



Directors' Fiduciary Duties to Perform in the Best Interest of the Companies: An Inter-Related Relationship Between Ethics and Governance

Suraiya Ishak^{1,*}; Ahmad Raflis Che Omar²; Azhar Ahmad³

¹School of Social, Development and Environmental Studies, Faculty of Social Sciences and Humanities, Universiti Kebangsaan Malaysia

²School of Business Management, Faculty of Economics and Management, Universiti Kebangsaan Malaysia, 43600 Bangi, Selangor, Malaysia.

Email: raflis@ukm.my

³School of Business Management, Faculty of Economics and Management, Universiti Kebangsaan Malaysia, 43600 Bangi, Selangor, Malaysia.

Email: azah@ukm.my

*Corresponding author.

Address: School of Social, Development and Environmental Studies, Faculty of Social Sciences and Humanities, Universiti Kebangsaan Malaysia, 43600 Bangi, Selangor, MALAYSIA

Email: suraiya@ukm.my

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Abstract

This study inspires from Smith Moral Sentiment Theory which recognizes moral as the essential motive for every human action. The purpose of this study is to prove the relationship between ethical principle and corporate governance. This study employs case-study approach comprising three Malaysian cases. Each case will be analyzed parallel to the governance principle of promoting the best interest for the company. Board of directors (BOD) is emphasized throughout this study due to the important role of BOD in the structure of corporate governance. This study suggests that in order to execute corporate governance effectively, it must be based on ethical principles. As a result, ethical principles are included in the corporate governance rules as reflected by the terms of "proper purpose", "in good faith in the best interest of the company", "reasonable care" and "diligence". These terms contain subjective and relative meaning. For this study, corporate governance rule cannot be separated from the confinement pillars of ethical principles. Thus, the study reiterates Smith argument that moral sentiment should underly human economic activities, including the jurisdiction of corporate management.

Key words: Ethics; Corporate governance; Agency theory; Moral sentiment; Board of directors

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INTRODUCTION

Most studies on corporate governance are focusing on the relationship of governance mechanisms and the companies' performance or shares' prices (Heaney, 2009; Neeraj and Arun, 2005; Setia-Atmajaya, 2008 and de Andres et al., 2005). Company's performance and shares' prices have been used as they reflect the results from the entire governance process. However, there is a gap in corporate governance studies in terms of investigation on ethics and corporate governance relationship.

One of the most important governance mechanisms lies in the roles of directors. The directors are elected to perform fiduciary duties with respect to the upholding of the company's interest. Some obligations of the directors are outlined legislatively in the Malaysia Companies Act 1965. However, the assumptions that the directors are naturally acting in the best interest of the companies is rather simplistic. Therefore, in lights of Smith Moral Sentiment Theory this study aims to prove the inter-related relationship between ethics and corporate governance. As far as ethics and governance are concern, the relationship of the two concepts is expected to be related to each other rather than substituting one another.

1. CORPORATE GOVERNANCE

Globalization allows freedom of capital movement throughout the world. Domestic and foreign investment is particularly important to provide sufficient resources for the development process. Thus, the ability to provide reasonable assurance of investment accountability and returns has formed the basis in rational investment decision-making. Investors' confidence towards the prevailing structures of corporate governance and practices would determine their willingness to participate in particular capital market (Skousen et al., 2005). This relationship can be induced from the evolution of US corporate regulations way back in 1930s. Before the securities' market crash in 1929, there was relatively little support for government regulation in US securities markets due to business deregulation policy (Sridharan et al., 2002). Since then, public confidence in securities market had declined. As a result, US government had introduced the Securities Act in 1933 and Securities Exchange Act in 1934 in order to restore public's faith by providing the capital market with structure and oversight mechanism. In 2002, the Congress passed a new act known as the Sarbanes Oxley Act due to the sudden collapsed of Enron Corporation in 2001. The Sarbanes Oxley Act 2002 had been enacted to protect public investors and regain investors' confidence through improvement of the financial reporting transparency. Thus, protection of investors' right and investment is becoming increasingly important in the era of globalization.

Severe economic downturn has contributed towards the increasing effort to improve and upgrade the governance structure in most countries. For example, corporate governance has emerged to be an important issue since the aftermath of 1997 Asian economic crisis (Backman, 2006). In Australia, the corporate governance issue has intensified since 2001 due to occurrence of major corporate collapse and scandals in the country. Corporate governance (CG) can be defined as "the system by which companies are directed and controlled" (Skousen et al., 2005). In Malaysia, the Finance Committee on Corporate Governance (2001) describes CG as "the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability. The ultimate aim is to realize long-term shareholder value, whilst taking into account the interest of other stakeholders". Hence, establishment of laws and regulations is indeed important to secure management obedience and to gain public investors' confident (Lamoreaux, 2009; Skousen et al., 2005 and Dellaportas, 2005). In addition, according to La Porta et al (1998 and 2000), the existence of laws and its implementation by the regulators and court is essential to the corporate governance and financial management. La Porta et al (2000) noted that countries which are based on common law rules usually have the strongest level of investors' protection (La Porta et al., 2000 and 1998). Consequently, laws and regulations are recognized

as the most important source of corporate governance mechanism in most countries especially in a common law based country such as Malaysia.

In terms of model, there are two dominant CG models, known as the Anglo-Saxon Model and the European Continental Model (Ooghe and Langhe, 2002; Neeraj and Arun, 2005; and Setia-Atmajaya, 2008). Both models differ in the nature of its control mechanism. The Anglo-Saxon model emphasizes on the use of external control (market mechanism) such as role of institutional investors and the threat of merger and take-over; while the European Continental Model relies on internal control mechanism such as directors' remuneration, board composition and management performance based-reward (Setia-Atmajaya, 2008). The choice of model depends on the type of capital market which is specifically determined by the level of investors' ownership concentration and power over the management. Nevertheless, the board of directors is recognized as important players in both CG models.

Boards are considered as the institutions that mitigate the effects of agency problems existent in the organizations (Khongmalai et al., 2010: 618; Neeraj and Arun, 2005: 163; Setia-Atmajaya, 2008: 332 and de Andres et al., 2005: 198). The boards are accountable with some fiduciary duties including formulating corporate policies, approving strategic plans, authorizing major transactions and the sale of additional securities and declaring dividend which finally impact the future of particular organizations. However, according to Hart (1995) and de Andres et al. (2005), the effectiveness of board of directors is in doubt for some reasons. Although there are ways to improve its effectiveness, it is unlikely able to solve the agency problems entirely. Thus, this derives a question whether governance rules is sufficient to ensure that the directors perform their task effectively? In other words, is it possible for the directors to perform their fiduciary duty independently from ethical value? As a result, this article will discuss deliberately these issues by focusing on governance provisions in the Malaysia Companies Act 1965 and to comprehend the necessary premise for directors in performing their fiduciary duties through observation on selected corporate cases in Malaysia.

1.1 Moral Sentiment Theory

The premise underlying this study originates from Smith Moral Sentiment Theory. Although Smith was well-known of his economic theories, it is also important to acknowledge that he had devoted his early scholar activities promoting idea of virtues and ethics. Since 1959, his moral idea has been published through Theory of Moral Sentiments. Smith proposed that the sense of propriety as the basic motive to govern all range of human activities including their economic activities. According to Smith, "pity or compassion is the emotion in which a

person feel the misery of others either when they see it or are made to conceive it in a very lively manner” (Smith, 1976, p.10).

According to Smith (1976, p.62) there are two different ways for people to obtain respect and glory which will finally mould their character or behaviours. The ways are:

- (1) Study of wisdom and practice of virtue
- (2) Acquisition of wealth and greatness

The first way will lead to conscious and deliberate move of actions that place goodness to the systems. It deters scrupulous greed and selfishness motive from human’s choice of actions or behaviours. They will fulfil their wishes or desires through moderate and cautious actions rather than emphasizing their ambition by expropriating others’ interest. However, according to Smith, “many men place his glory in being thought rich, without considering that the duties which that reputation imposes upon him, must soon reduce him to beggary, and render his situation still more unlike that of those whom he admires and imitates, that it had been glory” (1976, p.64). Smith contended that most people viewed wealth and richness as the popular way to obtain respect and greatness in their society. Therefore, wisdom and virtues have become unpopular to most people and Smith had described it in his own statement as “...They desired to be praised for what they do not think praise-worthy, and are ashamed of unfashionable virtues which they sometimes practice in secret, and for which they have secretly some degree of real veneration. There are hypocrites of wealth and greatness, as well as religion and virtue; and a vain man is as apt to pretend to be what he is not, in the one way, as a cunning man is in the other...” (1976, 64) Virtue can be placed into human action through proper means of approbation value which is confined in the domain of propriety sense. The most important source of propriety sense comes in the feeling of pity or sympathy to others.

However, Smith economic idea has been misinterpreted due to the abandonment of the moral sentiment. As a result, the abandonment of moral motive has led to over-emphasizing on utility rather than moral as the approbation value in human economic choices (Macfie 1959; Coker 1990; and Gramp 1948). This view has been noted from Smith statement, “...Every affection is useful when it is confined to a certain degree of moderation; and every affection is disadvantages when it exceeds the proper bounds. According to this system therefore, virtue consists not in any one affection, but in the proper degree of all affections. The only difference between it and which I have been endeavouring to establish, is, that it makes utility, and not sympathy, or the correspondent affection of the spectator, the natural and original measure of this proper degree” (1976, p. 306). Thus, the abandon of moral sentiment theory has also led to deception behaviours among corporate agents which praise pleasure of wealth and greatness in an isolated perspective. This is in line with Coker (1990) and Grampp (1948) ideas which

believe Smith’s concept of moral sentiment as essential components of the human personality which are vital to proper interpretation of the economic man of the Wealth of Nations.

Within the moral frame in the concept of economic man, the economic system has made to havoc due to incessant business failures characterized by various corporate insiders misdeeds (Lamoreaux, 2009). The insiders of Enron, WorldCom, Tyco International, Adelphia Communications and a number of major U.S companies were found out to use a variety of accounting tricks to cover up deals that had benefited themselves personally and seriously harm the companies. Lamoreaux (2009) referred the expropriation of companies by greed (or power-hungry) managers (inside threats) as Type 1 problem of corporate governance. In such condition, Agency Theory (Jensen and Meckling, 1976) has gained its most credits as it offers the theoretical basis for explaining cunning opportunist behaviours as well as arrays of possible mechanisms to minimize its occurrence (Kulik 2005; Daily et.al., 2003; and Ghoshal and Moran, 1996). According to Daily et al. (2003, p. 372), the popularity of Agency Theory in governance research is due to two factors:

- a) It is an extremely simple theory in which large corporations are reduced to two participants, managers and shareholders; and
- b) The notion of humans as self-interested and generally unwilling to sacrifice personal interest for the interest of others is widely spread for ages.

Agency Theory has assumed that management as the opportunist agents and thus requires constant monitoring from various type of monitoring tools (Culpan and Trsussel, 2005; Ghoshal, 2005; Kidder, 2005; Kulik, 2005; Jones and Pollitt, 1996; Adams, 1994; and Jensen and Meckling, 1976). In lights of Agency Theory, various monitoring tools which are ultimately related to corporate governance have been established and constantly improved in order to minimize agents’ opportunist behaviours. Previous studies within domain of corporate governance mechanisms have been focusing on the role of board of directors with specific emphasise on parameters such as board sizes, board compositions, board independency and boards’ structures and functions (Hearney, 2009; Setia-Atmajaya, 2008; de Andres et.al, 2005; Neeraj and Arun, 2005; Daily et al., 2003; and Jongmoo et al., 2007). However, this study will not be in the stream of investigating the results or effectiveness of governance mechanism within the frame of Agency Theory, but to provide evidence on the intertwining relationship between ethics and fiduciary duties of directors through qualitative investigation within the context of Smith moral sentiment theory. This is in line with Neeraj and Arun (2005) who suggested future researcher to conduct study on the qualitative aspect of BOD as it may have impact on the firm value. Thus, ethical value is the qualitative aspect that

is worth studying. In addition, this study also parallels to Daily et al. (2003) who viewed that corporate governance research should attempt to consider alternative theoretical perspectives rather than solely base on the premise of Agency Theory.

2. ANALYSIS

This study employs case-study approach to deliberate its' argument qualitatively. The analysis is divided into three sections. The first section contains the description of the Malaysian Companies Act provisions related to Malaysian director's fiduciary duties and responsibilities. The second section consists of description of corporate cases in which the prescribed sections of the Malaysian Companies Act are assumed to be exercised. The cases provide

background for the implementation of the specified provisions act as well as proving the concerned issue. The third section summarizes the issue by pondering into the area which reflects the existence of the inter-related relationship of ethic and governance. This part of analysis attempts to describe potential situation which would probably occur within such context and it does not reflect specific normative evaluation on the individual cases or subjects.

2.1 Malaysia Companies Act 1965

The Companies Act 1965 is one of the important guides for corporate governance in Malaysia. This study focuses on sections which relate to the director's fiduciaries duties. Table 1 show the relevant sections in the Malaysian Companies Act which are related to the company's directors' fiduciary duties.

Table 1
Duties and Responsibilities of Directors Stipulated in the Malaysian Companies Act

No.	Section	Description of provisions
1	Section 131B(1)	The business and affairs of a company must be managed by, or under the directions of, the board of directors.
2	Section 132 (1)	A director of a company shall at all times exercise his powers for a proper purpose and in good faith in the best interest of the company.
3	Section 132 (1A)	A director of a company shall exercise reasonable care, skill and diligence with: a)The knowledge, skill and experience which may reasonably be expected of a director having the same responsibilities; and b)Any additional knowledge, skill and experience which the director in fact has.
4	Section 132(1E)	A director, who was appointed by virtue of his position as an employee of a company, or who was appointed by or as a representative of a shareholder, employer or debenture holder, shall act in the best interest of the company and in the event of any conflict between his duty to act in the best interest of the company and his duty to his nominator, he shall not subordinate his duty to act in the best interest of the company to his duty to his nominator.
5	Section 132(1F)	Except as is otherwise provided by this Act, the memorandum or articles of association of the company or any resolution of the board of directors or shareholders of the company, the directors may delegate any power of the board of directors or any other person and where the directors, directors, officer, employee, expert or any other person and where the directors have delegated any power, the directors are responsible for the exercise of such power by the delegates as if such power had been exercised by the directors themselves.

Section 131B(1) of the Malaysian Companies Act provides the highest responsibility of corporate governance to the directors. The responsibility is strengthen through the provision of Section 132(1F) which states that, although the directors has delegated their power to other parties the final responsibility and accountability remain with the directors. Thus, the directors are accountable to act in the best interest of the company at all times.

Section 132(1) emphasizes the form in which the directors are obliged to render their power. The term "for a proper purpose" contains ethical imperative which require the directors to choose action which benefit to the organisation as a whole. Sections 132(1A) emphasizes on the value of prudence and sincerity whenever the directors exercise their duties. The value contains in the terms

of "reasonable care" and "diligence" in their business judgment in order to promote the best interest for the company.

Section 132(1E) extends it highest concern for directors to act impartially in the best interest of the company in all situations. It focuses on the agency relationships that exist between the directors and their nominators, which possibly lead to some degree of directors' partial consideration leaning towards the nominators' interest. The ethical imperative of impartial consideration has remained in the statement of "...he shall not subordinate his duty to act in the best interest of the company to his duty to his nominator".

2.2 Corporate Cases

These cases highlight contextual framework to the

investigation of ethics-governance relationship.

Case 1: Takeover of ABC Capital by AAA Bank

ABC Capital is a private listed company (PLC) in Malaysia. AAA Bank is the offeror for ABC takeover. The saga started with the ABC Capital board of director's (BOD) decision for not tabling and rejecting the AAA offers- worth RM 4.92 billion or RM 7.10 per share on cash basis for the acquisition of ABC Capital. The offer was rejected due to the under-price reason. The ABC Capital BOD decision had been influenced by *SSS Ltd* who owned 20.2 percent of stake in ABC Capital. *SSS Ltd* had bought their shares in ABC Capital at RM 9 per share. Meanwhile, there are other majority shareholders who were interested with the offer and keen of selling their stakes in the group. The three shareholders were Mr. R who owns 15.5 percent in ABC Capital, Mr. T (17.1 percent) and KM Ltd (10 percent). Their costs of investment were recorded at RM 2 for Mr. R and RM 6 for Mr. T and KM Ltd.

Mr. R who was interested with the AAA offer, had convened for ABC Capital extra-ordinary general meeting (EGM). The purpose of the EGM was to appoint eight (8) new directors to the current ABC board of directors. The proposed appointment would increase the board from 12 directors to maximum of 15 directors. Under section 145 of the Companies Act 1965, shareholders who hold at least 10 percent of the voting rights in the company are allowed to call for an EGM. As a result, the majority shareholder had exercised his power to convene the EGM for electing the new directors. The new board of directors had finally tabled the revised takeover proposal in September 2010. Finally, the resolution for the takeover had been approved by the simple majority shareholders.

Case 2: Takeover of YYY

YYY group is the largest toll-express operator in South-East Asia. YYY owns and operates 973 kilometres of inter-urban toll expressways in Malaysia stretching from the border of Thailand in the north to the border of Singapore in the south. On Oct 2010, MM Group and FEP (which also the government link entities) who already owned 68 percent shares in YYY, had proposed to buy all YYY businesses for RM 23 billions or RM 4.60 per share. At the same time, there are also other bidders who were interested with YYY business, such as GG who bid for RM 50 billion and UU for RM 26 billion.

An important implication arises from the intention of a take-over is the effect on the target company's stock price, especially when the bidder walk away from the proposal for whatever reason including unsatisfaction due diligence results. In such situation, the price and value of the target firm may plunge because of negative market reactions by market players. As in YYY case, the offerors had made their offer with was subjected to a satisfactory re-negotiation of the toll concession between YYY and the government. In general, the concession re-negotiation

would include the highway tariffs requirement. Thus, the BOD of YYY had required the bidders to place a deposit of RM 50 millions to the company. The purpose of the deposit was to compensate any potential negative consequences if the bidders choose to terminate the takeover deal. In addition, the offerors were also required to show proof of their funding capacity. Finally, only FEP and MM manage to put the deposit of RM 50 millions and other bidders had left the deal.

Case 3: ZZZ Malaysia Bank Proposed Take-over of JJJ Bank

Due to global market expansion strategy, *ZZZ Bank* had entered an agreement to buy 56 percent of equity interest in *JJJ Bank* in country A. The purchase price for the 56 percent stake was worth RM 8.8 billion and RM 4.8 billion had been paid in advance to execute the purchase deal.

Due to global economic turmoil, the capital market authority of country A had introduced strict regulation which required the liquidation of at least 20 percent of the foreign equity ownership to local public. Thus, the central bank instructed *ZZZ Bank* to hold the purchase and to negotiate for better acquisition price. Furthermore, the purchase price was reported to be at over-prices of 20 percent from the real value of *JJJ Bank*. *JJJ Bank* also was reported to have high level of non-performing loan (NPL) and a low-level of deposits. However, the price re-negotiation failed and the exercise period of the particular deal was due in September 2008.

2.3 Analysis on Ethics-Governance Relationship

According to Section 131(B)(1) of Malaysian Companies Act, the directors are the responsible agents for handling the company's affair. As stated in Section 132(1) and 132(1A) of the Act, the directors shall act for the best interest for the company. Thus, all directors are expected to render impartial consideration and to avoid any conflict of interest at all times.

Case 1: Takeover of ABC Capital by AAA Bank

Analysis: The independency of the new directors is the factor which may divert the execution of directors' fiduciary duty from the solid reason of promoting the company's interest. Hence, the element of "independency" is required for the inclusion of ethical value. The ethical motive may abstain element of partial consideration which potentially lean towards the interest of their nominator instead of the company. Although the requirement has been stated in Section 132(1E), the ability of the new elected directors to execute their power for the best interest of the companies' interest is internally determined by their ability to be impartial.

Case 2: Takeover of YYY

Analysis: Deposit and proof of funding may contain element that can be described as "for best interest of the company" as it allows only serious and credible bidders

to participate in the bidding, thus provides stability in company's share price. However, it may also violates the requirement of "the best interest for the company" if the action was taken due to other motive. Unless it has been based on a truly ethical motive of "good faith", the deposit requirement may serve as a strategy for eliminating other potential bidders rather than promoting the company's best interest. As in this case, GG which offer the highest price of RM 50 billion offer via bonds instruments had been dropped from the list of potential bidders as GG was unable to place the deposit. The government link entities, the MM-FEP which already owned 68 percents equity in YYY has been secured as the sole bidder though it offered only RM 4.60 per shares.

Case 3: ZZZ Malaysia Bank Proposed Take-over of JJJ Bank

Analysis: The decision of ZZZ board of directors to carry out the particular expansion strategy may or may not be in compliance of section 132(1) and 132(1A). It poses question has the expansion strategy been prudently analyzed in order to give good consequences for ZZZ as a whole? Section 132(1A) also emphasizes the prudence value in business decision-making. Unless the prudence value had been adopted throughout the decision-making, the strategy may not be in the best interest for the company.

3. DISCUSSION

Throughout the analysis, we found that ethical principle and governance have a very close relationship. The nature of the relationship can be describes as complementing rather than substituting one another. Implicitly, the ethical imperative has been associated through the word of "proper purpose", "in good faith", "in the best interest of the company", "reasonable care" and "diligence". Such ethical terms have been institutionalized in Section 131B(1), 132(1), 132(1A) and 132(1E) of the Malaysia Companies Act. Although the particular sections have specified the fiduciary duties and responsibilities of the BOD as well as the way they should deliver their power and duties, however, some parts has remain in the form of subjective and relative considerations. For example, in Section 132(1), the directors are required to exercise their power for proper purpose and in good faith in the best interest of the company. The terms of "proper purpose" and "good faith" require ethical motive from the incumbent agents. The subjective area requires for execution of individual ethical principle. Therefore, the organization can create its various types of governance tools, but the governance effectiveness still relies on the power of individual ethics and integrity.

This study reiterates Smith argument that moral motive must serve as the underlying premise for every human activities. In order to produce good consequences

in human life, all human actions must originate from the moral sentiment. Within the context of directors' fiduciary duties to the organizations and its' stakeholders, the element of 'prudence' and 'impartial consideration' are utmost important. We further proposed that moral sentiment theory must be re-consider as the basic assumption in the interpretation of human economic or managerial behaviours. The laws and regulations are indeed important, but as far as effective rules-execution is concerned, the human factor will remain as the significant determinant of good governance. Regulations cannot substitute human wisdom and discretion, and thus it is important to nurture ethical competency among our future management practitioners so that moral standards are incorporated into business governance practices.

CONCLUSION

This study concludes the close relationship between ethics and governance. Furthermore, ethics serves as the underlying premise for managerial actions. Thus, legal governance structure is indeed important. However, the rules are to be confined within the jurisdiction of ethical consideration as reflected through the terms of "proper purpose", "in good faith", "in the best interest of the company", "reasonable care" and "diligence". This study also found that corporate governance mechanisms cannot isolate itself from its most fundamental pillars which confine in the form of ethical principles. It is not merely an issue of governance but also ethics. Nobody knows whether the "good faith" or the "best interest" had been served by any particular directors except themselves. Thus, ethical and self-regulated mechanisms which are derived internally must be upholds to all incumbent corporate agents.

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