

## **Reform trends in directors' duties**

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COMPANIES COMMISSION MALAYSIA

A very important part of 'core company law' is the rights and duties of key corporate participants i.e., those who manage or direct the affairs or business of the company on behalf of investors/ shareholders; these directors who have the necessary skill and expertise to steer the company towards long-term sustainability. In Malaysia, as with other common law jurisdictions, the responsibility for managing the affairs the company is placed with the company's board of directors, who have a collective responsibility.

Notwithstanding the existence of market forces which operate to discipline directors, there is still a need for legal controls over directors' conduct. A study of various jurisdictions (commonwealth as well non-commonwealth countries) indicates that there are several approaches or strategies that can be adopted by the law to promote 'accountability' of those who manage the affairs of the company. These approaches, amongst other things, include having in place an effective disclosure regime, ensuring that shareholders can remove errant directors before the completion of their tenure in office, regulating transactions entered into by the company with directors and persons related/connected to the directors, enhancing the shareholders rights to remedy corporate abuses and of course clarifying and reformulating directors duties. It is to be noted that these approaches do not apply in isolation and in most cases are complementary of each other.

One important legal mechanism for ensuring directors' accountability is the imposition of duties on directors. Reform exercises in comparable jurisdictions indicate that there is a similarity of objectives in reforming directors' duties and that is to ensure an appropriate balance between legal rules that ensure directors' accountability and legal rules that may stifle appropriate risk-taking by directors. The following are some of the important areas that should be considered in relation to reforming directors' duties:

### **Widening the scope of directors duty**

In the strategic framework paper, the CLRC stated that its review will consider the interests of shareholders and stakeholders. Shareholders' interests have always been the paramount consideration as far as directors' duties are concerned. However, there is an increasing call for reform in this area of the law where reform exercises in other comparable jurisdictions have resulted in company law legislations that have incorporated provisions which expressly require directors to consider the interest of other stakeholders.

Incorporation of such provisions requires a change in mindset for, traditionally, company law has only been only concerned with the interest of the company's shareholders and to a certain extent with the interest of the company's creditors.

### **Setting out the role and functions of directors**

The current approach adopted by the Companies Act 1965 in respect of the role and functions of the board of directors of a company is that of minimum intervention. 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. For instance, Article 73 of Table A states that the business of the company shall be managed by the directors.

The Malaysian High Level Finance Committee on Corporate Governance, in its recommendations, stated that there should be a statutory clarification of the responsibility of the board to supervise management and there should be a statutory clarification of the minimum functions of the board of directors of public companies.

Reform exercises in comparable jurisdictions indicate that there are two approaches to specifying the board's role and functions.

One approach is to incorporate a provision to that effect in the company legislation. Australia and New Zealand have adopted this approach. Their respective company legislations set out a general statement of the board's role and function and that statement provides that the role and function of the board is to manage or supervise the affairs of the company.

The alternative approach is to set out the role and functions of the board outside the company legislation, for example, by way of a provision in the Articles of Association or by way of the codes of best practises as is practised in the UK.

Clarification of directors' duty of care, skill and diligence and directors fiduciary duties  
Clarification of the law on directors' duties is very much needed to enable the law to keep abreast of changes in the commercial and business environment. In many instances the duties imposed by the law on directors is influenced by standards of conduct that the public expects of directors. Publicity of recent corporate scandals such as Enron, Worldcom, HIH Insurance and Parmalat, to name a few, have raised concerns that the legal rules may not be clear or strict enough to prevent or minimise potential breaches of duties imposed on directors. However, it must also be pointed out in the above mentioned corporate scandals, glaring conflicts of interest situation and mismanagement did not go unpunished.

The Companies Act 1965, amongst other things, incorporates provisions that supplement the common law duties of directors. Hence, statutory law as well as the common law regulate the conduct of directors by imposing on the director a standard of behaviour that the director must comply with.

Legal standards of behaviour must keep abreast with the public's expectation and specifically in respect to standards regulating corporate behaviour. Those standards must also conform to established business practises otherwise the legal standards will not facilitate business.

It is not an easy task to make the legal standards of behaviour conform with established business practises as some business practises may not be so clear cut and can also at times be in conflict with the legal standard of conduct that are imposed on directors. For example it is a common business practise to appoint nominee directors to represent specific interests on the company's board or for a person to be a director in several companies belonging to the same corporate group. However, strict duty requires a director to act only in the interest of the company of which he is a director.

Of particular relevance to directors is the standard of behaviour imposed upon them by sections 132 (1) and 132 (2) of the Companies Act 1965.

Section 132 (1) of the Companies Act 1965 states that a director is to act honestly and use reasonable diligence when carrying out his stewardship function whilst section 132(2) of the Companies Act 1965 provides that an officer of the company shall not use information acquired by virtue of his office to benefit himself or another person.

The question, however, is whether these sections, as currently drafted, assist the company director in appreciating the full extent of the standard of behaviour that is expected of him.

Realising that the above sections may not necessarily do the above has caused the Malaysian High Level Finance Committee on Corporate Governance, in its recommendations in respect to section 132(1), to propose, amongst other things, that:

- section 132 (1) of the Companies Act 1965 be clarified to incorporate the directors obligations of care and skill; as these duties are not even referred to in section 132 (1);
- the duty to act honestly as imposed by section 132 (1) should be rephrased so as to state expressly that directors have a duty to act *bona fide* in the best interest of the company and that directors are also subjected to the duty to exercise powers for a proper purpose.

The first proposal as set out above, is not novel as reform exercises in comparable jurisdictions indicate that there is a trend in doing the same in other countries. The UK Companies Bill 2005 and Australia Corporations Law 2001 incorporate provisions requiring the directors to exercise care whilst carrying out their stewardship function. Further, both also provide the standard of care expected of directors and, in this respect, it should be pointed out that the trend is to impose a mandatory minimum standard of care that is to be exercised by a director with reference to an objective standard of care (care that would be exercised by reasonable person in a given situation).

Again, the second proposal as mentioned above, is not novel as this is also the approach adopted by the UK Companies Bill 2005, the Australian Corporations Law 2001 and the New Zealand Companies Act 1993.

### **Delegation and supervision**

It is a known fact that in larger companies, directors do not actually manage the company but in fact merely carry out a supervisory role. The actual management function is left to others (the managers of the company) and it is these persons who the directors are said to supervise.

Hence, delegating management function to others and relying on others has become the norm in the way directors manage the affairs of the company, especially in respect to large companies.

The question, however, is whether the delegation of functions to others and reliance on others by directors should provide directors with a shield from being made accountable for mismanagement or wrongs committed by the delegate or, in other words, should directors be allowed to pass the buck to the delegate.

Cross jurisdictional studies on corporate law reform in other jurisdictions indicate that there is a trend in making sure that although directors may have the right to delegate and rely on others, directors ultimately should remain accountable for the actions of their delegates, except where the director has exercised due diligence over the delegate.

### **Protection of honest directors**

Promoting the accountability of those who manage the affairs of the company not only means that there must be an imposition of liabilities for breaches of duty but there must also be protection afforded to the honest director.

Cross jurisdictional studies on corporate law reform in other jurisdictions indicate that a common approach used by corporate law in other jurisdictions to encourage proper persons to take up directorship is to extend immunity to those directors who have acted honestly and exercised appropriate standards of due diligence whilst carrying out their stewardship function.

In some countries, this approach has resulted in the enactment of a business judgment rule which provides a safe harbour to such directors.

### **Conclusion**

The above are some of the important issues that permeate the discussion on directors' duties. The task of clarifying and reformulating directors' duties so as to promote accountability is not an easy one but it has to be done so as to ensure that our corporate law framework remains effective and can facilitate businesses.