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AGENCY COSTS IN CONTROLLED COMPANIES

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Agency costs have become one of the significant issues in the protection of minority shareholders particularly in controlled companies. The obvious advantage of a controlling shareholder lies in the fact that the controlling shareholder's interest is aligned to that of the non-controlling shareholder. However the concern with controlled companies is that there may be "private benefits of control" which is usually taken to mean as including everything controlling shareholders are able to get out of their position without minority shareholders receiving a proportionate share. There is persistent danger that controlling shareholders will transfer company's resources to themselves. This article will deliberate the reasons why we need to extend protection to minority shareholders. The article will then examine the nature and extent of the agency problems faced by minority shareholders in controlled public companies in Malaysia. The article will achieve this objective by discussing the various strategies available to overcome agency costs arising from the relationship of controlling shareholders and minority shareholders. The article will also discuss the application of the strategies to overcome agency problems in Malaysia. The article will conclude that to entrench a culture of sound corporate governance in Malaysia requires more than just changes to laws and regulations, it requires the introduction of a self-enforcing model.

I. Introduction

Agency costs have become one of the most significant issues in the protection of minority shareholders[1] in public listed companies. An agency problem arises when the goals of the principal and agent are not in alignment.

Minority shareholders encounter different agency problems depending on whether the companies are widely held companies with dispersed shareholding[2] or controlled companies. Agency problems in dispersed shareholding arise from management as agents have cash flow rights and shareholders as principal have voting rights. An example of an agency problem here will be when managers entrench themselves

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[1] The term "shareholder" connotes a legal person (including either an individual or corporate entity) who holds shares in a particular company, and who may be either a registered member of the company or is otherwise beneficially entitled to the shares. The term "shareholder" is not defined in the *Companies Act 1965* (Act 125). S. 16(6) of the *Companies Act 1965*, however, provides that a person who agrees to become a member of a company and whose name has been entered into the register of members is a "member". In this thesis, though the terms "shareholder" and "member" are used interchangeably, they refer generally to a member, save where otherwise indicated.

[2] This means they do not have large shareholders who actively manage them.

by extravagant investments to secure for themselves continued compensation which is not linked to performance indices. This problem is reduced in controlled companies due to the close monitoring by controlling shareholders.

Malaysian public companies may be said to be controlled companies.[3] There is no doubt that the obvious advantage of a controlling shareholder lies in the fact that the controlling shareholder's interest is aligned to that of the non-controlling shareholder.[4] Further, given the fact that the controlling shareholders have invested heavily in the company, he has the incentive to monitor the management closely and carefully. The controlling shareholder will also ensure that there is timely and forceful intervention if there is mismanagement or the company performance deteriorates.

However the concern with controlled companies is that there may be "private benefits of control"[5] which is usually taken to mean as including everything controlling shareholders are able to get out of their position without minority shareholders receiving a proportionate share. There is a persistent danger that controlling shareholders will transfer company's resources out of the company to themselves. The controlling shareholders who control corporate assets can use these assets for a range of purposes that are detrimental to the interests of the minority shareholders.

Then again, it should be borne in mind that a person who joins a company does so on the understanding that he may be outvoted. Unless one controls the majority of the votes in a company there is no guarantee in getting one's way. A member who dislikes being in the minority should sell out; he cannot normally look to the court to change the decisions of the majority. The courts do not sit to hear appeals from decisions arrived at honestly[6] or substitute their views for a business judgement made in good faith and reasonableness. Nor is it the duty of the court to assume the duty of a policeman over the affairs of the company.[7]

Even so, it is necessary that there should be some mechanism for preventing a majority from abusing their power to bind the minority. It must be recognised that a person who joins a company does not thereby give up his legitimate rights and expectations. Normally, the will of the majority prevails. Indeed, this is the basis of the contract among the members, which the decision of the majority will be binding on the minority. However, one cannot push majority rule too far. When the rule of the majority crosses that thin line and gives rise to fraud on minority or minority oppression, there must be some relief available to the minority shareholder.

This article will examine the nature and extent of the agency problems faced by minority shareholders in controlled public companies in Malaysia. An overview will be taken as to the steps which have been taken by Malaysia to overcome these

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[3] R. Thillainathan, "Corporate Governance and Restructuring in Malaysia—A Review of Markets, Mechanisms, Agents & The Legal Infrastructure" (Paper presented for the joint World Bank/OECD Survey of Corporate Governance Arrangements, 1999). See also, Lim Mah Hui, *Ownership and Control of the One Hundred Largest Corporations in Malaysia* (Kuala Lumpur: Oxford University Press, 1981) at 113-117.

[4] Adolph Berle & Gardiner Means, *The Modern Corporations and Private Property* (New York: Macmillan, 1932).

[5] Karl Hofstetter, "One Size Does Not Fit All: Corporate Governance for Controlled Companies" (June 2005) online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=802705>.

[6] *Re Tri-Circle Investment Pte. Ltd.* [1993] 2 S.L.R. 523 (Sing. H.C.) at 526.

[7] *Re Tong Eng Sdn Bhd* [1994] 1 M.L.J. 451 (Malaysia H.C.) at 456.

problems. The article will also discuss if the solutions taken by Malaysia are viable, and if not, what should be recommended. The article will achieve this objective by initially discussing the various strategies[8] available to overcome agency costs arising from the relationship of controlling shareholders and minority shareholders. The article will then proceed to discuss the application of the strategies to overcome agency problems in Malaysia. Prior to doing the above, this article will deliberate the reasons why we need to extend protection to minority shareholders.

II. The Need for Shareholder Protection

Carl Fuerstenberg, a leading German banker, said, "shareholders are stupid and impertinent: stupid because they buy shares and impertinent because they demand a return."[9] Corporate law generally tries to control conflict of interests between controlling shareholders and minority shareholders. This is also known as the "agency problem". This problem arises when the agent is supposed to act in the principal's interests rather than the agent's own interests.

It must be averred that the central objective of corporate law is said to be the protection of shareholder interests as Henry Hansmann and Reinier Kraakman[10] have said, and shareholder wealth maximisation is accepted as the goal in American business circles. Scholars, like La Porta *et al.*[11] and Demirguc-Kunt *et al.*,[12] document that in countries where there is weak minority protection, it is considerably more difficult for a firm to raise external capital compared to a firm that protects its minority shareholders interests well.[13]

Studies have also showed negative correlations between performance and ownership concentration.[14] Galve Garris *et al.*[15] who tested listed controlled companies during the period 1999-2004, found that controlled companies grew at a smaller rate in some countries like Spain compared to the U.S. because of the differences in protection afforded to minority shareholders. Therefore it may be said that the better

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8 Enunciated from Henry Hannsmann & Reinier Kraakman, "Agency problems and Legal Strategies" in Reinier Kraakman *et al.* eds., *The Anatomy of Corporate Law: A Comparative and Functional Approach* (New York: Oxford University Press, 2004) at 21.

9 Theodor Baums & Kenneth E. Scott, "Taking Shareholder Protection Seriously?" (Law Working Paper No.17, European Corporate Governance Institute, 2003).

10 Henry Hansmann & Reinier Kraakman, "The End of History for Corporate Law" (2001) 89 Geo. L.J. 439.

11 Rafael La Porta *et al.*, "Legal Determinants of External Finance" (1997) 52 J. Finance 1131; Rafael La Porta*et al.*, "Law and Finance" (1998) 106 J. Pol. Econ'y 1113; Rafael La Porta *et al.*, "Agency Problems and Dividend Policies around the world" (2000) 55 J. Finance 1.

12 Asli Demirgüc-Kunt & Vojislav Maksimovic, "Law, Finance and Firm Growth" (1998) 53 J. Finance 2107.

13 This was also agreed upon by William A. Reese Jr. & Michael Steven Weisbach, "Protection of Minority Shareholder Interests, Cross-listings in the United States and Subsequent Equity Offerings" (November 1999) online: Social Science Research Network <http://ssrn.com/abstract=194670>

14 Jerry Grant & Tom Kirchmaier, "Who Governs? Corporate Ownership and Control Structures in Europe" (June 2004) online: Social Science Research Network <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=555877>. It tests data on the 100 largest firms in five major European economies (German, France, Spain, Italy and the U.K.) and indicated negative correlations between ownership concentration and company performance.

15 Carmen Galve Górriz & Vincente Salas Fumás, "Family Ownership and Performance: The Net Effect of Productive Efficiency and Growth Constraints" (Finance Working Paper No. 66/2005, European Corporate Governance Institute, 2005).

the protection afforded to minority shareholders in controlled companies, the better the company's performance. John C. Coffee Jr.[16] in his article stated that securities markets require a strong legal foundation that protects the minority shareholder in order to become deep or liquid. Further, it may be said that if a country provides better protection for minority shareholders, the less likely parties will be able to expropriate resources.

In Malaysia, due to the environment of concentrated shareholding in companies, there is a greater likelihood of expropriation from the minority shareholder and also reduced corporate governance which results as a consequence of the board and other executive officers being controlled by the concentrated shareholdings.

Scholars like Krishnamurthi *et al.*[17] and Lemmon *et al.*[18] have studied the joint impact of firm-level ownership structure and the legal environment for protection of minority shareholders using firm level data during the Asian financial crisis in 1997. They argue that firms with high control rights relative to their ownership have the ability to expropriate. Incentives are provided for expropriation in legal environments with inadequate protection to minority shareholders.

Bernard Black *et al.*[19] provide further reasons for the protection of minority shareholders in emerging economies. They say that the efficiency goal of maximizing the company's value to investors remains, the principal function of corporate law.[20] The efficiency goal dictates that corporate laws provide more investor protection. This is because insiders are likely to exercise voting control over most public companies and such controlled ownership structures raises the obvious concern that the insiders, whether managers or controlling shareholders can behave opportunistically toward other shareholders.[21]

The second reason they give is because markets are far less efficient, contracting costs are high because standard practices have not yet developed, enforcement of contracts is problematic because of weak courts, market participants are less experienced, reputable intermediaries are unavailable or prohibitively expensive, and the economy is likely to be in flux.[22]

Thirdly, political goals support strong shareholder protection in emerging economies. This reason according to them is to prevent corporate scandals. Corporate scandals will damage investor confidence in an environment where disclosure is minimal and legal remedies are slow and uncertain.[23]

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[16] John C. Coffee Jr., "The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control" (Working Paper No. 182, Columbia Law School, the Center of Law and Economic Studies, 2001).

[17] Chandrasekhar Krishnamurti, Aleksandar Sevic & Zeljko Sevic, "Legal Environment, Firm-level Corporate Governance and Expropriation of Minority Shareholders in Asia" (EFMA 2003 Helsinki Meetings), online: Social Science Research Network <http://ssrn.com/abstract=407847>.

[18] Michael Lemmon & Karl V. Lins, "Ownership Structure, Corporate Governance, and Firm Value: Evidence from the East Asian Financial Crisis" (Working Paper No. 393, William Davidson Institute, 2001).

[19] Bernard Black & Reinier Kraakman, "A Self-Enforcing Model of Corporate Law" (1996) 109 Harv. L. Rev. 1911, online: Social Science Research Network <http://ssrn.com/abstract=10037>.

[20] *Ibid.*

[21] *Ibid.*

[22] *Ibid.*

[23] *Ibid.*

A further political justification according to these writers[24] emerges in mass-privatized economies, where the government has transferred shares to employees or the general public for nominal consideration. Such a privatization program reflects, in part, a political bargain on how to distribute social wealth.[25] If the recipients of shares come to believe that insiders are getting rich at their expense by expropriating the cash flow of privatized companies, the political bargain will be breached.[26] This can undermine popular support for further privatization and other reforms needed for a healthy market.

A further reason why developing countries cannot make do with weak formal corporate law rules to protect shareholders is that shareholders are not embedded in a culture that discourages opportunism.[27] Therefore as minority shareholders do need to be protected, the next issue is to identify the problems faced by minority shareholders in controlled public companies in Malaysia.

III. Agency Problems

Agency arises when one party designated as an agent acts for or on behalf of or as a representative for the other, designated as a principal. An "agency problem" lies in motivating the agent to act in the principal's interest rather than simply in the agent's own interest. Almost all contractual relationships where one party promises performance may be subject to some amount of agency problems.[28]

Generally, three common agency problems arise in companies.[29] Henry Hannsmann *et al.* say that the first involves the conflict between the firm's owners and its managers where the owners are the principals and the managers are the agents. The problem here lies in ensuring that the managers are receptive to the owner's interests rather than the managers' own personal interest.

The second agency problem they say involves the conflict between the owners who possess the controlling interest in the firm and the minority who are the non-controlling owners. Here the difficulty lies in ensuring that the non-controlling owners who are the principals are not expropriated by the controlling owners who are the agents by, for example, self-dealing. They identify the third agency problem as involving the conflict between the company and other parties with whom the company contracts, such as employees, creditors and customers. Here the difficulty lies in assuring that the firm, as agent, does not behave opportunistically towards the principals, such as by exploiting workers and expropriating from creditors.[30]

As specified earlier in this article, the agency problem of controlling and non-controlling shareholders will be discussed.

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[24] *Supra* note 19.

[25] Maxim Boycko, Andrei Shleifer & Robert Vishny, "Voucher Privatization" (1994) 35 J. Financial Econ. 249 at 250-253.

[26] *Supra* note 19.

[27] *Ibid.*

[28] A different but also fruitful approach from this angle, Oliver D. Hart, "Incomplete Contracts and the Theory of the Firm" (1988) 4 J. L. Econ. & Org. 199.

[29] *Supra* note 8.

[30] *Ibid.*

The difficulty with agency is that because the agent has better information than does the principal about the relevant facts, the principal cannot without cost assure himself or herself that the agent's performance is precisely what was promised.

The agent has an incentive to act to his or her advantage, compromising on the quality of his or her performance, or even diverting to him or herself some of what was promised to the principal.

Further, the controlling shareholders acting as agents also enjoy certain internal benefits of control like extraction of assets to themselves. Internal benefits of control can be defined to include all benefits a controlling shareholder can extract from the company as an insider, which is as an agent with access to the company's assets, information and opportunities and at prices more favorable than at arms length negotiation. Some illustrations of these include siphoning cash and other assets without any business justification, transfer of assets to controlling shareholders or companies controlled by them, implementation of transactions which benefit the controlling shareholders but may not benefit the company or the use of inside information in connection with the sale or purchase of shares in the market.[31]

Besides internal benefits of control, controlling shareholders as agents also enjoy external benefits of control. Examples of these are elections to the board of directors, changes to the company's articles of association, its governance and mergers. Further, controlling shareholders can increase their stake in the company or sell their shares en bloc.

Besides internal and external benefits of control for the controlling shareholders, these agents also incur internal and external costs of control which yet again do not benefit the minority shareholders. Illustrations of this may arise when controlling shareholders pay very high salaries to founders or family members who hold management positions.[32] External costs will include under-diversification of a business due to the fact that the controlling shareholders want to minimize their risk.

As for a minority shareholder in a controlled company, there is also always the risk that the majority shareholders as agents will destroy value or refuse to consent to value-enhancing proposals or otherwise also said to be entrenchment risks. These risks may occur when there is a corporate crisis or in connection with a strategic decision like diluting control or the decision to sell the company to a third party. Though controlling shareholders' incentives will naturally be aligned to the minority shareholders as compared to the incentives of an independent board, nevertheless there is always the risk of them acting in their own interest.

This means, in turn, that the value of the agent's performance to the principal will be reduced, either directly or because, to assure the quality of the agent's performance, the principal must engage in costly monitoring of the agent.[33]

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[31] *Supra* note 5.

[32] This can be illustrated by Lim Goh Tong, the founder of Genting Bhd. being paid a very high salary. See Nik Ho, "Are Malaysian Chiefs Getting Their Dues?" *The World Paper* (30 April 2003) online: The World Paper <www.worldpaper.com/archive/2003/april_30/index.html>.

[33] *Supra* note 8.

IV. Strategies for Overcoming Agency Costs

The recent book *The Anatomy of Corporate Law: A Comparative and Functional Approach*[34] presents various strategies used to control related party transactions, amongst others. *The Anatomy of Corporate Law* adopts a ten-part regulatory strategy to address agency problems. These strategies address issues arising from the conflicted relationships like that of the managers and shareholders in companies with dispersed shareholding and the relationship between controlling shareholders and minority shareholders in companies with concentrated ownership.[35]

In this article, the discussion will be on the strategies used to overcome agency costs arising from the relationship of controlling shareholders and minority shareholders. *The Anatomy of Corporate Law* establishes two broad general categories of strategy, which are the "regulatory strategies" and the "governance strategies". The regulatory strategies generally dictate substantive terms that govern either the content of the agent-principal relationship, or the formation or dissolution of that relationship. On the other hand, the governance strategies protect the principal by either enhancing their power or molding the incentives of the agents.[36]

The regulatory strategies include two sets of control techniques. The "agent constraints" operate through the imposition of duties on controlling shareholders via rules and standards.[37] The second regulatory strategy is the "affiliation terms" which dictates the conditions in which the parties can "enter" or "exit" the agency relationship. The entry and exit strategies are important to minority shareholders. For the entry strategy, the main requirement is mandatory disclosure. This will reveal to the minority shareholder any controlling shareholder misdeed and also helps in direct voting on major issues that may deal with related party transactions or control transactions. The exit strategy is used more sparingly as it is normally only used if there is a blatant abuse of power by the controlling shareholders.[38]

The governance strategy on the other hand includes six pairs of control techniques.[39] The first relates to shareholders participatory rights via the appointment rights strategy. Minority shareholder protection may be achieved by two possibilities here, firstly by reserving seats on the board for minority shareholders and secondly, by limiting voting rights of large (controlling) shareholders. The second governance strategy is the "decision rights" strategy. Here for public companies, the super-majority voting requirement will be beneficial for companies with concentrated shareholding.[40] The next two are the agents' incentives that comprises of the trusteeship and reward strategies, which motivates the agents to act in the

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[34] *Ibid.*

[35] *Ibid.*

[36] *Supra* note 8 at 23.

[37] *Supra* note 4 at 23-24. Legal constraints in Malaysia include the s. 181 of the *Companies Act 1965* which sets the oppression and the unfair prejudice standards, the fiduciary duty of utmost good faith and the common law remedies on the abuse of the majority shareholders: S. Rachagan, J. Pascoe & A. Joshi, *Principles of Company Law in Malaysia* (Kuala Lumpur: Malayan Law Journal, 2002) at 496.

[38] *Supra* note 8 at 60.

[39] *Supra* note 8 at 26-27.

[40] *Supra* note 8 at 57.

interests of the principal. The trusteeship strategy has a limited use in the protection of minority shareholders. This is because the director who serves as a trustee for minority shareholders must be independent from the company's managers as well as the controlling shareholders. The cost of such independence means that the directors can pursue their own interests. One of the ways in which this strategy may work is to weaken the power of the shareholders as a whole over the appointment of directors. Another method is to sever the financial ties between the board and the controlling shareholders, for example by barring parent companies from appointing their employees to the boards of their partially-held subsidiaries.[41] The third is when board approval is required for every important decision.[42] An example of the reward strategy, which is an equal treatment of all shareholders, is the requirement of providing dividends to all shareholders. It follows that corporate distribution which benefits controlling shareholders must benefit minority shareholders. Other rules that aim at *pro rata* distribution include rules that require repurchase of shares from all shareholders and not a selected group.

V. Agency Problems in Controlled Companies and the Application of the Above Strategies in Malaysia

A. *Related Transactions Involving Controlling Shareholders*

A related-party transaction is a transaction with someone who has a close and possibly privileged relationship with the company, including controlling owners or directors of the company, their immediate families and other companies that they control. Gerard Hertig *et al.*[43] say that no jurisdiction bans transactions by companies and controlling shareholders as their potential value is too great and thus, these jurisdictions regulate these transactions by treating controlling shareholders as "*de facto* directors" or, by providing separate regulation of conflicted shareholder transactions. Related-party transactions are one of the recurring areas of concern.[44]

It is true to say that a healthy financial standing is crucial for a public-listed company because it will help them to raise finance easily. However, for public-listed companies with poor financial standing, it will be the contrary, and they will be under pressure to answer to the regulator and its shareholders. In Malaysia, some of the public-listed companies with poor financial standing try to camouflage their poor financial standing by inflating their sales profits through transactions with related-party companies or by earnings management accounting. These companies inflate their sales profits so as to artificially increase their profits to meet their profit forecasts and fulfill the Regulator's requirements especially during the early years

[41] *Supra* note 8 at 58.
[42] *Ibid.*
[43] Gerard Hertig & Hideki Kanda, "Related party Transactions" in *Anatomy of Corporate Law*, *supra* note 8 at 101.
[44] A case example of this in Malaysia is the Renong/UEM saga. C. Rajandram, "Workouts and Restructurings in Malaysia" (Paper presented at the Conference on "Insolvency Systems in Asia: An efficiency Perspective", November, 1999).

of their listing on the exchange, to convince the banks or financial institutions to grant them loan facilities, to avoid being questioned by shareholders and to maintain investors' confidence.

However, the act of inflating profits and creating imaginary value will bring serious consequences to minority shareholders. This is because amongst others, a company that uses fictitious "healthy profits" to obtain financing from financial institutions could become a financially distressed or "PN17"[45] company when its debts are bigger than its assets, its share price will eventually fall, minority shareholders' capital may be wiped out, it won't be able to pay dividends to its shareholders and it is against the law and the Regulator will take action against the company.

1. *The affiliation strategy*

In Malaysia, all related-party transactions have to be disclosed.[46] The IAS 24[47] on related party disclosures has been adopted as an accounting standard in Malaysia as FRS 124.[48] Bursa Malaysia's listing rules on related-party transactions cover transactions involving the interests, direct or indirect, of directors, substantial shareholders, and persons connected with directors or substantial shareholders. Chapter 10.08 of the *Bursa Malaysia Listing Requirements* specify that a listed company is required to make a public announcement, send a circular and seek the approval of shareholders on all material related-party transactions. Directors are subject to penalties and criminal sentences for breach of disclosures with respect to directors' interests in their company or a related company. This is punishable by imprisonment for a term of seven years or a fine of RM 150,000.[49]

In a World Bank report,[50] Malaysia had a score of 10/10 for the extent of mandatory disclosure where the United States scored 7/10 and Australia scored 8/10. Malaysia also has an exit clause by virtue of section 181, which allows for corporate dissolution in the event of oppression or an "unfairly prejudicial" act.

2. *The trusteeship and decision rights strategy*

In Malaysia, there are non-executive directors appointed to monitor transactions between companies and their controlling shareholders.[51] However, the issues of concern are whether these non-executive directors can in fact discharge their monitoring

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[45] Practice Note 17/2005, issued pursuant to Listing Requirements 8.14C. The classification as a PN17 company means that the company will have to submit a restructuring plan to the Securities Commission (SC) within a period of eight months and implement their restructuring plans within the timeframe stipulated by the relevant authority.

[46] R. 111 to 120 under Part 4 of the *Main Board Listing Requirements of Bursa Malaysia Sdn. Bhd.* [*BMLR*].

[47] International Accounting Standards (IAS).

[48] Financial Reporting Standards (FRS). The Malaysian Accounting Standards Board MASB initially adopted 24 of the 34 International Accounting Standards (IASs).

[49] S.131 of the *Companies Act 1965*.

[50] Lex Mundi, the World Bank & the International Finance Corporation, *Doing Business: Protecting Investors* (Washington, D.C.: The World Bank, 2006), online: Doing Business <http://www.doingbusiness.org/documents/Protecting_investors.pdf>.

[51] Para. 15.02 of the *BMLR* requires at least two or one-third of board directors (whichever is higher) to be independent directors.

functions and the fact that these directors have the tacit approval of the controlling shareholders and hence he/she may not be totally "uninterested". Therefore most jurisdictions are moving away from a high reliance on disinterested directors or non-executive directors to monitor transactions between companies and controlling shareholders.

Reiner *et al.*[52] recommended that minority shareholders' approval must be required before there can be a related-party transaction between the company and the controlling shareholders.[53] However, they too see a problem with this as it limits the control rights of shareholder majorities and may reduce effective entrepreneurial enterprise. The French too acknowledged this concern and hence the French law allows the minority to require an expert to investigate the transaction and challenge it if it is unfair.[54]

In Malaysia it is recommended for the protection of minority shareholders from related-party transactions by the company and the majority, there should be minority approval. This will not really curtail control rights of the majority as it is limited to only related-party transactions of certain thresholds between the company and connected persons to the majority.

3. *The standards strategy*

Malaysian law now provides many rules and standards to regulate related party transactions of controlling shareholders. Most of the steps taken in overcoming the problem of related party transaction are in the form of non-statutory reforms, particularly the implementation of the *Code of Corporate Governance*,[55] and resulting changes to the *Bursa Malaysia Securities Berhad*[56] *Listing Requirements*.[57]

Malaysia's *Companies Act 1965* contains specific related-party prohibitions that reinforce general provisions against conflicts of interests. The specific and general prohibitions act in addition to the common law fiduciary principles set out in established cases.[58] The provisions in legislation governing specific conflict of interest situations are sections 133 and 133A, prohibiting loans and guarantees provided to directors and connected persons;[59] section 132C requiring shareholder approval for the disposal or acquisition of a company's main undertaking or assets; section 132D requiring shareholder approval for the issue of shares by directors; section 132E requiring shareholder approval for the acquisition and disposal of substantial non-cash assets; section 132G prohibiting the acquisition of shares or assets in a company

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[52] *Supra* note 8 at 122.

[53] At present, ss. 132C, 132D, 132E and 132G of *Companies Act 1965* and chapter 10 of the *BMLR* require shareholder approval for substantial property transaction.

[54] Art. L 225-231 *Code de Commerc, France.*

[55] The *Code* is available online: Securities Commission of Malaysia <http://www.sc.com.my/eng/html/resources/inhouse/mccg.pdf > [*Code*].

[56] Following the process of demutualisation, the Kuala Lumpur Stock Exchange was officially renamed the Bursa Malaysia Securities Bhd. [BMSB] on 20 April 2004. It operates under a new organisational structure with its holding company now named as Bursa Malaysia Bhd.

[57] *Bursa Malaysia Listing Rules,* online: Bursa Malaysia, <http://www.bursamalaysia.com/website/documents/LR_MBSB_Jan05.pdf > [*LR*].

[58] See *e.g. Regal (Hastings) v. Gulliver* [1942] 1 All E.R. 378 and *Cook v. Deeks* [1916] 1 A.C. 554.

[59] S. 122A, *Companies Act 1965*.

in which a director, substantial shareholder or related party has a direct or indirect interest.

However, it must be noted that the related party provisions under the *Companies Act 1965* require disclosure to shareholders, but do not expressly prohibit an interested director from voting at a board meeting that is considering a contract with the directors unless there is provision to that effect in their articles. As the Chief Executive Officer of the Companies Commission of Malaysia noted recently in the context of the concentrated ownership model typical of most East Asian companies: "If disclosure of interest is made compulsory but is not accompanied by prohibition of the interested person from voting, this will render the disclosure mechanism virtually worthless."[60]

The Finance Committee considered it inappropriate for directors to vote in circumstances where they are directly or indirectly interested in a contract with the company. The Finance Committee recommended that the *Companies Act 1965* be amended to prohibit directors, and persons connected with a director, from voting as shareholders on matters in which they have a direct or indirect interest. The prohibition was seen as necessary to deter directors from influencing a company's decision to enter a transaction which may be to its detriment. The Finance Committee also recommended that the prohibition be extended to cover substantial shareholders.

The High Level Finance Committee[61] also expressed concerns about the provision in section 132E(2) that allows for ratification of a substantial property transactions, observing that in practice shareholders may be unwilling to vote against a transaction that has already been entered into. The Committee recommended that the provision should be removed. In addition, section 132E should be reformulated to adopt a simplified method of defining a substantial property transaction. In accordance with the criteria adopted in the *LR*, the prohibition should extend to situations where the size of the transaction is 25 per cent or more of the value of the company's assets.

The High Level Finance Committee made several recommendations for the reform of section 132G. The Committee noted that the absolute prohibition with respect to section 132G transactions should be reviewed, given that the provision may have the effect of capturing legitimate transactions. Section 132G should also be amended to require errant vendors and directors to indemnify the company for expenses incurred in acquiring the shares or assets and any further expenses in recovering the consideration. In addition, any amendment to section 132G should also clear up the ambiguity with respect to phrase "first held the shares in that other company" which has increased costs of transactions without concomitant gains.

It is beyond the scope of this article to outline related-party provisions and their relevant exceptions in detail.[62] It would suffice to say that a number of substantial weaknesses and loopholes in the provisions have been identified. The Finance

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[60] Tuan Abdul Alim Abdullah, CEO, Companies Commission of Malaysia, "Shareholders Protection and Corporate Governance: A Regulator's Perspective" (Presentation for MAICSA National Conference of Directors and Company Secretaries, Kuala Lumpur, 13 July 2004).

[61] Government of Malaysia, Finance Committee, "Report on Corporate Governance" (February 1999), online: Securities Commission <http://www.sc.com.my/eng/html/cg/Oview.html#FCR>.

[62] For a detailed analysis of the provisions see J. Pascoe, "Regulation and Disclosure of Financial Benefits to Directors and Related Parties: a Comparative Analysis of the Malaysian and Australian Experience" (1999) 3 Sing. J.I.C.L.108.

Committee has made a number of important recommendations to tighten specific related party provisions. The High Level Finance Committee recommended amendments to section 133 to close off some apparent loopholes. As presently formulated, section 133 only prohibits loans and guarantees to directors and related parties. Other financial benefits, gifts, quasi loans and generous extension of credit facilities are not covered. The Finance Committee therefore recommended that the scope of section 133 be widened to include other types of financial benefits provided to directors and others that would have the potential to adversely affect the company. Moreover, the *LR* extends to transactions between a company and substantial shareholder. With the exception of section 132G, this is not the case with the *Companies Act 1965* related party provisions. Overall, the sections of the *Companies Act 1965* are a disparate group of provisions which are poorly drafted, have complicated and differing exceptions and as noted above, contain wide loopholes.

In Malaysia, the 2001 amendments to the *LR*[63] strengthened the provisions on related-party transactions that are now tighter than the rules under the *Companies Act 1965*. The changes have widened the range of related party transactions. The definition under Paragraph 10.2 of the *LR* covers the acquisition and disposal of assets, the provision and receipt of services and the provision of financial assistance. However, it now also extends to the establishment of joint ventures and any business transaction or arrangement entered into by a listed issuer or its subsidiaries. Further, the changes have enhanced the disclosure requirements. Whether the listed company must comply with disclosure requirements depends on whether the values of the transaction exceed certain financial ratios prescribed by the *LR*.[64] In particular, a listed company has special disclosure obligations concerning substantial related-party transactions where the prescribed percentage ratios exceed five per cent.[65] These transactions require full disclosure to and approval of disinterested shareholders. In other words, a director who is interested in a substantial related party transaction must abstain from board deliberation and voting on the relevant resolution. Significantly, this prohibition also extends to connected persons[66] or substantial shareholders with any interest, direct or indirect, in the transaction. Prior to approval, the company must appoint an independent adviser to advise shareholders whether the transaction is fair and reasonable from their point of view and whether or not the transaction is to the detriment of the minority shareholders.

Bursa Malaysia Securities Berhad made further amendments to *LR* for the Main Board and Second Board of Bursa Malaysia Securities Berhad in relation to related party transactions in November 2005. The key amendments to the *LR* are dispensation of shareholders' approval for issuance of securities by the subsidiary of a

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[63] Bursa Malaysia, Practice Note No. 12/2001, issued in relation to paras. 10.08 and 10.09 of the *LR* and pursuant to paras. 2.06, 2.08 and 2.19 of the *LR*.; online: Bursa Malaysia <http://www.bursamalaysia.com/website/listing/pn.htm>.

[64] *LR*, *supra* note 58 at para. 10.02(h). Practice Note 14/2003 Related Party Transactions provides particular guidance on the exemptions from the related party provisions of the *LR*.

[65] Para. 10.08 of the *LR*, *ibid*., considers substantial transactions by reference to a "percentage ratio" exceeding five per cent on a number of variables including profits, equity, market capitalisation and assets.

[66] It is interesting to note that the definition of "person connected" under the *LR* is substantially wider that the corresponding definition in s. 122A of the *Companies Act 1965*, which contains no reference to substantial shareholders.

listed issuer ('PLC') to its directors or major shareholders or a director or major shareholder of the holding company (other than the PLC or the PLC's holding company) and imposition of certain duties on directors of a listed issuer; clarification/revision of the scope or ambit of the definition of "director" and "major shareholder" for the purposes of Chapter 10 of the *LR*; substitution of "net tangible assets" which is one of the denominators used to compute the applicable percentage ratios with "net assets" except in relation to paragraph 8.23(2)(c) of the *LR*; expansion of the role of the independent adviser to include advising minority shareholders in relation to voting on the related party transaction in question; amendments in relation to related-party transactions where the related party is only at subsidiary level; introduction of a threshold for the requirement to disclose in the annual report, the aggregate value of recurrent transactions made during the financial year for which a mandate has been obtained; and prescription of a timeframe for the issuance of circulars which do not require clearance from Bursa Securities Malaysia Berhad.

As stated earlier, the IAS 24 on related party disclosures has been adopted as an accounting standard in Malaysia as FRS 124. There are also standard strategies for the protection of minority shareholders in the event of related party transactions when the controlling shareholders divert value unfairly from the company and the minority shareholders to themselves. Here, the controlling shareholders may be liable as *de facto* or shadow directors who like other directors owe a fiduciary duty to act with "utmost good faith".[67] However, most of these cases apply to private or closed companies and not public companies.[68]

It must be noted that although the changes to the *LR* are commendable, statutory reform is still essential. As Thillainaithan, Koh and Kandiah point out,[69] reliance on just the *LR* is not satisfactory for the following reasons: there are a wider range of penalties open to the statutory regulator compared with those of the exchange and the ability of the exchange to de-list or suspend a defaulting company may not always be an appropriate action and may end up compounding losses to shareholders and outsiders. The exchange does not have the enforcement capability of the statutory regulator, which for example can require information and examine parties and has the rights of search and seizure.

B. *Significant Corporate Actions*

The focus here is on corporate agency problems in the context of significant corporate actions, such as mergers, major sales of corporate assets or alteration of capital. Significant corporate actions relate normally to the size of the transaction, actions that require broad investment like judgment and decisions that bear the risk of the

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[67] *Tai Kim San v. Lim Cher Kia* [2001] 1 S.L.R. 607. See also *Yap Sing Hock & Anor v. PP* [1991] 2 M.L.J. 334 (rev'd on other grounds at [1992] 2 M.L.J. 714 (Malaysia S.C.)).

[68] This is derived from the reported cases from the Malayan Law Journal and the Current Law Journal.

[69] R Thillainaithan, Phillip Koh & Shanti Kandiah, Report submitted to the World Bank, "Corporate Governance in Malaysia—An Assessment" (1999), online: Organisation for Economic Co-operation and Development <http://www.oecd.org/dataoec>. See also Philip Koh Tong Ngee, "Corporate Governance in Malaysia: Reforms in Light of Post-1998 Crisis" in Ho Khai Leong, ed., *Reforming Corporate Governance in SEA, Economics Politics and Regulations* (Singapore: ISEAS, 2005).

controlling shareholders making self-interested decisions. As most companies just require a special majority for these actions, minority shareholders interest is not always taken into account.

Significant corporate actions are best illustrated by examples and an example of this is the sale of all or substantially all of a target company's assets. This is comparable to the acquisition of a target company in a merger transaction. This is seen as a "significant transaction" in some jurisdictions, thus it requires shareholder approval (like in a merger) even though it does not alter the company's charter. However, other jurisdictions vary in their treatment of large asset sales.[70] Another example will be mergers itself. Laws and codes[71] play an important role in regulating conflicted transaction like mergers. In Malaysia, the courts may rely on the statutory standard of "unfair prejudice"[72] to force controlling shareholders of merging companies to buy up minority shares at fair price.

With regards the agent constraints, Malaysia has many rules and standards. The Malaysian Code on Take-over and Mergers 1998 was prescribed by the Minister of Finance, on the recommendation of the Securities Commission, to come into force on 1 January 1999 pursuant to sub-section 33A(1) of the *Securities Commission Act 1993*.[73]

The Securities Commission ('SC') has also worked very closely with the Bursa Malaysia Securities Berhad, as some of the changes introduced require consequential changes to the *LR*. The economic turmoil experienced by the country in the 1997-1998 economic crises has brought into even sharper focus various deficiencies in the old Code. The SC had, on several occasions reiterated that these deficiencies would be addressed to enhance transparency and to protect the interests of minority shareholders.

According to SC Chairman, Dato' Dr Mohd Munir Majid: "The new Code is indeed a testimony of the commitment of SC towards ensuring higher standards of disclosure and corporate behaviour and greater professionalism from all involved in mergers and acquisitions."[74]

The new Code thus seeks to ensure that minority shareholders are given a fair opportunity to consider the merits and demerits of an offer and to enable them to decide whether they should retain or dispose of their shares. The new Code also requires offer documents, board of directors circulars and independent advice circulars to include all relevant information required by shareholders and their professional advisers to make informed assessments of the merits and risks of accepting or rejecting a take-over offer.

The SC expects market participants and advisers, who are already familiar with the requirements of standards of disclosure and due diligence for corporate submissions, to comply with the disclosure and due diligence requirements under the new Code without difficulty.

[70] Edward Rock, Hideki Kanda & Reinier Kraakman, "Significant Corporate Actions" in *Anatomy of Corporate Law*, *supra* note 8 at 139.

[71] *Companies Act 1965* and the *Take-over and Merger Code* 1998.

[72] S. 181 of the *Companies Act 1965*.

[73] Act 498.

[74] Speech by YBhg Dato Dr. Munir Abdul Majid, Chairman, Securities Commission of Malaysia, online: Securities Commission of Malaysia <http://sc.com.my/eng/html/resources/fr_stats.html>.

The new regulatory framework on take-overs and mergers includes provisions imposing criminal liability on the relevant parties to a takeover offer for providing false or misleading information to the SC and shareholders. In particular, section 33E of the *Securities Commission Act 1993* and section 38 of the new Code now impose requirements that are similar to those found in section 32B of the *Securities Commission Act 1993*.

Additionally, provisions relating to "creeping" take-overs have been amended to allow an acquirer who holds between 33 per cent and 50 per cent of the voting shares in a company to acquire 2 per cent within a period of six months instead of 12 months and hence, effectively reduce the time taken to "creep" into control of the company.

Previously, such persons were not allowed to acquire more than 2 per cent of the voting shares in the company in any 12-month period. The purpose of a creeping provision is to restrict the time frame whereby a person can obtain statutory control of an amendment is made in order to be more consistent with international practices such as those of Hong Kong, Singapore and Australia. The SC wishes to emphasise that while the creeping provision in the new Code has been relaxed, the *Securities Commission Act 1993* has provided for stricter penalties against participants for breaches of the Code.

In addition to the new Code, the Minister of Finance has also brought into force section 11 of the *Securities Commission (Amendment) Act 1995*.[75]

Among others, section 33C of the *Securities Commission Act 1993* makes the Securities Commission the sole authority to grant exemptions from provisions of the new Code. The SC must observe the principles and objectives that are specified in sub-section 33A(5) of the *Securities Commission Act 1993* in exercising its powers under the Act, including when granting an exemption. That subsection requires the Securities Commission to ensure that take-overs and mergers take place in an efficient, competitive and informed market.

The Practice Notes to the new Code govern the treatment of specific situations or elaborate on the interpretation of certain sections of the Code. The Practice Notes also list the circumstances or transactions which the Securities Commission would consider granting exemptions to. The Practice Notes are deemed to be rulings made by the Securities Commission pursuant to sub-section 33A(4) of the *Securities Commission Act 1993* and that the breach of any ruling, as with a breach of the Code, is an offence punishable under section 33B(4) of the Act with a fine not exceeding ten million ringgit or imprisonment not exceeding ten years.

To further protect minority shareholders in these instances, Malaysia has the "exit strategy" if there has been oppression or "unfairly prejudicial" acts or what may be construable as minority oppression.[76] The French Supervisory Authority, also known as the Autorite des Marches Financiers, has an additional policy that encourages controlled companies to buy back shares of minorities in cases of mergers and acquisitions. Unlike controlled companies, transactions undertaken by uncontrolled companies ordinarily treat all shareholders identically, and thus minority

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[75] This section replaces the existing ss. 33 and 34 of the *Securities Commission Act 1993* with new ss. 33A, 33B, 33C, 33D, 33E, 34A, 34B and 34C.

[76] S.181 of the *Companies Act 1965.*

shareholders are automatically protected through the basic "shared returns" rewards strategy.[77]

Additionally, minority shareholders in uncontrolled companies also benefit from several other protections on significant corporate actions. For example, major jurisdictions require supermajority shareholder approval of significant corporate actions, thus large-block minority shareholders will sometimes have the voting power to block corporate actions. Also, some countries like the U.S. and Japan use the trusteeship strategy which protects minority interests by requiring board initiation of significant corporate actions[78] or an exit strategy which is the appraisal remedy, that allows dissatisfied shareholders to escape the financial effects of organic changes approved by shareholder majorities by selling (putting) their shares back to the corporation at a reasonable price. This protects shareholders as a class by making unpopular decisions more expensive for management to pursue.[79]

These protections are however neither available nor suitable for controlled companies in Malaysia. It is however recommended that Malaysia have an additional policy which encourages controlled companies to buy-back shares of minorities in cases of mergers and acquisitions similar to the French Supervisory Authority.[80]

C. *Legal Capital, Share Issues, and Corporate Distributions*

This comprises of those actions that bear on the flow of equity capital into and out of the corporation. Some examples will be actions to reduce or increase legal capital, new issues of shares and distributions of capital by means of share repurchases and dividends.

The concerns about share dilution arise whenever companies issue new shares or repurchase outstanding ones. Further, although shareholders risk dilution from new equity and corporate distributions, minority shareholders face the largest risk. They are not protected by shareholder decision rights and have to depend on other legal strategies for protection. One solution is the right of pre-emption.[81] However, preemptive rights have a cost; they delay new issues of shares by forcing companies to seek out their own shareholders before approaching the public. Also, the management is limited from issuing large blocks of shares with significant voting power. These two constraints reduce a company's ability to raise equity capital. This might also be the reason that the U.S. and Japan have abandoned pre-emptive rights as the statutory default.[82]

Instead of pre-emptive rights, the U.S. depends on the standards strategy in the form of the duty of loyalty in thwarting opportunistic issue of shares. This is costly

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[77] *Supra* note. 70.
[78] *Ibid*.
[79] *Ibid*.
[80] *Ibid*.
[81] In Malaysia pre-emptive rights have been recognized by the courts as in *Arunachalam v. Kwality Textiles (Malaysia) Sdn. Bhd*. [1990] 2 M.L.J. 167 and also s. 33 of the *Companies Act 1965*.
[82] Paul Davies & Klaus Hopt, "Control Transactions" in Reinier Kraakman *et al.* eds., *The Anatomy of Corporate law, A comparative and Functional Approach* (New York: Oxford University Press, 2004) at 157–161.

and litigation-intensive, but minority shareholders are more likely to be better protected. For example in the U.K. where both pre-emptive rights and the standards strategy are available, minority shareholders prefer to file petitions alleging "unfair prejudice" instead of filing for pre-emptive rights to buy share as its less affordable. Japan combines the two strategies—companies must get shareholders approval when offering shares to third parties at low prices.[83] In Malaysia though the pre-emptive rights and the standards strategy are available, minority shareholder prefer to file petitions under the standard strategy alleging "unfair prejudice/minority oppression"[84] rather than exercise their pre-emptive rights to buy shares they cannot afford.[85]

I shall now provide some case studies of improper dilution/bailouts encountered by the emerging markets in the post-1997 financial crises period.[86] Here it will be seen that existing shareholders rights can be diluted even with pre-emptive rights. The information was gathered from public sources in these countries. One of the examples was when rights issue of Thai Farmers Bank, Thailand, was priced at a discounted price to the prevailing market price of the company's common shares. Here, following the severe asset quality deterioration in the 1997 financial crises, Thai Farmers Bank raised US$800 million at a price of 88 baht per share to re-capitalise its balance sheet. At the time of issuance, the investors were assured that no further capital need be raised. However, one year later, the Bank announced a one for one rights issue at 20 baht per share, an incredibly sharp discount to the prevailing market price of about 70 baht. This left the minority shareholder with either investing more money or getting their shares severely diluted.

Another example of massive dilution was the *government*-controlled Hanvit Bank in Korea.[87] Hanvit Bank was formed from a government-ordered merger between the Commercial Bank of Korea and Hanil Bank in January 1999. It became the largest domestic bank in the country after the merger. The government then in August 1999, sought to re-capitalise the bank with a US$1 billion offering to international investors in the form of global depository receipts ('GDRs'). Due to the claims and assurances by the management on the quality and thoroughness of the Bank's balance sheet, the GDR issue was successfully completed and foreign shareholders owned about 12 per cent of the Bank in the first quarter of 2000. However, following an unchecked deterioration in asset quality and increase in loan losses, the Bank's entire capital was wiped out by the end of 2000. After formally effecting a 100 per cent capital reduction and de-listing the stock, the Korean government re-capitalised the bank with a W2.8 billion injection of public funds.[88]

In Malaysia, during the financial crises of 1998, Bank Bumiputra, a state bank, was pushed into bankruptcy for the third time since its establishment in 1966. The

[83] Arts. 280-282(2) of the *Japanese Commercial Code*, *supra* note 70 at 149.

[84] Under s.181 of the *Companies Act 1965*.

[85] An illustration of this can be seen in the case of *Eric Lau Man Hing v. Eramara Jaya Sdn. Bhd. & Ors* [1998] 7 M.L.J. 528 where the minority shareholder brought an action against the majority under s. 181 for amongst others, non payment of dividend.

[86] Though there are numerous case studies in Asia, Thailand is used to illustrate as the 1997 financial crises did begin in Thailand.

[87] This is a good example of issues of concern with government-linked companies.

[88] Cases of this nature do occur in Malaysia, *e.g*. Danaharta's report on companies such as Wing Tiek, Lion Group and Gadang Holdings Berhad, Case Studies and Feature Articles, Danarharta Annual Report, 2004.

government had to put in at least RM2 billion as capital in order for Bank Bumiputra to meet the minimum risk-weighted capital adequacy ratio. Also, Sime Bank and RHB Bank, merged in mid-1998 and received an infusion of RM1.5 billion from Danamodal, a state company established to re-capitalise troubled banks.[89]

Lastly, corporate distribution of capital also creates risk of discriminatory treatment for minority shareholders, unless cash was paid out *pro rata*. A *pro rata* payout protects minority shareholders in terms of the sharing strategy. Even dividend policy can be manipulated, as when payouts are withheld to squeeze out minority shareholders, or when dividends are paid out excessively to deprive the company of investment opportunities. This is perhaps the reason that jurisdictions prevent shareholders from forcing a dividend payment over management (trusteeship strategy)[90] or allow shareholders a challenge of insufficient dividends (standards strategy).[91]

VI. Control Transactions

Control transactions are seen as an agency problem because a control transaction is defined as being a transaction between a third party that is interested in acquiring a majority stake in the company and the said company's shareholders.[92] When there is a majority shareholder who holds a large block of shares, the third party may choose to make an agreement with that majority shareholder before considering making an offer to the non-controlling shareholders. This would cause agency problems between the third party and the non-controlling shareholders because the controlling shareholders would be selling control of the company to the third party, allowing the third party to pillage from the company or who may not choose to recognize the rights of the minority shareholder. When a third party makes an offer to acquire a company that has a controlling shareholder, the minority shareholders and the management would not be able to practice its decision rights because the majority shareholder would decide whether to sell the company or not.

A controlling transaction of this nature would allow the third party acquirer to appoint its nominees to the board of the company. The control transactions can be executed in a variety of methods. These methods comprise of private treaties with an influential block of shareholders, a purchase of shares on the open market or via a general or public offer to the shareholders of the company. A public offer can be divided into being a friendly or a hostile offer to the target company. A friendly offer would be one where the offer is supported by the management of the target company whereas a hostile bid would be made directly to the shareholders of the target company without notice to the management of the target company.[93]

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89 Dwight Heald Perkins & Wing Thye Woo, "Malaysia in Turmoil: Growth Prospects and Future Competitiveness", (Paper presented at Davos Conference of World Economic Forum, January 1999) online: University of California, Davis <http://www.econ.ucdavis.edu/faculty/woo/davosmal.html>.

90 In the case of *Re SQ Wong Holdings (Pte.) Ltd.* [1987] 2 M.L.J. 298, the Singapore High Court held that the directors have discretion whether or not to recommend a dividend.

91 *Chiew Sze Sun v. Cast Iron Products Sdn. Bhd.* [1994] 1 C.L.J. 157, where the court held that minority shareholders can bring an action against the majority under s. 181 for non payment of dividend.

92 Of course the acquirer could also be a shareholder of the target company but it need not be and most of the relevant rules do not turn on whether it is or not.

93 Paul Davies & Klaus Hopt, "Control Transactions" in *Anatomy of Corporate Law*, supra note 8 at 157-191.

In Malaysia, securities law deals with certain aspects of control transactions.[94] However, these laws do not address effectively the agency issues between the controlling shareholder and the acquirer and the minority shareholders (non-controlling shareholders) on the other. The controlling shareholders may engage in rent-seeking and hence sell to an acquirer who for commercial reasons may be less respectful to the interest of the minority shareholders compared to the vendor. Alternatively, an exit strategy may be used.[95] In the event that a fair exit strategy is to be provided for all shareholders, more specialized rules would be required because the general company law does not make it compulsory for the majority shareholders to share the decision rights or control premium when there is a sale of control with the non-selling minority.

The law in Malaysia does not make it mandatory for controlling shareholders to buy out minority shareholdings at the same rate as offered by the third party unless a General Offer situation arises. However, the issue of imposing fiduciary duty on majority or substantial shareholder need to be balanced with view that shareholder right is a property right that a market economy should be slow to interfere with unless there are countervailing equitable factors.

In the U.S., the sale of controlling interests is not illegal but it has been made harder by way of imposing fiduciary duties on controlling shareholders towards minority shareholders. The sale of control of the company cannot be made if it may alienate the minority shareholders and minority shareholders are to be compensated by the majority shareholders, if they may be made worse off by the majority's sale of control.[96] It is interesting to note that France Regulators initiated protection for minority shareholders in the transfer of control before acquisition of control by introducing the exit strategy for the former before the latter.[97] Since the early 1970's, the French Regulators imposed an obligation on those who acquired controlling shares from existing controllers to stand in the market and buy shares of the non-controlling shareholders as they were offered to them and only in 1989 did this become a requirement for acquisition of control shares.[98]

This protection may be required for minority shareholders in Malaysia as there are a lot of cases where the majority shareholders transfer control to other family members or controlling shareholders and the minority shareholders are disadvantaged due to sale.[99]

VII. Conclusion

Therefore it may be said that controlling shareholders can divert corporate assets to themselves, through expropriation,[100] dilution of outside investors through share

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[94] Please see J. Pascoe & S. Rachagan, (2005) "Corporate Law Reform in Malaysia" [2005] Sing. J.L.S. 93 for more on latest securities laws.

[95] S.181 of the *Companies Act 1965*.

[96] *Supra* note 70.

[97] Art. 5-4-2, Chapter IV, Reglement general CMF. See also Paul Davies, "Institutional Investors in The United Kingdom" in Theodor Baums, Richard M. Buxbaum & Klaus J. Hopt, eds., *Institutional Investors and Corporate Governance* (New York: W. de Gruyter, 1994) 257 and Davies & Hopt, *supra* note 94.

[98] Reglement general CMF, *ibid.*

[99] *Supra* note 70.

[100] Expropriation is the act of taking from the owner.

issues to the insiders, excessive salaries, asset sales to themselves or other corporations they control at favorable prices, or transfer pricing with other entities they control or using inside information in connection with the sale or purchase of shares in the market. Alternatively, controlling shareholders can use corporate assets to pursue investment strategies that yield them personal benefits of control, such as growth or diversification, without benefiting outside investors.[101] Also, controlling shareholders have large discretion in creating value for themselves as shareholders. This includes the use of voting power for their benefit and not that of the minority shareholder, which is the majority rule issue.[102]

The divergence between control and cash-flow rights creates an incentive for the controlling shareholders to expropriate minority shareholders and other stakeholders.[103] It has been said that it could be implemented through a variety of ways:

> [I]ntra-group shifting of assets, cross-lending, smoothing company decisions (inter-company transfers designed to adjust the volume or the price of inter-group trade, the level of inter-firm dividend payout, cross-lending either to avoid taxes, to exploit the government's fiscal incentives, or to lock in private benefits linked to corporate control over technological or other decisions), cross-lending and co-insurance.[104]

Therefore controlling shareholders have the power to make decisions that may be damaging to the minority shareholders and thereby increasing agency costs. Corporate governance principles which are adopted from the U.S. or the U.K. may not be totally apt for Malaysia as the dispersed ownership in the U.S. and the U.K. gives rise to different agency problems which occur from the alignment between the managers and the shareholders as opposed to controlled ownership where the issues arise from the alignment between controlling and non-controlling shareholders.

It may be said that law can play an important role in reducing agency costs in controlled companies. This may be by placing rules and procedures so as to facilitate enforcement actions brought by principals against dishonest or negligent agents or augment disclosure by agents. In protecting the principals against exploitation by their agents, the law can benefit agents as much as it benefits the principals since the agent will be offered greater compensation by the principal if the principal is assured of performance that is honest and of high quality. An illustration of this will be the legal constraints on the ability of controlling shareholders to expropriate minority shareholders should reduce the cost of outside equity capital for corporations or rules of law that inhibit insider trading by corporate managers should increase the compensation that shareholders are willing to offer the managers.

It can be seen that Malaysia seems dedicated towards raising the standards of its corporate governance. Much has been achieved concerning the regulation of listed

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[101] William J. Baumol, *Business Behaviour, Value and Growth*, 2d ed. (New York: Macmillan, 1959).

[102] In this regard, there is the similarity between controlled companies and dispersed companies this agency problem exists for both.

[103] Nam Sang-Woo, "Business Groups Looted by Controlling Families, and the Asian Crisis" (Research Paper No 27. *Asian Development Bank Institute,* 2001).

[104] Najah Attig, Klaus Fischer & Yoser Gadhoum, "On the Determinants, Costs, and Benefits of Pyramidal Ownership: Evidence on Expropriation of Minority Interests" (Paper presented at 2nd Asia Corporate Governance Conference, Seoul, 2002) [unpublished].

companies and the formulation of principles designed to ensure sound corporate governance systems and practices. The corporate governance system that has emerged in Malaysia is a result of the interplay of historical, cultural economic and political factors. The CLSA Emerging Markets Report does highlight this point. However, it can be seen that there is still a lot to be done as far as enforcement and political environment is concerned.

CLSA Emerging Markets Report 2001-2003[105]
Regional Comparative Finidings

CLSA Country Ratings (Malaysia): Trend Analysis

	Year		
	2001	2002	2003
Rules & Regulations	9.0	9.0	9.0
Enforcement	2.0	3.0	3.5
Political/Regulatory environment	2.0	3.0	4.0
Adoption of IGAAP	5.0	6.0	7.0
Institutional Mechanisms & CG culture	5.0	6.0	6.5

It may be said that Malaysia seems to have done well in the regulatory strategies but is faring poorly in the governance strategy.

Therefore it may be concluded that to entrench a culture of sound corporate governance in Malaysia requires more than just changes to laws and regulations. Besides law, Malaysia can move forward by introducing a self-enforcing model[107] that will put a check on the controlling shareholders and improve Malaysia's governance strategy.

[105] *CG Watch: Corporate Governance*, CLSA, April 2003.
[106] See *supra* note 19.