# NAVIGATING THE DIRECTORS' DUTY TO ACT IN THE BEST INTEREST OF THE COMPANY: THE PETRA PERDANA DECISION AND THE COMPANIES ACT 2016*

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## INTRODUCTION

This paper analyses the Federal Court's decision in *Tengku Dato' Ibrahim Petra bin Tengku Indra Petra v Petra Perdana Bhd* [2018] 2 MLJ 177 ("**Federal Court Decision**") in setting out, among others, the test for directors to act in the best interest of the company. The Federal Court Decision was decided under the Companies Act 1965 ("**CA 1965**"). Presently, the Federal Court Decision will also have to be seen in light of the new section 195 of the Companies Act 2016 ("**CA 2016**"). This section provides for the members' right of management review on decisions made by the board of directors.

## THE PETRA PERDANA DECISION

The Federal Court Decision relates to two appeals which emanated from a High Court action relating to questions in company law on governance and management of a company as between its directors and shareholders in general meetings. In particular, it gives guidance on the division of powers between the shareholders and directors on managing the affairs of a company and sets out the test to be adopted in determining whether a director has acted in the best interest of the company.

## BRIEF FACTS

The plaintiff, Petra Perdana Berhad ("**PPB**"), owned 126 million ordinary shares in Petra Energy Berhad ("**PEB**"), amounting to approximately 64.62% of the issued and paid up capital of PEB. At all material times, the three defendants were directors of PPB.

In April 2007, an ordinary resolution was passed and a general mandate was given to PPB to, among others, divest up to 19.5 million of its shares in PEB ("**Shareholders' Divestment Mandate**"). On or about 10 December 2007, PPB divested 9 million of its PEB shares (which represented approximately 4.62% equity stake in PEB), thereby reducing PPB's holding in

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PEB from 64.62% to 60%. The Shareholders' Divestment Mandate was renewed on an annual basis.

Subsequently, there were payment demands by a ship builder in respect of the balance purchase price of a vessel. PPB's board of directors resolved in August 2009 to sell 10.5 million PEB shares (5.38% equity stake in PEB) ("**August Board Mandate**"). Pursuant to the August Board Mandate, PPB divested 10.5 million PEB shares on 10 September 2009, reducing its stake in PEB from 60% to 54.62% ("**Second Divestment**").

By November 2009, PPB was facing serious financial difficulties and cash flow problems. After considering various fundraising options, PPB's board of directors resolved to divest PPB's remaining 54.62% shareholding in PEB ("**November Board Mandate**"). Pursuant to the November Board Mandate, PPB sold 48.8 million PEB shares (25.03% equity stake in PEB) to Shorefield Resources Sdn Bhd ("**Shorefield**"), resulting in Shorefield becoming the controlling shareholder of PEB ("**Third Divestment**"). The proceeds of the disposal obtained from the Third Divestment were utilised to pare down bank borrowings and the gearing ratio of PPB's group of companies. The Third Divestment also resulted in a gain of approximately RM13.7 million for PPB's group of companies.

During the board of directors' meeting on 22 December 2009, the PPB board deliberated on the divestment of the remaining 29.59% shareholding in PEB pursuant to the November Board Mandate ("**Intended Fourth Divestment**"). The Intended Fourth Divestment did not take place as an injunction was obtained in the High Court by one of PPB's directors to restrain the sale of the shares.

This led to a corporate power struggle dispute within PPB and resulted in the defendants being removed as directors of PPB at an Extraordinary General Meeting on 4 February 2010.

**DECISION OF THE HIGH COURT**

With a new management in place, PPB commenced an action in the High Court against the defendants on the basis, among others, that, in causing PPB to undertake the Second Divestment and Third Divestment:

(i) the defendants had acted in breach of their statutory duties under section 132(1) of CA 1965
(ii) the second and third defendants dishonestly assisted the first defendant in the various breaches of duty and were accessories thereto;
(iii) the defendants and the fourth defendant (who was at the material time an executive director of PEB) conspired, whether by lawful or unlawful means, to injure PPB vide the Second Divestment and Third Divestment; and
(iv) the defendants in breach of their fiduciary, statutory or common law duties, failed to act in the best interest of PPB.

The defendants argued that the Second Divestment and Third Divestment were undertaken due to urgent cash flow problems caused by a downturn in PPB's business. On the other hand, it was PPB's contention that the cash flow problems were not genuine and that the defendants' ulterior motive was to dispose of PEB to Shorefield under a conspiracy contrived by the defendants to enable Shorefield to become the controlling shareholder of PEB.

The High Court's decision in *Petra Perdana Bhd v Tengku Dato' Ibrahim Petra bin Tengku Indra Petra & Ors* [2014] 11 MLJ 1 ("**the High Court Decision**") was in favour of the defendants. The High Court held that, at all times, the decisions by the defendants to undertake the Second Divestment and Third Divestment were business judgments made in good faith after exercising due care and diligence. Further, the High Court found that the defendants did not breach their fiduciary duties to PPB.

**DECISION OF THE COURT OF APPEAL**

PPB's appeal to the Court of Appeal was allowed. The Court of Appeal decision in *Tengku Dato' Ibrahim Petra Tengku Indra Petra v Petra Perdana Bhd & another appeal* [2018] 2 CLJ 641 ("**the Court of Appeal Decision**") focused on determining whether the defendants had acted in the best interest of PPB and found that the proposition "*best interest of the company*" was for the majority of shareholders to decide.

In particular, the Court of Appeal found that the Shareholders' Divestment Mandate provided a barometer as to what the shareholders gauged as being the best interest of PPB[1]. In this regard, it was held that in failing to comply with the restrictions of the Shareholders' Divestment Mandate, the defendants had failed to act in the best interest of PPB.

Secondly, the Court of Appeal held that a shareholders' resolution carried at a general meeting of company amounted to "*regulations*" pursuant to the articles of association of a company by which the defendants were obligated to comply with[2]. Further, it was held that shareholders by a majority could decide what was in the best interest of a company.

**DECISION OF THE FEDERAL COURT**

Eighteen questions of law were posed to the Federal Court, seven of which the apex court found unnecessary to answer. This paper will focus on the main issues discussed in the Federal Court decision.

*Division of powers*

One of the main issues was the division of powers between the shareholders in a general meeting and the board of directors. The question posed to the Federal Court was whether the

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[1] [22] of the Court of Appeal Decision.

[2] [25] of the Court of Appeal Decision.

powers of management conferred on directors by CA 1965 and the articles of association could be overridden by an ordinary resolution passed by a simple majority of shareholders at a general meeting. In other words, whether the Shareholders' Divestment Mandate could override the powers of the directors to divest the PEB shares held by PPB.

The Federal Court answered the question in the negative, holding that shareholders may *only* override the powers of the directors by altering the articles to take away the powers of the directors, or, by refusing to re-elect the directors of whose actions they disapprove[3].

Statutory force to this legal position can be found in section 131B of CA 1965 which provides that "*the business and affairs of a company must be managed by, or under the direction of, the board of directors",* subject to *"any modification, exception or limitation contained in the Act or in the memorandum or articles of association of the company."*

Furthermore, the articles of association of PPB had set out that the business affairs of PPB shall be managed by the directors with the exception, *inter alia*, that the directors' exercise of powers were subject to "*these regulations*" and CA 1965. The Federal Court (in upholding the High Court Decision) held that the reference to "*regulations*" means regulations as envisaged under CA 1965 and not resolutions passed at a general meeting such as the Shareholders' Divestment Mandate, and as such, the directors were not bound to comply with the Shareholders' Divestment Mandate to divest only up to 19.5 million shares in PEB. In other words, the Divestment Mandate did not deprive the defendants of their power to deal with the PEB shares in accordance with CA 1965 and the articles of association[4].

*Test for breach of duty to act in the best interest*

Another main issue here was the test to be applied in determining whether a director had acted in the "*best interest of the company*". The Federal Court held that the test to be applied is a combination of both a subjective element and an objective element[5].

*Subjective element*

The breach of a director's duty is determined based on an assessment of the state of mind of the director, i.e. whether the director (and not the court) considers that the exercise of discretion is in the best interest of the company. The director is under a duty to act in what he believes to be the best interest of the company[6].

*Objective test*

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[3] [120] and [133] of the Federal Court Decision.
[4] [142] to [148] of the Federal Court Decision.
[5] [166] of the Federal Court Decision.
[6] [166] of the Federal Court Decision.

However, the director's assessment of the company's best interest is subject also to an objective review or examination by the courts. The Federal Court adopted the test laid down by the Court of Appeal in *Pioneer Haven Sdn Bhd v Ho Hup Construction Co Bhd & Anor* [2012] 3 MLJ 616 which in turn had adopted the principles in *Charterbridge Corporation Ltd v Lloyds Bank Ltd* [1970] Ch 62[7]. The test is 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*."

On the facts, the Federal Court decided that the Second Divestment was carried out in view of the urgency of the cash flow problems faced by PPB. As such, it was justifiable to sell the shares at a depressed price. In respect of the Third Divestment, similarly, the Federal Court found that the defendants had carried out the same as they were advised that the cash flow problem faced by PBB for the following 12 months would deteriorate and PPB would face serious liquidity problems.

Applying the tests above, the Federal Court concluded that an honest and intelligent man in the position of the defendants would reasonably have concluded that the Second Divestment and the Third Divestment were necessary in the best interest of PPB. As such, the defendants had acted in good faith and in the best interest of PPB[8].

*Business judgment rule*

Briefly, the business judgment rule anticipates that in the absence of fraud, breach of fiduciary duty and conspiracy, a court should not undertake the exercise of assessing the merits of a commercial or business judgment made by the directors of a company, especially with the benefit of hindsight. This is necessary to preserve the directors' discretion and to protect them from the court's interference.

This rule was encapsulated in section 132(1B) of CA 1965 (now section 214 of CA 2016). It states that a director who makes a business judgment is deemed to meet the requirements of his statutory duty to exercise reasonable care, skill and diligence and the equivalent duties under the common law and in equity if he (i) makes the business judgment in good faith and for a proper purpose; (ii) has no material personal interest in the subject matter of the business judgment; (iii) is informed about the subject matter of the business judgment to the extent that he reasonably believes to be appropriate in the circumstances; and (iv) reasonably believes that the business judgment is in the best interest of the company.

This rule has been applied by the courts consistently (see: *Howard Smith v Ampol Petroleum Ltd* [1974] AC 821; *Vita Health Laboratories Pte Ltd and others v Pang Seng Meng* [2004] 4 SLR (R) 162; *Intraco Ltd v Multi-Pak Singapore Pte Ltd* [1995] 1 SLR 313).

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[7] [173] of the Federal Court Decision.

[8] [180] of the Federal Court Decision.

The Federal Court held that the decisions to undertake the Second Divestment and the Third Divestment were business judgments made for a legitimate purpose by the defendants who had acted in good faith and in the best interest of PPB. As such, there was no basis for the court to substitute its own decision with that of the defendants[9]. Having made the above findings, the Federal Court set aside the orders of the Court of Appeal and reinstated the orders of the High Court.

*Distinction in duties owed by non-executive directors and executive directors*

One of the questions posed to the Federal Court was "*whether a distinction should be drawn between executive directors and non-executive directors in circumstance where non-executive directors have limited management functions and played a limited role in executing the impugned decisions made collectively by the board of directors*".

This question followed the High Court's decision that the two non-executive directors were entitled to rely on the operational forecasts, financial data and information provided to them by PPB's management as they had less direct knowledge of the day to day operations and finances of PPB than that of the executive director[10]. The Federal Court declined to answer this question given that its answers to the other questions posed were sufficient to dispose of the matter. We will have to wait for another case on this.

**OTHER PRACTICAL TAKEAWAYS FROM THE PETRA PERDANA DECISION**

Aside from the points of law, the Petra Perdana case also highlighted some useful practical examples. These examples flesh out how directors can adopt practices to demonstrate that they are complying with their duties. I draw on certain facts highlighted in the High Court Decision and in the Federal Court Decision.

*Minutes of meetings: Strength of contemporaneous documents*

The Federal Court noted the "*compelling*" evidence of all the contemporaneous documents, in particular, the minutes of the board meetings[11]. These minutes showed how all members of the board had collectively and unanimously decided on the sale of the PEB shares.

As the High Court trial judge pointed out, when assessing the directors' purpose or rationale in making a decision, the court will consider the full chronology of events. The court found the most useful available and objective evidence would be the minutes of the board meetings during that period. The minutes of meetings relied upon were all confirmed as correct by the chairman and the rest of the directors. The minutes would provide an accurate and

[9] [191] of the Federal Court Decision.

[10] [377] of the High Court Decision.

[11] [61] and [62] of the Federal Court Decision.

contemporaneous record of the state of mind of the directors, the rationale for their decisions and their acts and omissions. It also offers an insight into the running and management of the plaintiff including the part played by senior management personnel[12].

Hence, it may be good practice for minutes of board meetings to capture in greater detail what was discussed by the directors and the rationale for the decision. This is in contrast with merely having skeletal minutes noting that a decision was made. This is more so when the directors are embarking into potentially contentious territory. Like in the *Petra Perdana* case, the directors may be faced with the situation of an urgent need to sell certain assets, there may be aggrieved shareholders or media scrutiny.

Another example is also seen in the High Court Decision. It was noted that after one of the extraordinary general meetings held in November 2009, one of the directors asked that the minutes of that general meeting be amended to record down the questions and answers recorded during that general meeting[13]. The company secretary then explained that it is the general practice for minutes of general meetings to be recorded in the conclusive rather than in the narrative form, and that had been the practice for years. But the director was adamant in ensuring the full questions and answers be reflected in the minutes. In the end, these minutes and the subsequent minutes became crucial parts of the contemporaneous record of the sequence of events.

*Tape recording of a contentious meeting*

In this dispute, there was one particular crucial board meeting of 18 November 2011. This was a board meeting where the directors agreed to make the Second Divestment of the PEB shares. Audio recordings had been made of several of the board meetings and the recordings had been admitted into evidence at the High Court trial.

The High Court trial judge listened to the more than 2-hour long audio recording of this particular board meeting[14]. The judge found the recording to be "*of considerable and significant use.*" It afforded an objective and honest depiction of the manner in which the decision to dispose of the PEB shares was arrived at. This is especially where the recording contradicted the evidence subsequently put forward by one of the other directors.

Having audio recordings and retaining such recordings are usually not common company practice. But where there is the possibility of disputes among the directors, or the among shareholders, such audio recordings of important board meetings or shareholders' meetings can be crucial. This is especially where there are disputes on the accuracy of subsequent minutes of that meeting.

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[12] [37] of the High Court Decision.

[13] [104] of the High Court Decision.

[14] [106] of the High Court Decision.

*Company management's advice to the directors*

The Federal Court also noted that the High Court had taken into account the role played by the company's senior management[15]. The High Court judge noted that the manner of operations and day to day running of the company required significant input from two key senior management personnel[16]. The board operated on the basis of factual data and information provided by these two personnel. There was no reason for any member of the board to doubt the veracity of the presentations by the personnel. These presentations show the cash flow problem that the company faced.

Further, the High Court judge accepted the evidence of one of the non-executive directors that he relied entirely on the data and information provided by the company's management. He had no reason to doubt the accuracy of the information provided to the board. He would have verified matters personally only if he doubted the information presented by the management[17].

*External advice to the directors*

The High Court and the Federal Court gave weight to the fact that the directors had made an assessment of the professional external advice they had obtained. The directors had obtained the following: a legal opinion, professional advice from Affin Investment Bank on the methods to raise funds to alleviate the company's financial difficulties, and professional advice from TA Securities Holdings Bhd.

The directors were advised by these professional advisers and were entitled to rely on their advice.

**MANAGEMENT REVIEW**

As recognised by the Federal Court, shareholders in general meetings generally may not control the powers of management of the directors. The shareholders can only do so by altering the articles of association, or now known as the constitution, or by refusing to re-elect the directors whose actions they disapprove of. Hence, there is a division of powers between the board of directors and the shareholders in general meeting.

Section 195(3) of CA 2016 does disrupt this conventional division of powers. However, as a general overview, section 195 of CA 2016 is titled members' right for management review. There are three tiers contained within section 195 of CA 2016.

*Chairperson to allow reasonable opportunity*

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[15] [72] of the Federal Court Decision.

[16] [104] of the High Court Decision.

[17] [277] of the High Court Decision.

The first tier under section 195(1) of CA 2016 makes it mandatory for the chairperson of a meeting of members to allow for a reasonable opportunity for members to question, discuss, comment or make recommendations on the management of the company. So for example, this would apply for the annual general meeting of a public company where there must be such a reasonable opportunity provided to the shareholders.

*Meeting of members may pass a resolution to make recommendations*

The second tier under section 195(2) of CA 2016 provides that a meeting of members may pass a resolution that makes recommendations to the board of directors on matters affecting the management of the company. Under this second tier, these are only recommendations and are not binding on the board of directors. In this sense, it does not disrupt the division of powers between the board of directors and shareholders. This second tier does promote shareholder activism and allows for a mechanism for the shareholders to express their views and recommendations on management matters.

Nonetheless, in order to utilise section 195(2) of CA 2016, the shareholders would have to likely requisition or convene a meeting of members to allow for them to table a resolution to make such a recommendation to the board of directors.

*A binding recommendation on management matters*

The third tier is in section 195(3) of CA 2016. Section 195(3) makes clear that the recommendation made under section 195(2) of CA 2016 will not be binding on the board of directors. However, the recommendation can be binding if it is in the best interest of the company and either (a) the rights to make recommendations is provided for in the company's constitution; or (b) the resolution is passed as a special resolution.

In particular, section 195(3)(b) of CA 2016 is similar to the wording of Article 70 of the Table A articles of association of the UK Companies Act 1985. This Article 70 provided that "Subject to the provisions of the Act, the memorandum and the articles *and to any directions given by special resolution*, the business of the company shall be managed by the directors who may exercise all the powers of the company." This allowed shareholders to pass a special resolution to provide such directions that appears to bind the directors in managing the business of the company.

However, this Article 70 could always be removed from the company's articles of association or constitution. In contrast, section 195(3) of CA 2016 presents two potential difficulties. The first is that section 195(3)(b) of CA 2016 is a mandatory statutory provision that allows for the special resolution to be binding on the board of directors. The second is that this must still be deemed to be in the best interest of the company. It is difficult at this stage to determine what is the test for the best interest of the company. There could be the following two arguments.

The first argument is that it is for the directors to decide what is in the best interest of the company. Section 195(3) of CA 2016 then must apply both the objective and subjective test of what the directors deemed to be in the best interest of the company. The second argument may be that it is for the shareholders to determine what is in the best of the company.

It remains to be seen how section 195 of CA 2016 will be applied in practice here in Malaysia. It may be more likely for shareholders to express their displeasure by voting on an ordinary resolution to remove the directors on the board instead of having to pass a special resolution under section 195(3)(b) of CA 2016.

**CONCLUSION**

The Federal Court Decision has provided much clarity to the law in respect of the governance and management of a company. It affirmed the clear division between the powers of the directors and shareholders in managing the affairs of a company. The case further establishes the appropriate test to be applied in determining whether a director had acted in the best interest of the company, and the application of the business judgment rule in decisions made by directors. Nonetheless, there may be disruptions in the future of such a division of powers when applying section 195 of CA 2016.