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Corporate Governance Mitigates Board's Conflict of Interest and Corporate Fraud

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Abstract

Boards of directors are one of the centerpieces of corporate governance. Corporate governance commonly explained the way in which a company is managed by the board of directors, scrutinized and held accountable. The governance of companies has been the subject of increasing interest following the East Asian financial crisis in 1997. Central to this governance mechanism is the board of directors. Concerns have been expressed on the levels of responsibility, accountability and transparency of the board in managing the company. Good corporate governance requires a range of regulatory checks and balances or mechanisms so as to be effective. If one mechanism fails, the system will fail like a chain with a weak link. The objective of this paper is to offer solution(s) and explain briefly of the mechanism in order to have a good corporate governance system for the board of directors to mitigate issues on conflict of interests and corporate fraud. It is of particular relevance since 2001, the collapsed of major corporations around the world trigged the concerned on the potential for corporate fraud especially financial statement fraud.

Keywords: Corporate governance, board of directors, conflict of interests, corporate fraud

1. INTRODUCTION

The practice of good corporate governance encourage investors confidence, promote competitiveness and also contributes to the nation's economic growth. It is evidence that board of directors are a key group in the study of corporate governance because of their management duties and responsibilities in the company. Central to this governance mechanism is the board of directors. Concerns have been expressed on the levels of responsibility, accountability and transparency of the board in managing the company. Good corporate governance requires a range of regulatory checks and balances or mechanisms so as to be effective. If one mechanism fails, the system will fail like a chain with a weak link. Corporate governance mechanisms have the purpose of monitoring the management of corporation so as to result in more effective management. Good corporate governance is a corporate set up that leads to maximize the value of shareholders legally, ethically and on a sustainable basis, while ensuring equity and transparency to every stakeholder: the company's customers, employees, investors, vendor-partners, the government and the community.

Governance, be it in a country or in a team will generate conflicts of interest and hence it requires the development of relationships and contracts among the different actors implicated. Agency theory accounts have dominated the corporate governance literature in which the agency theory (Fama & Jensen 1983) of the firm suggests that when individual engage in firm relationships they are utility maximizers, self-seeking and opportunistic and therefore, the governance system must introduce mechanisms that will align the interests of principals (owners) with those of their agents (the managers). Property rights theory (Alchian, & Demsetz.

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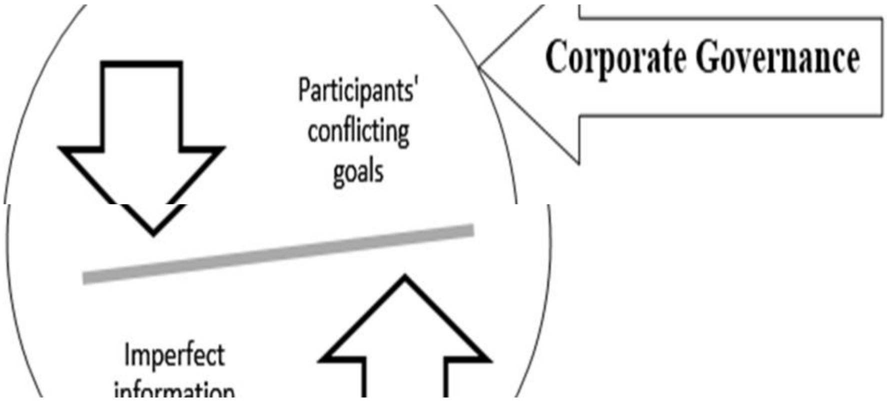
1972) complements the principal-agent relationship by recognizing that explicit contracts between the different actors in the firm and the distribution of firm value do not always capture the complexity of corporate governance as contracts can be implicit and incomplete.

Potential conflicts of interest among participants (stakeholders) in the corporate structure create the need for corporate governance in a corporate setting. Imam and Malik (Imam & Malik 2007) identified two major causes behind this conflicts.



Firstly, difference in the participants' preferences and goals. Secondly, lack of perfect information among participants about each other's knowledge, actions and preferences. Jensen and Meckling (1976) addressed these conflicts by examining the separation of corporate ownership from corporate management. They claims that this separation provides executives with the ability to act in their own self-interest rather than in the interests of shareholders in absence of other corporate governance mechanisms.

2. GOVERNANCE AND BOARD OF DIRECTORS

The Malaysian corporate structure is noted for her concentrated ownership shareholding. Concentrated ownership illustrates that not only in the concentration of control but also the concentration of control over financial assets and productive capacity of the economy. This concentrated corporate structure characterized by widespread presence of the family group and the State. The 1999 survey conducted by *Classens et al* (2004) found that in Malaysia, the top 10 families control about 25% of the total market capitalization. The majority of the public listed companies in Malaysia are family-controlled, followed by significant state control. About 85% of public listed companies in Malaysia are owner managed where the post of Chief Executive Officer (CEO), Chairman or Vice-Chairman has been filled by a member of the controlling family or an employee drawn from the ranks of the controlling shareholders (Rachagan et.al.2013). Hence, the nominee directorships are common in the concentrated ownership in Malaysian corporate structure. The term nominee director is often used to describe a person who has been appointed as a director to represent the interests of a particular group of shareholders or class of shareholders. Under other circumstances, the appointment of the nominee director is to represent the interests of a group of employees, a lender or debenture holder or a participant in a corporate joint venture. However, the nominee director differs from a "normal" director in the sense that nominee directors were appointed at the behest of a third party rather than the company they serve. These directors may also be appointed by those holding a significant share interest in the company who had been given a contractual right (Cumbrian Newspapers Group Ltd) an expectation (John de Lacy, 2006) or a right conferred by the company's articles (Cumbrian Newspapers Group) to appoint a director to the board (John de Lacy, 2006). A nominee director is a director who has been appointed specifically to represent and protect the interests of some outside party (Ben Pettet, 2005), perhaps a venture capital company which has agreed to lend or subscribe capital only on condition that it can 'keep an eye' on the company by having its nominee on the board. While the phrase 'nominee director' has no legal definition, the term 'nominee director' is accepted as referring to individuals who are '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'. A nominee director is at law, a de jure director (Keay, 2007). Keay states that companies might have nominee directors, who are de jure directors owing their appointment due to some third person, often a member or members of the company who hold a strong position in relation to company affairs. This arrangement must be permitted by the articles of association. Ahern (Ahern, 2011) opined that a nominee director is simply a species of the de jure director. However, the nominee director differs from a "normal" director in the sense that nominee directors were appointed at the behest of a third party rather than the company they serve. These directors may also be appointed by those holding a significant share interest in the company who had been given a contractual right (Cumbrian Newspapers Group Ltd, 1987), an expectation (John de Lacy, 2006) or a right conferred by the company's articles (Cumbrian Newspapers Group,1987) to appoint a director to the board (John de Lacy,2006). A nominee director is a director who has been appointed specifically to represent and protect the interests of some outside party (Ben Pettet,2005), perhaps a venture capital company which has agreed to lend or subscribe capital only on condition that it can 'keep an eye' on the company by having its nominee on the board.

3. NOMINEE DIRECTORS IN THE VARIOUS CORPORATE STRUCTURE

3.1 Nominee directors in Listed Public Companies, Listed Subsidiary and Associated Companies

The nominator will often be a significant shareholder of the listed public companies or the listed companies are subsidiaries. The right of appointment may arise from mere agreement of the board in recognition of that shareholding or it may be contractually based. In exceptional circumstances, it may be provided for in the articles of association of the company. The nominee director will usually be a representative nominee director although any additional nominee director may well be an independent nominee director to satisfy sensitivities. In the words of one commentator (Lishman, 2010) as a matter of commercial reality, directors are appointed to the board to represent a particular shareholder. For listed companies, this often occurs where the listed company is either a subsidiary or has a significant shareholder who seeks representatives on the company's board and directors are appointed to the board to represent a particular shareholder.

3.2 Wholly Owned Subsidiaries and Partly Owned Subsidiaries

The boards of such companies will mostly comprise of representative directors but not in its entirety. Non-executive independent nominee directors are often appointed to wholly own subsidiary boards to provide an external perspective to the business of the company. In these companies, there will usually be representative nominee directors, independent nominee directors, directors who are senior managers of the company and independent directors representing the minorities.

3.3 Joint Venture Companies

A joint venture company is essentially the adoption of the corporate form, rather than an incorporated joint venture, a trust or partnership for the pursuit by a small number of parties (usually 2 or 3) of a common business enterprise. The company will normally be constrained by its Memorandum and Articles or shareholders' agreement to a single enterprise or purpose.

Appointment of directors by each participating party will normally be the means by which that party protects its own interests. As such, such appointees are representative directors who act as spokespersons for and carry out their duties, solely in the interests of the nominator. The articles may expressly empower the participating parties to remove and replace their appointees on the board.

3.4 Venture Capital Investments

In the venture capital process, the venture capitalists will often "wear two hats" – one as a director, the other as a shareholder, and will owe fiduciary duties in both these capacities. The venture capitalist may have the interests of the venture capital fund represented through the appointment of a director. In a small company, it is not unusual for the majority shareholder to have the power to appoint directors (Santos Ltd v Pettingell, 1979). However, in the venture capital setting, it is considered the norm. The terms of appointment for a director may be set out in the shareholders' agreement (Ford et al, 2005) or may be conferred by the constitution, which may make provisions for outsiders to appoint directors (Woodlands Ltd v Logan, 1948). The appointment of a nominee director raises an inherent possibility of conflict with the recognized fiduciary and statutory duty of directors to act in good faith in the interests of the company as a whole (Australian Corporations Act 2001). Conflict arises because the nominee director will owe simultaneous duties to the portfolio firm and the venture capitalist.

3.5 Government-Linked Companies (GLCs)

The nominee directors of GLCs are often appointed to the board of directors of a company as the representative director of the government. The articles of association of the company may accord the right to the government to appoint its representative. This is to protect public investment in the entity or to ensure adherence to some public policy which the entity is capable of affecting.

The recently launched Malaysian Green Book, Setting the Guidelines for GLC Boards (Putrajaya, 2006) provides that "there must be a balance in the Board between Independent Directors, representation from management and representation from major shareholders. However, significant shareholders should also be adequately represented – usually in proportion to the size of their investment – via nominee directors". In government-linked companies, for example, Malaysian government-linked companies (GLC), the government representative by way of her representative, that is the nominee director, will hold the shareholdings termed as the 'Special Share'. As in the example of the Memorandum and Articles of Association of a local company, Malaysian Airline System Berhad, states that:

> Article 5 (1) The Special Share may be held only by or transferred only to the Minister of Finance (Incorporated) or its successors or any Minister, representative or any person acting on behalf of the government of Malaysia.
>
> Article 5(2) Subject to Article 2(2) of these Articles, the Special Shareholder shall have the right from time to time to appoint or nominate in accordance with Article 119 of these Articles, three (3) government appointed directors and to appoint one of them to be the Chairman in accordance with Article 144.
>
> Article 119(1) The Special Shareholder shall have the right from time to time:-
>
> (a) To appoint any person; or
> (b) To nominate any existing director (with the consent of the Director concerned) to be a government appointed director so that there shall not be more than three (3) government appointed directors at any time comprising:
> (i) The Chairman; and
> (ii) Two representatives of the government;

Other examples of Malaysian GLCs such as the telecommunications company, Telekom Malaysia Berhad (TMB), vide the provision of Article 2 of the company's Article of Association stipulates that the designation 'Special Shareholder' denotes the Minister of Finance, a body corporate established under the Minister of Finance (Incorporation) Act, 1957, its successor or any Minister, representative or any other person acting on behalf of the government of Malaysia in the holding of the Special Share. The 'Special Shares' denote the one Special Rights Redeemable Preference Share of RM1.00 only. By virtue of the following Articles 4 (TMB), 5, 8(1) through (5), 109 the government representative or the nominee director of this company indicates that his or her powers are extensive. It is submitted that these powers are conferred on to the nominee directors as the controlling shareholder. Koh submitted that, "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".

4. SOLUTIONS UNDER THE COMPAIES ACT 2016

The law in Malaysia is now clear. Section 217(1) CA 2016 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 short, nominee directors have to tread carefully with prudence and discernment. Information about subsidiaries that is price-sensitive cannot be passed on to their appointers if there is knowledge and intention that it may be used for trading of the securities. For now, the unbearable lightness of being a nominee director carries with it burdens that require vigilance and judgment.

Balan et al (2008) too of the view that s.132(1E) CA 1965 lists the categories of nominee directors. This list is wide enough to cover the usual kind of nominee director. The duty imposed by the new provision is similar to the duty under the common law. A point to note is that the new provision makes no exception. The strict rule seemingly applies even in the case of the director of a wholly owned subsidiary. However a possible but limited escape route is the wording of the section which is that a nominee director "shall not subordinate his duty to act in the best interest of the company to his duty to his nominator". Thus it is arguable that he may, act in the interest of his nominator provided that his act also advances the interest of the company or does not conflict with his duty to the company.

Lee (2008) state that the position of nominee director in Malaysia is that the phrase 'shall not subordinate his duty' under Section 132(1E) CA 1965 is worded in the negative. Therefore, as a final result, the company's best interest will prevail over the interest of the nominator.

These commentators have agreed that (Koh, Balan, Balan Balan, Salim, 2008) s.132 (1E) CA 1965 place the position of nominee directors in Malaysia as illustrative of the strict or the traditional approach. The strict or traditional approach requires the nominee directors only to consider the best interests of the company and shall not subordinate his duty to act in the best interests of the company to his duty to his nominator. This strict or traditional approach has been discussed above as in the case of Industrial Concrete Products Bhd v Concrete Engineering Products Bhd.

However, taking into consideration the concentration in Malaysian corporate economy (Lim Mah Hui,1983) and the joint venture company or incorporated joint venture is a common form of corporate entity in Malaysia (Salim, (2007) the adjusted fiduciary duty approach could be adopted in Malaysia because it would be applicable to a corporate group structure and to joint venture companies. In the Malaysian corporate set-up it is not uncommon for family-based enterprises and government corporatised bodies to have a legitimate interest in maintaining nominee directors to oversee their interests (Koh, 2007).

5. CONCLUSION

Nominee directorships are commonly found on the board of directors of companies to represent the sectional interests of their appointors and do not by reason of their nominee status infringe their fiduciary duties of undivided loyalty. In qouting Auyeung's (Auyeung 2004) words, "a nominee director's duty to either the company or the appointor is not static – the degree of the respective obligations varies depending on the circumstances of each particular deliberation undertaken by the board and the terms of the appointment of the nominee director." It is submitted that so long as there is no conflict between the interests of the appointor and those of the company, the nominee director shall not breach the fiduciary duty. The dual loyalty has been acknowledged by the judiciary, however, the conflict of this dual loyalty that causes the primary difficulty.

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For example, it is common practice for a person who holds 10% of the shares in a listed Plc to be offered the opportunity to appoint a director, this being a reflection of the importance attached to such a relatively large shareholding. In John de Lacy, "The Concept of a Company Director: Time for a New Expanded and Unified Statutory Concept?" [2006] Journal of Business Law, p.284

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TMB's Articles of Association, Article 4: Subject to Article 5 below, no person other than an Entitled Person shall be qualified to hold office as a Director, chief executive officer of the Company (by whatever name called), Secretary or Auditor of the Company. TMB's Articles of Association, Article 4: Subject to Article 5 below, no person other than an Entitled Person shall be qualified to hold office as a Director, chief executive officer of the Company (by whatever name called), Secretary or Auditor of the Company.

Article 5: No person not being an Entitled Person may be appointed to hold office as a Director of the company without the prior written consent of the Special Shareholder.

Article 8

(1) The Special Share may only be held by or transferred to the Special Shareholder.
(2) The Special Shareholder shall have the right from time to time to appoint any Entitled Persons to be Directors, (hereinafter referred to as "Appointed Directors") so that there shall not be less than 2 nor more than 6 Appointed Directors at any time.
(3) Except as expressly provided for in these Articles, the Special Share does not confer any other rights to the Special Shareholder.
(4) The Special Shareholder shall be entitled to received notice of and to attend and speak at all general meetings or any other meeting of any class of shareholders of the Company, but the Special Share shall carry no right to vote nor any other rights at any such meeting.
(5) The Special Shareholder may, subject to the Act require the Company to redeem the Special Share at par at any time by serving written notice upon the Company and delivering the relevant share certificate. In a distribution of capital in a winding up of the Company, the Special Shareholder shall be entitled to repayment of capital to any other member. The Special Share shall confer no other right to participate in the capital or profits of the Company.

Article 109: The Special Shareholder may from time to time, appoint one or more Directors to be executive director(s) of the Company, for such period and upon such terms as he may think fit but if the appointment is for a fixed term the term shall not exceed 5 years and may from time to time (subject to the provision) remove or dismiss him or them from office and appoint another or others in his or their place or places. The executive director(s) may be conferred such other designation(s) as may be determined by the Special Shareholder.