditor for cost, expenses and liability incurred by that officer or auditor in defending an action commenced by a third party (the third party being a person other than the company);
- (c) that any insurance or indemnification will have to be disclosed to shareholders.

Questions for Consultation

Question 31:

Do you agree that a company should not be allowed to purchase or maintain insurance for its officers in relation to the liability owed towards the company? If yes, do you agree that the prohibition be extended for liability towards a related company?

Question 32:

Do you agree that section 140 should be clarified to allow a company to purchase or maintain insurance or to indemnify its officer or auditor for costs, expenses and liability incurred by that officer or auditor in defending an action commenced by a third party (the third party being a person other than the company)?

Question 33:

Do you agree that any insurance or indemnification will have to be disclosed to the shareholders? If yes, should the disclosure be made in the directors' report?

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