OWNERSHIP VERSUS CONTROL:  
FAULT LINES IN DIRECTORS-SHAREHOLDERS RELATIONSHIP-SPECIAL REFERENCE TO MALAYSIAN FAMILY BUSINESS

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Abstract

The structure of family business is unique compared to the non-family business as it combines three elements, namely, family relationships, composition of owners and management structure under the name of the business. This distinctive attribute often give rise to governance issues. Under the conventional concept of corporate governance, directors should act in the best interest of the shareholders. In doing so, the directors’ action is governed by certain rules which specify their duties and these rules are relevant to the shareholders with respect to their rights. Although there are laws which govern the relationship between the directors and shareholders, in certain circumstances there are some latent problems. These hidden problems can be identified as the fault lines in the relationship between directors and shareholders. This article discusses the issues pertaining to fault lines which may arise in a family business due to the complex and overlapping structure between directors and shareholders in a family business. Research methodology applied in this research is mainly doctrinal analysis.

Keywords: Family Business, Directors, Shareholders

Introduction

The structure of family business is unique compared to the non-family business as it combines three elements together under the name of the business. The three elements are family relationships, composition of owners and management structure. These elements inter-mingle with one another and often give rise to governance issues. This paper intends to discuss one of the issues; the conflicts between ownership and control.
Family Business

According to Chrisman, Chua and Sharma, there are 21 different definitions of family business in their review of 250 research articles. Generally, it refers to a business structure in which the ownerships, the management and the decision making power are retained and intended to be for the family members. The restrictions are structured as such from the beginning to establish a business legacy of the family name.

The Family Business Models

There are many models used in family business study. One of the models is the system theory model. According to this theory, the family firm is modeled as three overlapping and interdependent subsystems comprising of family, management and ownership. Each subsystem maintains boundaries that separate it from the other subsystem and the general external environment in which the family business operates. In order for the organization to perform at its utmost capacity, the subsystems must be integrated so that there is a unified functioning of the whole system.

The System Theory Model of Family Business

Another model which is used to explain elements of family business is the three-circle model. This model is generally similar to the system theory model except that it replaces the element of management with the element of business.

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Under this model, everyone involved in a family business falls within one of the seven sectors created by the three circles. Numbers 5, 6 and 7 refer to individuals who only have one connection with the business either as family member, owners or employed by the business. People who are involved in a single domain will probably have less knowledge of the other domains and may have different expectations. For example, a parent who is not involved in the business will tend to support the business without regard to that person’s qualifications and experiences and will tend to make decisions based on parental (or other family roles) rather than the

basis of a business.8 Non-family employees are also single-domain individuals.9 They work for the company, but do not have the same interests as owners or family members.10 Their own hopes and dreams may conflict with those of family employees, particularly when family employees are promoted or when family members discuss business issues at home, thus excluding non-family employees from the discussion.11

Numbers 2, 3 and 4 are in the double domain area. In the double domain area, the combination could be:

- Family + Business; this is commonly referring to employed family members, not owners.
- Family + Owner; this is commonly referring to family shareholders who do not work in the business.
- Business + Owner; this is commonly referring to employee shareholders.

The most important sector in the model is sector 1 which covers individuals who are family members, own shares and work in the business. This sector comes under the three domain area. Under this domain, all three components are overlapping; Family + Business + Ownership = family members involved in all three sectors.12 Family members who work in the business and owners are probably the most knowledgeable about the inherent workings of all three domains because they have more frequent and intimate interaction with all three domains.13 These individuals may have more responsibility and authority in the business.

The themes underpinning family business are relationships and their obligations and the values of reciprocity and respect.14 There are two main factors which justify the survival of family business:15

8 Ibid.
9 Ibid.
10 Ibid
11 Ibid
12 Ibid
13 Ibid.
15 Ibid.
Decisiveness in the marketplace which allows the companies to be aggressive and effective.

The family ties/relationship ensures cohesiveness and trust that makes such companies formidable adversaries.

Nonetheless, despite its secured tenure in the market place, the expansion of family business faced two main threats. Firstly, the inability of succeeding generations to maintain the entrepreneurial spirit and success of the founders and secondly, the issue of sustainability. A family business is claimed to be able to expand only up to a certain size, and beyond that size, the enterprise can only operate effectively through the application of more universal rules, impersonal processes, and without reliance on individual links of kinship. BDO Canada highlighted that only one-third of family-owned businesses survive the transition to the second generation. The issue of sustainability is actually the impetus behind this paper which meant to highlight the possible diversion of ownership in the course of expansion of the family business.

Ernesto Poza highlighted that a simple business ownership is preferable because its ownership structure can work well for one generation. However, it can quickly turn dysfunctional in the next generation. He contended that successful family businesses often compete on speed and agility and as such, finding a suitable corporate structure is very important. A simple approach used by many family businesses is to separate the business from the family assets whereby only family members who are not active in the business get family assets, while those who work in the company get shares. Another useful approach applied in family businesses is to redesign the capital or ownership structure of the company whereby only those who are active in the company can own shares of the

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16 Ibid.
17 Ibid.
18 Ibid.
21 Ibid.
22 Ibid.
company. In such ways, the third-generation family members who are retiring will have to sell their shares to members of the next generation. 23

Malaysian Family Business

A report of a national survey covering 225 companies conducted by Grant Thornton and Malaysian Institute of Management in 2002,24 stated that majority of family businesses in Malaysia is small scale enterprises and generally managed by the founder. Manufacturing, retailing or constructions are the notable sectors in which family business ventured most.25 It is also found that most of the family businesses were initiated by people having six years or more of work experience.26 The study indicates that in Malaysia, people with appropriate experience commenced family businesses.

The Report also underlines the characteristics of family business in Malaysia, which can be summarized as:

- 59% of the business is still run by the founder and 30% are run by the second generation, the majority of whom are children of the founder;
- 65% of small scale enterprises are managed by the founders;
- 55% of family businesses in the small scale enterprises employ less than 51 persons;
- 35% of family businesses in the medium scale enterprises employ between 51 - 250 persons;
- 10% of family businesses from large scale enterprises employ more than 250 persons; and
- main activity of family business lies in manufacturing (35%), followed by retailing (12.9%) and construction (10%).

The Report also highlighted two main concerns in a family business structure:

- Means to finance the business
- Involvement /Participation of family member

23 Ibid.
25 Ibid.
26 Ibid.
Although these two factors are seen to be distinct, in practice they are actually interrelated. In starting up, carrying out and expanding the business, often family business faced not only the challenge of getting sufficient financing but also the appropriate source of finance. The Report also recorded responses on outsiders’ participation in the family business. It was found that only 39% of the respondents from the large scale business were concerned about outsiders coming into the business and taking control of the business whilst in the medium scale businesses, 43% of the respondents expressed their concern about external participation in the family business. On top of that, 44% of the respondents in the medium scale business expressed their worry over losing control if outsiders are allowed to be in the family business. The Report supports the rationale of this paper, i.e. that one of the main issues of concern in family business is the conflict between control and ownership.

Control and Ownership

The dichotomy of control and ownership, which is the essence of directors-shareholders relationship, is the main spectrum of the fault lines between the owner and the management. Thus, it would be essential to elaborate the dichotomy of control and ownership in a company before discussing the fault lines evolving from it.

Separation of control and ownership occurs in a situation where shares are widely dispersed or where the shareholders are not involved in management of the company. This situation would be inevitable in a public company. The shareholders who own shares in the companies are known as the owners whilst the directors who manage the companies are said to have control over the entities. Berle and Means discussed the concept of control and ownership in their book *The Modern Corporation and Private Property* whereby they averred that a greater dispersion of share ownership would cause a decrease of the shareholders’ power and interest in the company. This is known as a separation of ownership from control. The writers argued that as a result of the separation of ownership from

control, shareholders would no longer have charge of the direction of the company and the directors are vested with wider power in developing the company. Consequently there will be a divergence of interest between the managers and owners in certain situation.

According to Dr Saleem Sheikh and Professor SK Chatterje:

The divergence of interest between ownership and control had created a division of functions. Within the corporation, shareholders had only interests in the enterprise while the directors had power over it. The position of the shareholders had been reduced to that of having a set of legal and factual interests in the enterprise.

When there is a separation between the owners and the controllers in a company, there is a possibility that the interests of the shareholders would not be carried out since they have no control over the running of the company. In other words, such divergence would cause the company to depart from the traditional theory of profit maximising behaviour. It appears that directors who are also the managers have the control, and would act towards maximisation of their own lifetime incomes. According to Edward S. Herman control relates to power which is ‘the capacity to initiate, constrain, circumscribe, or terminate action, either directly or by influence exercised on those with immediate decision-making authority.’

Thus the directors might disregard the interests of the shareholders which should have been their paramount consideration. The directors may own some shares and such ownership is usually the result of the directors’ executive positions in the company. Therefore these

29 Dr Saleem Sheikh and Prof SK Chatterjee, Perspectives on Corporate Governance, in Dr Saleem Sheikh and Prof William Rees (eds), *Corporate Governance & Corporate Control*, (Cavendish Publishing Limited, London, 1995) at 38.
30 Ibid at 40.
32 Above note 2, at 42.
33 Edward S. Herman, *Corporate Control, Corporate Power,* (Cambridge University Press, 1981) at 17
34 Above note 2, at 42.
directors who operate the business of the company are primarily motivated by their own self-interest, which may not coincide with the interest of the owners.36

Furthermore, the separation of ownership from control limited owners to being satisfiers instead of maximisers.37 This means the shareholders will be satisfied with the dividend received without participating in the management of the company for the purpose of obtaining maximum profit. When the owners lack control of the company, they become unfamiliar with the policies engaged by it.38 As a result, the managers may aim at achieving steady growth of earnings instead of maximising profits for the owners.39 This situation is known as shareholders passivity. Cohen Committee acknowledged that the lack of active participation from the shareholders was due to the separation of ownership from control.40 Furthermore the dispersion of capital among an increasing number of small shareholders made them pay less attention to their investments and they are contented with the dividends which are forthcoming.41 However the Cohen Committee averred the need for a separation of ownership from control:

Executive power must inevitably be vested in the directors and is generally used to the advantage of the shareholders. There are, however, exceptional cases in which directors of companies abuse their power and it is, therefore, desirable to devise provisions which will make it difficult for directors to secure the hurried passage of controversial measures... 42

This is indeed true since not all shareholders have the knowledge to manage the business of the company and it will be more appropriate to leave management of the company to more qualified persons

36 These views have been objected by Herman who contended that his survey revealed that the broad objective of both large managerial and owner-dominated firms tended to be profitable growth and that motive has not been affected by the rise of control.
37 Above note 2, at 42.
38 Ibid.
39 Ibid.
40 In Board of Trade, Report of the Company Law Committee (1945) Cmnd 6659 (Cohen Committee).
41 Ibid at 135.
42 Ibid.
like the directors. The directors should therefore be treated as mere managers of the company and should manage the company in conformity with the policies approved by the shareholders.\textsuperscript{43}

Cohen Committee and Jenkins Committee have recommended disclosure of the company’s activity to remedy any possible abuse of powers by the directors. The latter had also agreed that the existence of separation of control from ownership was essential for the general good of the company.\textsuperscript{44} The report in Jenkins Committee focused more on the directors’ powers and shareholders’ control. It appears that Jenkins Committee was concerned with the issue whether shareholders who contribute the equity of a company should really be involved in the management of that company and the directors should perform their duties without being involved in the ownership of the company to avoid any conflict of interest.\textsuperscript{45} In other words the separation of ownership from control is something inevitable, but the directors should not abuse the control and the shareholders should be allowed to monitor it only to a certain extent so as not to interfere with the directors’ freedom i.e. to do what they think best in the interest of the company. This is supported by Lipton and Rosenblum\textsuperscript{46} who viewed that the relationship between managers and shareholders is problematic in the modern public company and there should be a system where these two parties may work cooperatively towards the company’s long-term success.

**General Power to Manage**

Generally, companies adopt article 73 of Table A\textsuperscript{47} in their articles of association. The article provides:

\begin{quote}
The business of the company shall be managed by the directors who may... exercise all such powers of the company as are not, by the Act or by these regulations, required to be exercised by the company in
\end{quote}

\textsuperscript{43} Above note 2, at 10.
\textsuperscript{44} Ibid and above note 13.
\textsuperscript{45} Above note 2, at 11.
\textsuperscript{47} Fourth Schedule, Companies Act 1965 (Malaysia).
There are two main points in this article. The first limb prescribes the directors’ general power to manage a company whilst the second limb explains the limitations to that power. The former indicates that if the management of a company is vested with the directors, the members i.e. the shareholders may not give instruction to the directors or override their decision.\textsuperscript{48} Harman J. in 	extit{Breckland Group Holdings Ltd v London Suffolk Properties Ltd & Ors}\textsuperscript{49} confirmed that the powers of the board of directors are independent of the shareholders and further held:

\textit{The principle, as I see it, is that the article confides the management of the business to the directors and in such a case it is not for the general meeting to interfere...If the board does not adopt it, a general meeting would have no power whatever to override that decision of the board and to adopt it for itself}\textsuperscript{50}

The second limb provides limitation regarding directors’ power to manage had been subject to certain argument. The majority viewed that directors have autonomous powers to manage the company and they were against any interference by the owners in managing the company.\textsuperscript{51} Those agreed with this view are more inclined to leave matters relating to the management of the company in the hands of the directors. On the other hand, in certain cases shareholders

\begin{itemize}
\item \textsuperscript{49} [1989] \textit{BCLC} 100.
\item \textsuperscript{50} Ibid at 106.
\item \textsuperscript{51} Refer cases like Automatic Self-Cleansing Syndicate Co Ltd v Cunninghame [1906] 2 Ch 34, John Shaw & Sons (Salford) Ltd v Shaw [1935] 2 KB 113, Dato Mak Kok & Ors v See Keng Leong & Ors(1990) 1 MSCLC 90,357, NRMA v Parker (1986) 4 ACLC 609, Queensland Press Ltd v Academy Instrument(No 3) Pty Ltd (1987) 11 ACLR 419.
\end{itemize}
are allowed to interfere to limit the directors’ powers to manage. However, this view had not been taken up or developed, and had even been ignored.

**Refusal to Register Transfer of Shares**

Section 98 of the Companies Act 1965 provides that shares of any member in a company shall be movable property, transferable in the manner provided by the articles of association. However, the right of a shareholder to transfer his shares would be subject to restrictions in the Companies Act 1965 and also in the articles of association. Though these restrictions are meant primarily for the private companies, it would be relevant to discuss the issues since family owned companies are commonly formed as private companies.

Restriction to transfer shares could be in the form of Article 22 of Table A where directors may decline to register any transfer of shares to a person whom they do not approve of or which the company has a lien. However, most companies provide for restrictions in their articles of association which go beyond the restrictions in Article 22. For instance in *Re Smith & Fawcett Ltd* the article provided that “the directors may at any time in their absolute discretion and uncontrolled discretion refuse to register any transfer of shares.” The Court of Appeal in this case accepted the restrictions as provided in the above article and added that it would not be necessary for the directors to give reasons. The above decision was later reinforced in the Malaysian case of *Kesar Singh v Sepang Omnibus Co Ltd.*

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53 Refer section 15 of the Companies Act 1965.

54 It should be noted that in *Four Seas Enterprise Corporation Sdn. Bhd v Yap Tean Cheong* [1995] 1 LNS 273, Zakaria M Yatim J mentioned that non-listed public company may impose restrictions on the right of transfer if its articles of association so provide.

55 Fourth Schedule, Companies Act 1965 (Malaysia).

56 [1942] 1 *All ER* 542.

57 (1964) 30 MLJ 122.
In the above circumstances directors are left with wide discretion and absolute power to refuse to register a transfer of shares. When the directors were empowered by the article with “absolute discretion and unlimited power and without assigning any reasons” to refuse the registration of any shares, they can be said to have a veto power on that matter and would be difficult for anybody not even the owners (i.e. the shareholders) of the company to challenge it. The unlimited power to refuse to register the transfer of shares exercised by the directors may affect directors-shareholders relationship.

Nevertheless the exercise of such power by the directors is limited by their fiduciary duty to act *bona fide* in the best interests of the company as pointed out by Lord Greene MR in *Re Smith & Fawcett Ltd*[^58]. This means unsatisfied shareholders may challenge the directors’ action by proving *mala fide*. However as averred by M.T. Lazarides[^59], bad faith is difficult to be proved in the absence of a requirement to give reasons (for the refusal to register transfer of shares). It is only when reasons are given, either required or not, the court will examine its legitimacy. In *Lim Ow Goik & Anor v Sungei Merah Bus Co Ltd*, the court had examined the reasons given though it was not required and held that it was an improper exercise of power by the directors. Also in *Re Bells Bros Ltd*, Chitty J. had ordered for the registration of the proposed transfer since the reason given was not justifiable. In this case the directors refused to register a transfer on the grounds that the transferee was not a member of the Bell family and the court considered that the directors, in rejecting the transfer based on the policy of keeping shares within the family had exercised the power on a wrong principle and for a reason not within the legitimate purposes of their power.

In the absence of the requirement to provide reasons for the refusal to register a transfer of shares by the directors, the rights of the shareholders might be jeopardized. To leave the directors with absolute power and uncontested discretion would be unfair to the

[^58]: Above note 29. Lord Greene MR held that ‘*In the present case the article is drafted in the widest possible terms, and I decline to write into that clear language any limitation other than a limitation, which is implicit by law, that a fiduciary power of this kind must be exercised bona fide in the interests of the company.*’

shareholders who own the company. Thus appropriate provisions would be necessary to balance the absolute power given to the directors who control the company.

**Power to File Winding Up Petition**

A company may be wound up by way of voluntary winding up or compulsory winding up. According to Section 217(1)(a) of the Companies Act 1965, compulsory winding up needs to be initiated by a petition filed by the company concerned. However, the provision is silent on whether the shareholders’ approval is necessary before a company files a winding up petition. In other words, the word ‘company’ stated in that provision is unclear. Thus it refer to the board of directors or the shareholders or both? The interpretation on that issue is given by case laws and it can be divided into two i.e. those which require the shareholders’ sanction and those which do not. Some of the Australian cases like *In re Standard Bank of Australia*\(^{60}\) and *In re Birmacley Products Pty Ltd*\(^{61}\), the courts held that it was necessary to obtain the shareholders’ approval before a petition to wind up a company could be made. In coming to this decision the courts referred to the old English case of *Smith v Duke of Manchester*\(^{62}\) where Bacon VC held that on such an important question of whether a company should be destroyed or not, the shareholders should have a right to express their views. *In re Standard Bank of Australia*\(^{63}\), Hodges J in discussing about who would file for a winding up petition, had elaborated that the article which rendered powers to the directors to manage the business of the company did not include the power to destroy the company. Therefore before filing for a winding up petition, the directors must first obtain the shareholders’ consent.

On the other hand, cases like *Re Inkerman Grazing Pty Ltd*\(^{64}\), *Spicer & Anor v Mytrent Pty Ltd & Ors*\(^{65}\) and *Re New England Agricultural Corporation Ltd*\(^{66}\), allowed the directors in the absence of the

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\(^{60}\) (1898) 24 V.L.R. 304.


\(^{62}\) [1883] 24 Ch D 611.

\(^{63}\) Above note 62 at 306.

\(^{64}\) (1972) 1 ACLR 102.


\(^{66}\) (1982) 1 ACLC 557.
shareholders’ sanction to file a winding up petition. Street J in *Re Inkerman Grazing Pty Ltd*[^67] viewed that directors have the power to file a winding up petition on behalf of the company by virtue of Article 73 of Table A (which discussed about directors’ power to manage the company) and during financial crisis it would be justified for the directors to resolve to that procedure without seeking the approval of the shareholders.

In Malaysia, VC George in the case of *Miharja Development Sdn Bhd & 8 Ors v Loy Hean Heong & 9 Ors*[^68] followed the decision of Street J. in *Re Inkerman Grazing Pty Ltd*.[^69] According to the learned trial judge, the effect of and the practice in respect of Section 217(1) (a) of the Companies Act 1965 was that the directors of a company may petition for the winding up of a company without obtaining the sanction of the shareholders. According to Choong Yeow Choy this should not be conclusive since it was only a High Court decision and the court in construing the articles of association of a company should be mindful of the fact that the shareholders as owners of the company should have a say in a crucial decision like winding up.[^70] Loh Siew Cheang[^71] who disagreed with the reasoning given in *Re Inkerman Grazing Pty Ltd*[^66] and *Spicer & Anor v Mytrent Pty Ltd & Ors*[^73], opined that directors as persons who manage the financial affairs of the company might be the ones who trigger the company’s financial crisis and it is not right to let them wind up the company without consulting the shareholders.[^74]

The above are examples of the fault lines which may occur in family owned companies. These fault lines are the result of the ambiguity concerning the locus of certain powers in a company. Failure to resolve them may affect the standard of corporate governance that may cause the collapse of the company in the long term.

[^67]: Above note 66 at 106.
[^69]: Above note 66.
[^70]: Choong Yeow Choy, Who has the right to terminate the life of a company-shareholders or the board of directors?, *The Company Lawyer* (1996) Vol 17 No 2, at 64.
[^72]: Above note 66.
[^73]: Above note 67.
[^74]: Above note 48.
Conclusion

The separation of ownership from control would result in the directors or managers more dominant than the owners or the shareholders. The definite meaning of the provisions concerning control and management is essential to ensure that the directors will not abuse their authority and powers. It is necessary to determine whether or not the power is absolute and whether or not it allows for interference and control by the shareholders. It is also necessary to determine whether the shareholders are allowed to interfere in the management of the company and if so, to what extent this may affect the power of directors. If not alleviated, these fault lines may disrupt the corporate governance of a company. Since separation of ownership from control is obscure in family owned companies, the practices of corporate governance principles, such as accountability and disclosure are essential to formulate an acceptable standard of transparency as a means of check and balance between directors and shareholders.