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Research paper

Corporate Governance and Directors Duty to Act in Good Faith and in the Best Interest of the Company: The Malaysian Experience

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Abstract

Corporate governance is not a legal term. It is a term that refers broadly to the rules, processes, or laws by which businesses are operated, regulated, and controlled. It has traditionally specified the rules of business decision making that apply to the internal mechanisms of companies. Corporate governance mechanisms have the purpose of monitoring and controlling the management of corporations resulting in more effective management and to enhance shareholder value. The aim of this paper is to examine the duty of company directors to act in good faith and in the best interest of the company by way of making reference to the Malaysian experience. This paper adopts a legal library based research methodology focusing mainly on primary and secondary legal sources. The paper concludes that although directors must exercise their discretion in good faith, the fiduciary duty to act in good faith in the interests of the company is a subjective duty. There is no breach where the directors act in what they honestly believe to be in the interests of the company. The courts are generally reluctant to override the business judgment of directors. The paper recommends that courts should adopt a flexible approach in dealing with directors' duty to act in good faith and in the best interest of the company. The erosion of a director's obligation to act in good faith does not bode well for the modern corporation and the economy, and a meaningful interpretation of "not in good faith" is necessary to help halt the erosion.

Keywords: *Best Interest, Corporate Governance, Company, Company Directors, Corporation, Fiduciary Duties, Good Faith.*

1. Introduction

Corporate governance is a global concern. There are a number of reasons for this- the globalisation of the markets and a number of high profile corporate collapses are among the prime causes.1-2 These corporate failures as well as revelations of mismanagement and fraud have done much to erode confidence in the capital markets. Effective corporate governance is the key mechanism through which the trust in the organisation can be achieved and maintained. Corporate governance has now attracted a good deal of public interest because of its apparent importance for the economic health of the companies in particular and the society in general.1 It is generally accepted that good corporate governance helps maintain overall confidence in the market, renew the countries industries bases, attract long term investment capital, sustain economic growth and ultimately enhance the nations' overall wealth and welfare.

This paper examines the duty of company directors to act in good faith and in the best interest of the company by way of making reference to the Malaysian experience. There is no doubt that Malaysia has a corporate governance system that works relatively well. However, it cannot be denied that the fiduciary duty to act in good faith in the interests of the company is a subjective duty. For example, there is no breach where the directors act in what they honestly believe to be in the interests of the company. In addition, the courts are generally reluctant to override the business judgment of directors. In some cases directors may breach their fiduciary duties where they fail to give proper consideration to the company's interests or where they act in a way that no reasonable person could consider bona fide in the interests of the company.2 Thus, directors are presumed to have acted bona fide for the benefit of their company and those persons alleging a breach of duty bear the onus of proving that they have not acted bona fide. The paper is structured, first, to introduce to the reader briefly the position of corporate governance in Malaysia. With this introduction's reference to the position of corporate governance in Malaysia, the paper then discusses the fiduciary duty of company directors to act in good faith and in the best interest of the company. With that approach in mind, the paper draws conclusions and discusses pertinent issues relating to the duty of company directors to act in good faith and in the best interest of the company.

2. Corporate governance in malaysia

Before addressing the position of corporate governance in Malaysia, it is important to define the term 'corporate governance'. In the Malaysian context, the Report on Corporate Governance Finance Committee, 1999 defines the term 'corporate governance' as:

"the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realising long-term shareholders value, whilst taking into account the interests of other stakeholders."3-4

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From the above definition, corporate governance concerns both the internal controls (e.g. board structure) and external aspects (e.g. the relationship with shareholders and stakeholders). It also provides the mechanism through which corporate objectives may be set, monitored and achieved. The governance mechanisms can be broadly characterised as being either internal or external to the firm. Internal monitoring mechanisms have a direct influence on firm performance through the monitoring process and the checks and balances in company operations. External monitoring mechanisms refer to the mechanisms that indirectly influence firm performance.1 Thus, the development of increased interest in corporate governance reflects higher expectations by the investment community for greater effort by listed companies to develop their own structures and procedures to ensure appropriate standards of corporate behaviour.2

Therefore, it is widely accepted that corporate governance is a mechanism to manage the distribution of power within the firm and facilitates the maximization of firm value.5 Good corporate governance is aimed at enhancing business prosperity, whereby accountability is the key to the legitimacy of the entire corporate system.

Turning now to the position of corporate governance in Malaysia, as mentioned earlier, Malaysia has corporate governance system that works relatively well. Development in corporate governance in Malaysia was influenced primarily by the developments in United Kingdom (UK) arising out of the 1993 Cadbury Committee's report.6 The Malaysian Code on Corporate Governance (MCCG) was first promulgated in 2000 as a result of the recommendations of the Malaysian Finance Committee on Corporate Governance (1999). The MCCG 2000 was reviewed in 2007, 2012 and more recently in 2017.

The MCCG 2017 was released by the Securities Commission Malaysia and takes effect on the 26 April 2017, replacing the 2012 code. The new MCCG introduces substantial changes and recommendations with a view of raising the standards of corporate governance for companies in Malaysia. For example, it now employs the 'Comprehend, Apply and Report' (CARE) approach by shifting from 'comply and explain' method in the 2012 code to a 'apply or explain an alternative' method.7 This is believed to allow greater flexibility.

In Malaysia, there are also rules in the Bursa Malaysia Listing Requirements (BMLR) to enhance corporate governance compliance and enforcement. Chapter 15 of the BMLR contains governance issues such as: composition of the board, including the appropriate mix of executive and non-executive directors and skill set requirement; procedure for selection of new directors and criteria for board membership; arrangements for setting and reviewing remuneration of directors; arrangements relating to selection of the auditor, reviewing audit arrangements, establish audit committee and rights of an audit committee; procedures for identifying and managing business risk; and establishment and maintenance of appropriate communication channels between company and investors.8

It would suffice to note that consistent with global trends, corporate governance in Malaysia is regulated by a hybrid form of statutory regulation (including the Companies Act 2016, the Securities Commission Act 1993 and the Capital Markets and Services Act 2007) and BMLR. Perhaps in the context of this paper, it would be vital to point out that the principles of corporate governance in the MCCG reinforces the fiduciary duties of directors. The Code recognises the role of the board to ensure good corporate governance and that the board should take the lead role in establishing the company's best practices. The MCCG 2017 now requires companies to provide a meaningful explanation in their annual reports on the manner in which the practices are applied and, where alternative practices are adopted to meet the Intended Outcome, to provide reasons for such alternatives and where appropriate, the timeframe required for its implementation.

3. Fiduciary duty of company directors to act in good faith and in the best interest of the company

One of the most important governance mechanisms lies in the roles of directors.9 The directors are appointed or elected to perform fiduciary duties with respect to the upholding of the company's interest. Therefore, fiduciary duties are imposed on persons who are involved in the management of a company. This obviously includes directors. It is a trite law that directors are fiduciaries and therefore they are under a duty to act properly and in good faith towards the company as well as required to exercise duty of loyalty to the company.10-13 The characteristics of a fiduciary is explained in Bristol and West Building Society v Mothew by Millet LJ stating that:

"A fiduciary is someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence. 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 place himself in a position where his duty and interest may conflict; he may not act 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, but it is sufficient to indicate the nature of fiduciary obligations."11-12

Looking at the above statement echoed by Millet LJ, it is clear that in company law, directors stand in a fiduciary relationship to the company and all the powers of the directors are entrusted to the directors in the directors' fiduciary capacity.13 In other words, the relationship of a director to the company is fiduciary in character. The primary consequence of this principle is that a director is bound to exercise the powers and discretions conferred upon him bona fide in the interest of and for the benefit of the company as a whole. Hence, the exercise of a fiduciary power for a purpose beyond the legitimate scope of the power is invalid. The validity of the exercise of the powers of a director therefore depends upon the purpose of the exercise being for the benefit of the company as a whole.

3.1. Duty to Act in Good Faith

The duty to act in good faith requires directors to perform their duties honestly and with integrity.10 Directors must act honestly in what they believe to be in the best interest of the company and they must not exercise their assigned powers for any collateral purpose.14 In other words, directors must exercise their powers in good faith, in what they consider and not what the court may consider to be in the interests of the company, and not for any collateral purposes. Section 213 of the Companies Act 2016 requires that a director shall act honestly and use reasonable diligence in the discharge of his duties.15 Upon their appointment, directors are fiduciaries and must therefore display the utmost good faith towards the company in their dealings with it or on its behalf.

Directors owe a fiduciary duty to the company of which they are directors. They owe a fiduciary duty to act in good faith and in the interests of the company as a whole. It can be said that s. 213 of the Companies Act 2016 is largely a restatement of the existing position of the fiduciary duties of directors at common law. It requires a director at all time to act honestly and use reasonable diligence in the discharge of his duties. Abdul Malik Ishak J in Fong Poh Yoke & Ors v The Central Construction Co (M) Sdn Bhd, reiterated that duty in the following words:

"It is an onerous office if one were to be a director of a company. This section is a restatement of the principles of honesty and good faith that should govern the conduct of directors which would free the courts from technicalities of the existing law when faced with an array of dishonesty and impropriety by directors. It is in the nature of a pious declaration. In my judgment, properly construed Section 132(1) of the Companies Act 1965 requires a director to perform his fiduciary duties and to act bona fide in the interest of the company when performing his functions as a director. Section 132(1) is now Section 213(1) of the Companies Act 2016."16 (Emphasis added)

From the above statement, it is important to note that as a director, you are required by law to act in good faith for the best interest of the company and not for your own interest or for any collateral purposes. Apart from that, the law also requires each and every director not to put oneself in a position where the duties and interest are likely to conflict or in other words avoiding any conflict of interest. If there is a conflict of interest, the interest of the company should be given preference or allow to prevail.

Although s. 213 of the Companies Act 2016 combines the duty to act in good faith and in the best interest of the company, but the section leaves open the definition of the phrases "proper purpose", "good faith", and "best interest of the company". For example, the use of the word "honesty" has led to the view that if a director honestly believe that he is acting in the best interests of the company, he should not be made liable for the breach of duty. The paper argues that this view is incorrect as case law on directors' fiduciary duty to act honestly is made up of the duty to act in the best interests of the company and to exercise power for proper purpose.14 The phrase to "act honestly" in s. 213(1) refers to acting bona fide in the interests of the company in the performance of the functions attaching to the office of a director. Hence, even if directors had honestly believed that they are acting in the best interests of the company, they must ensure that any powers exercised by them were exercised for a proper purpose.

Regardless of the argument presented here i.e. the correct view or approach to the word "honesty", the paper still argues that this problem is far from being solved bearing in mind that what constitute the interests of the company are subjective. These are left to the directors to decide and to consider whether or not the matters are for the interest of the company as a whole. The court may not interfere into the affairs of the company since the persons who know better of the company's affairs are the directors. So long as the directors honestly believe that the act of them is to be in the interest of the company, they may not be in breach of their duties. In Re Smith and Fawcett Ltd,14 Lord Greene MR said that the directors must exercise their discretion bona fide in what they consider and not what the court may consider to be in the best interest of the company, and not for any collateral purposes.

3.2. Duty to Act in the Best Interest of the Company

As mentioned earlier, directors must exercise their duties in good faith, in what they consider and not what the court may consider to be in the interests of the company, and not for any collateral purposes. This is expressed as a duty to act bona fide for the benefit of the company as a whole. In discussing whether the duty has been breached, the court has laid down the test to be adopted. This test, the Charterbridge principle states that in assessing whether the decision was in the best interests of the company, the court will consider whether:

"an intelligent and honest man in the position of the director of the company concerned, could in the whole of the existing circumstances have reasonably believed that the transactions were for the benefit of the company."17

Looking at the above test, there seems to be some uncertainty whether this is an objective or a subjective test or a combination of a subjective and objective test. It could be argued that the test is a combination of a subjective and an objective test. It is a subjective test because the court will not replace the directors' decision with the court's view of what is in the best interest of the company.6 This view has already been addressed earlier in the case of Re Smith and Fawcett Ltd.14 Thus, the courts have been very careful not to take over the board's role in making business or commercial decisions and have tried to avoid deciding based on hindsight.18 It is submitted that the court will not assess the commercial viability of the decision or transaction and will defer to the decision of the board. However, the transaction to decide whether any director in the same position could have reasonably believed the decision is in the best interests of the company. The directors' honest belief that the decision was in the best interest of the company must be credible. The test enables the court to strike a balance between allowing directors to make risky commercial decisions and making directors accountable for unreasonable business decisions.19

In Kesar Singh v Sepang Omnibus Co Ltd,20 the company's articles gave directors an "absolute and uncontrolled" discretion to refuse to register any proposed transfer of shares. The directors declined to register a transfer of shares. The directors' decision was challenged in court. In the court, the reason given for the refusal for the transfer was that the transferor owes the company money. In upholding the directors' decision, the court held that the meaning of the phrase "bona fide for the interests of the company" was something to be considered by the directors as they, the directors, see them.

In Pioneer Haven Sdn Bhd v Ho Hup Construction Co Bhd & Anor & other appeals,21 a case which involved Ho Hup owning 70% of the issued paid up share capital in Bukit Jalil and Pioneer Haven, who was a party to a joint venture agreement entered into between Bukit Jalil and Pioneer Haven. The Court of Appeal stated that the main question in deciding whether there has been a breach of directors' duties is "whether in all the circumstances that existed on 16 March 2010, there were grounds upon which a reasonable board could have considered that the JDA was in the best interest of the shareholders." It is submitted that the Court of Appeal in Pioneer Haven's case has correctly applied the relevant tests to decide whether the decision was in the best interests of the company and for a proper purpose. It is important to note that in the judgment, the court referred to the business judgment rule and s. 132(1B), the "business judgment rule" as found under s. 132(1B) only relates to the duty of care, skill and diligence and is not relevant in relation to the duty to act in the best interests of the company and for a proper purpose (now s. 214 of the Companies Act 2016). Hence, the common law principle mentioned in Pioneer Haven should be understood to refer to the principle that the court will not make commercial or business decision for the company since this is the role of board of directors.

In Petra Perdana Bhd v Tengku Dato Ibrahim Petra & Ors,22 the court held that the directors had acted in the best interests of the company and exercised power for a proper purpose relating to the divestment of the entire shareholdings in Petra Energy (PE). The facts indicated that the power to sell the shares have been exercised properly and in the best interest of the company. The court found that the divestment was a result of considered and collective decision of the entire board based on the information provided by senior management relating to the company's cash flow position.

Apart from the two Malaysian cases referred to above, reference can also be made to the English case of Re W & M Roith Ltd,23 where a director named Roith entered into an agreement with the company which provided term for payment of pension for life to his wife if he died. Soon after his death, his wife tried to enforce the term against the company but failed. She sued the company but the court held that the director i.e. Roith breached his duty to the company to act honestly in the interest of the company and thus the contract was declared void.

Irrespective of the cases cited above, the paper argues that the courts are still faced with some daunting tasks in addressing this duty due to the use of phrases such as "the company as a whole" and "the interests of the company" appearing in s. 213 of the Companies Act 2016. For example, the duty requires directors to act in the best interests of the company. But how do directors assess what is the company's best interest? Are they required to consider whether their decision will benefit each individual member, the majority of the members or the company as a whole?6 It is important to remember that a company is regarded as a legal entity separate and distinct from its shareholders. Despite this, the courts take the view that the duty to act bona fide for the benefit of the company does not mean that the directors owe a duty to the company as a distinct commercial entity. Acting for the benefit of the company means that the directors must act in the interests of the shareholders as a collective group.24

Therefore, it cannot be denied that there could be some difficulties in ascertaining the interest of the company as a whole when the directors are required to make decisions affecting several types or classes of shareholders. The interests of different classes of shareholders or members in a company may not be the same.6 Where a company has classes of members with different interests, directors are expected to act fairly when making decisions which affect the interest of those members. Hence, decisions that benefit one class of shareholders and not the other, is not necessarily in breach of directors' duties.

In addition, whilst directors must act bona fide in the interests of the shareholders, this does not mean that they owe duties to particular shareholders. In Percival v Wright,25 a case which involved a transfer of the company's shares by some shareholders to the directors. The shareholders had approached the company to find purchasers for their shares and the sale was negotiated by the chairman of the company acquiring the shares for himself and on behalf of two other directors. During the negotiation, there were offers made to the company by a third party to acquire the company's business. The court held that the directors are not trustees for individual shareholders, and may purchase their shares without disclosing pending negotiations for the sale of the company's business. However, there have been developments suggesting that there could be a duty owed to individual shareholders due to special facts i.e., there is a relationship of trust and confidence; the shareholder has relied on the information and advice given by the director; the significance of some particular transaction for the parties; and the extent of any positive action taken by or on behalf of the directors or directors to promote it.6 In BSNC Corporation Bhd v Ganesh Kumar Bangah,26 the court acknowledged that a fiduciary duty can be owed to shareholders but the special circumstances for the duty to exist were not proven in this case.

Looking at some of the issues raised above in terms of the directors' duty to act in the best interest of the company, the paper argues that some of the problems are far from being solved judicially. As mentioned earlier, the company is a separate entity from its members. However, the company refers to the members as a group i.e., the general body of members of the company. In reality, we seldom come across a situation where all members are in agreement about the issue. If that is the case, it makes the assessment of the decisions of directors difficult, for some actions can be more beneficial for some members' i.e. present shareholders than future one and vice versa, depending on how much of a long-term view is taken. For example, creditors are capital providers in the sense that they provide long term debt capital or provide goods and/or services to the company to enable the company to carry on business.6 Therefore, when a company is insolvent or nearly insolvent, the directors have a duty to consider the interest of its creditors in addition to its shareholders. Thus, any decisions of the directors must not adversely affect the interest of its creditors. In Walker v Wimborne, where the directors of Asiatic guaranteed loans of other companies in a group even though the company was having financial problems. The liquidator brought an action against the directors to make the directors personally responsible for the losses. Mason J made the following observation in his judgement:

"[I]t should be emphasized that the directors of a company when discharging their duty to the company must take account of the interest of its shareholders and its creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for them."27

In addition, despite the law recognising that it is the creditors' interest that must be taken into consideration by directors where a company is insolvent or near insolvent, this does not mean that the creditors can sue the directors for breach of directors' duty. Directors do not owe a direct duty to creditors which is enforceable by creditors themselves.6-28 Any action for breach of duty because of failure of the directors to take into consideration the interest of creditors is to be enforced by the company or in most cases by the liquidator as seen in the case above.

4. Conclusion

In view of the foregoing discussions above, the paper concludes that directors' duty to act in good faith and in the best interest of the company, which is provided in s. 213 of the Companies Act 2016 is definitely without thorny issues. The section leaves open the definition of the phrases "proper purpose", "good faith", and "best interests of the company". True corporate directors are obligated to act "in good faith," and directors face personal monetary liability to their shareholders for acts "not in good faith." Every time the issue of a director's good faith comes up in court, the court forces the complaining shareholder to prove that her directors acted affirmatively in bad faith as opposed to merely in the absence of good faith. The judiciary completely misses the point that acts lacking good faith are not always the same as acts affirmatively taken in bad faith. A director can act in the absence of good faith without going so far as to be affirmatively acting in bad faith. The erosion of a director's obligation to act in good faith does not bode well for the modern corporation and the economy, and a meaningful interpretation of "not in good faith" is necessary to help halt that erosion. The courts ought to remember that the duty to act in good faith in the best interests of the company requires directors to act honestly, for the benefit of all shareholders. Hence, the paper recommends that our courts should adopt a holistic approach in dealing with the issue of whether a director has acted honestly or not. Hence, all factors or circumstances of the case must be taken into consideration.

Apart from the issue of good faith, the other observation made in the paper is relating to the exercise of directors' powers in the best interest of the company. The problem surrounding the exercise of this power is partly related to the test used in addressing the issue of whether the duty has been breached. There seems to be some uncertainty whether the test is an objective test or a subjective test. Due to this uncertainty, courts are wary of usurping management's role, partly because they lack intimate knowledge and experience of the day-to-day affairs and needs of the particular company. In other words, the courts are generally reluctant to override the business judgment of directors. Hence, it could be argued that the courts will only interfere when there is a breach of duty, such as fraud or an abuse of power, but they will not substitute their discretion or judgment for that of the directors acting in good faith. In order to address this problem, the paper recommends that directors' must ensure that any powers exercised by them are exercised for a proper purpose. In other words, courts should not be blinded by the phrase that the directors "honestly believed" that they were acting in the best interest of the company. It is submitted that bona fide cannot be the sole test. The guiding principle should be based on the powers exercised for a proper purpose.

Still on the issue relating to the directors' exercising their powers to the best interest of the company, as highlighted earlier, there could be some difficulties in ascertaining the interest of the company as a whole when the directors are required to make decisions affecting several types of shareholders. This is because the courts take the view that the duty to act bona fide for the benefit of the company does not mean that the directors owe a duty to the company as a distinct commercial entity. Acting for the benefit of the company means that the directors must act in the interest of the shareholders as a collective group. However, the paper argues that the interests of different classes of shareholders or members in a company may not be the same. Based on this line of reasoning, the paper recommends that in order to resolve this problem, the courts should give full effect to the requirements laid down in s. 214 of the Companies Act 2016 dealing with business judgment rule. By doing so, even if a director genuinely believed his/her actions are in the best interests of the company, the court will not refute that assertion by evaluating the commercial value of the act itself. Therefore, it may be noted that a director only enjoys the protection of the business judgment rule if he/she does not have a "material" personal interest in the subject-matter of the business judgment.29 However, the court will look for independent, objective evidence that the director truly held that belief.

As a concluding remark, directors must exercise their corporate powers for the purposes for which they were granted the position of director. This permits the court to invalidate decisions taken by directors where the motivating purpose is one which a court permits as beyond those for which the particular power may legitimately be exercised or if not to benefit the company generally. There is no doubt that in Malaysia the law governing directors' duties consists of various forms of law such as case law, legislation and self-regulation.30 Thus, if a director exercises his/her power for personal profit, he/she has typically acted for an improper purpose and failed to show good faith for the best interests of the company.

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