Group governance – directors with many hats

COMMENT By PHILIP KOH

THE modern corporation has many hydra forms. Complex structures include pyramidal form, chainownership forms (popular in Asia as entrepreneurs leveraged their investments with outsider investors). There could also be network crossholdings with dominant substantial block.

Bob Tricker has observed that there are two distinct options in governance and management structure of conglomerates. One which embraces group self-governance with each company governing itself subject to overall group policies. Alternatively, group-wide governance where entities are treated as divisions or departments of holding company.

Group entities abound and directors find that their roles may intertwine and that while being a director at the holding board level, they may be nominated to hold office in a subsidiary or related company to represent, defend and ensure the interest of the appointer corporation. It is also common that joint venture company have nominee directors which specifically are appointed to ensure that the distinct interest of the joint venture partners are not negated .

The dilemmas confronting a nominee director are acute and complex. At one level, she owes duty to her appointer, but at another, the law holds her accountable to discharge her duties for the interests of the corporation in which she holds office, irrespective of her being an employee of the appointer. The dualities and overlapping duties coalesce especially in contested and questionable transactions.

Nominee directors

The first time it was recognised in legislation was in the Pengurusan Danaharta Nasional Bhd Act 1998, which conferred a right on the special administrator to appoint a person on to the board of a defaulting company to oversee and represent the interest of the special administrator.

Section 132(1E) of the Companies Act 1965 now recognises that there can be a director who has been appointed by virtue of being an employee of a company or as a representative of a shareholder, employer or debenture holder.

It states categorically that a nominee director "shall act in the best interest of the company and in the event of any conflict between his duty to act in the best interest of the company and his duty to his nominator, he shall not subordinate his duty to act in the best interest of the company to his duty to his nominator."

In an earlier version of a consultative bill that led to passage of Companies (Amendment) Act 2007, it was first proposed by the Companies Commission of Malaysia (CCM), a nominee director is to owe an exclusive duty to the company to which he has been appointed. If these wordings had prevailed, nominee directors in Malaysia would have found themselves in an impossible and untenable role. It is laudable that the CCM was sensible, and took into account representations from the marketplace so that the law on nominees is now put on a realistic footing.

In Malaysia, institutions such as Permodalan Nasional Bhd, Khazanah Nasional Bhd and the Employees Provident Fund have many such appointees who act as nominee directors on boards of corporations in which they hold substantial interests.

Directors' discretion

In one early case, Kregor v Hollins (1913), the principle was established that a director cannot fetter his discretion by way of a contract with an outsider. Hollins invested 5,000 and agreed to pay remuneration to Kregor to act as his nominee director. Hollins defaulted in paying and Kregor succeeded in a suit when there was a finding of fact that the agreement did not obligate Kregor to put Hollin's interest above that of the company. Implicit, however, to the finding is that if Kregor was to prefer the interest of Hollins to that of the shareholders and that if there is "conflict that (Kregor) was to promote (Hollin's) interests rather than the interests of the whole body of shareholders which were in conflict," then the agreement will be unlawful.

Joint venture governance

A case involving minority oppression which highlighted the plight of nominee was the Scottish Co-operative Wholesale Society Ltd v Meyer & Ors (1959). The Scottish Co-operative Wholesale (Co-op) with Meyer formed a Joint venture Company (JVC) to manufacture rayon cloth. The Coop is the majority shareholder and had three nominee directors while Meyer and his partner have the expertise to secure license and held the balance of board seats.

When the commercial basis for the JVC ceased as licensing was no longer required the Co-op embarked on corporate actions that effectively transfer the business to another and also by stopping supplies of raw materials to the JVC.

In the telling words of Lord Denning, "So long as the interest of the two companies were in harmony, there is no difficulty. The nominee directors could do their duties to both companies without embarrassment. But so soon as the interests of the two companies were in conflict, the nominee directors were placed in an impossible situation." The passivity of the nominee directors were judicially criticised as "they did nothing to defend the interests of the JVC against the conduct of the Co-op. The House of Lords held that by subordinating the affairs of the JVC to that of the appointer Co-op that the affairs of the JVC has been conducted oppressively and remedies are available to the minority .

What the case illustrates is that matters concerning JVC business must be dealt with at the JVC level in accordance with the laws which the JVC is incorporated. JV partners must resolve matters between themselves through negotiated settlement and if necessary amendment of the JV agreement.

Multiple duties

The Kuwait Asia Bank holds 40% shares in AICS, a NZ company, which was involved in deposit taking from public. Two employees, H and A, of the bank was appointed to be two of five directors of AICS. When AICS went into liquidation NMLN, as trustees of depositors brought action against H and A and also the bank. The Privy Council held that while there is prima facie case against H and A for negligence, a claim against the bank (in absence of bad faith or fraud) failed. H and A owed three separate duties. Firstly to AICS of which they are directors. Secondly H and A owed duties of care to NMLN to ensure that honouring of certificates complied with the terms of trust deed and finally, H and A owed duties to their employer bank to exercise reasonable diligence and skill in their performance of their duties as directors of AICS.

Both in the scope and nature, these are separate and distinct duties. The appointer bank is not responsible for breaches of H and A duties to AICS as any breaches on the facts do not expose the Bank to vicarious liabilities to creditors. It was also held that the bank is not a "shadow director."

Realism & practice

In fact, case law long recognised the amphibious aspect of a nominee director. In the Australian case of Levin v Clark (1962), it was argued that the appointments of a mortgagee-lender, who had appointed two individuals to the board of a mortgagor-borrower were invalid, as they would be acting solely in interests of mortgagee. The judge however rejected this argument, and observed that: "to argue that a director particularly appointed for the purpose of representing the interests of a third party, cannot lawfully act solely in the interests of that party, is in my view to apply the broad principle, governing the fiduciary duty of directors, to a particular situation, where the breadth of fiduciary duty has been narrowed by agreement amongst the body of shareholders."

However in one Malaysian case, it was made clear that a nominee director cannot completely abdicate his duties and seek only to advance the interests of his appointer. In one Malaysian case, the judge (Datuk James Foong J, as he then was) castigated severely the actions of a nominee director as being one which not only did not act in the interests of the company in which he was appointed, but that he completely subordinated that interest to that of his appointer [Industrial Concrete Products Bhd v Concrete Engineering (2001)].

The criticised director was held to account for hiving off the assets of the company to which he was appointed without considering the interest of the company. In such a situation the other members of board have to exercise utmost vigilance and make careful evaluations of proposals placed before the board. If independent advice is needful, seek it out. If minutes do not reflect accurately your dissenting views, insist upon it in writing. Failure to do so can cause unnecessary exposure to even criminal sanctions and penalties.

Treading softly

Nominee directors have to tread carefully, and with prudence and discernment. Information that is price-sensitive in subsidiaries cannot be passed on to their appointers if there is knowledge and intention that it may be used for trading of the securities. This could fall foul of the insider-trading prescriptions of the Capital Markets & Services Act 2007. Any corporate information which may be construable to be pricesensitive has to be handled with discretion. A nominee director risks exposure to liabilities if at any one time, the information is characterised to be a tip for tippee and/or procurement to invest or divest securities. So, a nominee director has to be prudent and ensure that any information supplied during closed period of dealings are not utilised by recipient for investment decisions.

A government-linked company director once shared in a workshop that she handled the dilemma of being accountable to her appointer, Khazanah in a transaction which she as director of the company upon which she is appointed may have an honest opinion that it is in best interest of the company.

However, she made it clear that the decision of Khazanah as shareholders is reserved and will be exercised independently at the EGM convened. This is a defensible position in law as the vote of a shareholder is a recognised property right and is distinct from that of the nominee director who holds agents' duties in multiple and overlapping ways.

RPTs

This is a complex area filled with land mines for the unwary. Firstly there are core provisions of the Companies Act which prohibits and or delineates transactions between a substantial shareholder and by a director. Section 133 A prohibits loans to person connected with directors. Substantial related property transactions (RPTs) cannot be carried out if the value of the undertaking or property exceeds 25% of total assets of the company; or the net profits attributed to the transaction amounts to more than 25% of the net profit if the company or the value exceeds 25% of total issued share capital of the company, whichever is highest. If the company is a listed company, then the prescribed value is now aligned to

that of the Bursa Listing Requirements. Again, it lies on directors to be extra vigilant whenever transactions are proposed that carries a whiff of RPTs. Listed company directors must ensure compliance with chapter 10 of the Listing Requirements.

How many hats can you wear?

Bob Tricker (2009) cited Lord Caldecote's (Chair of Delta Metal) advice to executive directors in words which all directors may give heed to. "Executive directors have two hats the hat of the executive and the hat of the director. When you come into my board room, I want you to be wearing your director's hat. Each director is equally responsible with me for directing the company. You are not there to represent your function or your divisional company. Nor are you there to defend your executive performance or bid for resources for your executive activities. You are there to help me govern the company overall."

Wise words. Directors must give heed to those words. The possibility of missing one's head and wearing the wrong hat will be obviated.

Philip Koh is a senior partner at Messrs Mah-Kamariah & Philip Koh, Advocates and Solicitors. This is the second of a 3-part series which examines the dilemmas confronting nominee directors.