

**Responses to the review of the role and effectiveness of non-executive directors,
a Consultation Paper by Derek Higgs of 7th June 2001**

This response is provided by Gouldens, Solicitors, of 10 Old Bailey, London EC4M 7NG. We advise some 50 or so public companies on the Official List or on AIM. A number of our partners have been or are non executive directors in both public and private companies and the following responses, set out in brief, represent our collective experience. References to the Combined Code are to the Combined Code produced by the Committee on Corporate Governance, June 1998.

The responses below are given by reference to the numbering of the paragraph in the Paper

- A1 *Roles.* The role of the board is two-fold: to administer the company as corporate entity, and to manage the business of the company, i.e. its corporate activity.

The role of the chairman is to act as the final authority in the company. He must have the moral authority and strength of purpose to do that. He must run board meetings and dispatch their business efficiently. He must ensure consultation between all the directors. Like it or not, he will be the first public butt of any criticism of the company, and in that sense even a non-executive chairman will be treated as if he or she has an executive role.

- A2 *Non-executive roles.* Both the role of non-executive directors in strategy formation and their role of ensuring objective analysis and sharpness of thinking is very important. However as a practical matter, in our observation, trading companies which have a preponderance of non-executive directors on the board can lose some momentum. We believe it is important that the executive directors should be in the majority, with the chairman (distinguished by his fair-mindedness), ensuring that proper weight is given to non-executive directors without them having to be constantly asserting an adversarial position.

While the non-executive role is referred to in Cadbury as not being in conflict with the unitary nature of the board, we believe it will have a tendency to be so, if the character of the chairman cannot ensure that an adversarial climate is not engendered.

It follows from all directors having different skills that they will each contribute to the board in a different way and not always in equal measure in all the roles, though there is no reason why they should be excluded from any particular role and it would probably be counter-productive to try to formalise specific divisions.

- A3 *Comparison with present.* Many companies' current position reflects what is said above. Positions are constantly evolving however and too prescriptive an approach would not necessarily assist in the ultimate aim of corporate governance, which may be defined as delivering the structures and processes to enable the company to create and deliver value to shareholders.
- A4 *Degree of independence.* The substance of the matter is that non-executive directors should be independently minded (and shall not be cronies of the CEO). This may or may not be reinforced by the fact that they are "independent" in the sense of having

no current or previous connections with the company other than their directorship and their remuneration (or otherwise only within the parameters set out in A.3.2 of the Combined Code).

- A5 *Major potential conflicts.* Clashes of personality, where the non-executive directors may have to play a role in discerning what the priorities are so that an appropriate decision can be made; forceful personalities pressing their point without it having been thought through; the operation of mass psychology where the whole board can get involved in considering an issue from one particular point of view and fails to consider, or ignores, other factors; a key executive effectively holding the company to ransom for one reason or another; a divisive climate persisting where non executive directors see themselves in a different camp.

After the event, very little can be done that would not prove to have other than adverse effects on the company (e.g. providing the non-executive directors with a right of informing major investors in some way without breaching their fiduciary duties of confidentiality or running the risk of defamation, or market abuse) but any such fall-back if used would have an extremely problematical result: in relation to what information was reaching the market and if it were adversely to affect share prices, it could be extremely detrimental not only to the potential purchasers of shares but to existing shareholders (who are frequently forgotten as being among those who should be the principal beneficiaries of a board's concerns, particularly in the context of a regulatory system which in practice considers the position of potential buyers before it considers the position of potential sellers i.e. existing shareholders).

- A6 *Time commitment.* The non-executive chairman of the company cannot afford to be involved on a basis that is other than day-to-day, that is to say, at least in daily contact. However, the efficiency and character of the chief executive officer and finance director of the company will be the principal determinants of the extent to which the chairman and other non-executive directors have to spend more time than they would otherwise expect to do on company affairs. A non-executive director should probably spend between 12 and 20 days a year either at board meetings, committee meetings, away days or generally familiarising himself with and meeting personnel in the company's offices and plants, and, possibly, investing institutions.
- A7 *A 'senior independent' director.* It is nearly always the case that one non-executive director emerges as the leading voice for his colleagues but it would be better to let that emerge naturally - and change naturally - than to officially designate someone in that role. In any event the first port of call for shareholders should be the Chairman/CEO.
- A8 *Statement of duties.* The principal concern should not be the statement of directors' duties, but the control of directors' liabilities. Increasingly, expectations are placed on non-executive directors which put them in the firing line with shareholders, creditors and customers - and increased profile leads to increased risk of liability suits. Yet, in extremis, non-executives are faced with a dilemma: by resigning they may be letting down the shareholders whom they are there to serve; by staying on in difficult circumstances they may be courting involvement in liabilities which are not of their making.

If they were given stronger "representative powers", as has been advocated along the model of some venture capital companies which have non-executive directors appointed by the venture capital investors specifically to look after their interests (although this is not recognised in law), their liabilities will be increased further but the protection which venture-capitalist-appointed non-executive directors would have (of knowing that their appointors were not likely to sue them just because they are there to do a particular job) would not be available to non-executive directors in ordinary public companies, unless there was a statutory indemnity always available as of right except in the case of their bad faith. To increase their duties would be to make the job so risky as to make it likely that no one of any sense would be prepared to take a position.

- B9 *Key skills necessary.* Non-executive directors need to be clear-headed in decision making, sympathetic listeners, able to admit when they are wrong, but firm minded. They should have some previous knowledge of commerce and the ability to read and understand accounts.

Unless they have a professional background which has been used to dealing with business, individuals should only be appointed to the boards of commercial companies if they themselves have been involved in commercial companies before: they should be able to bring something more to the table than just analytical skills and a monitoring ability.

In an age that expects increasing professionalism it would be foolish to allow non-executive directors to be fulfilling the role of a gifted amateur: yet sometimes it seems that the search for 'independent' directors has led to the appointment of people with little experience of commerce.

- B10 *Personal qualities.* See above.
- B11 *Mix of experience.* Accountancy, law, finance, preferably all backed by previous experience of business. In specialist businesses where there may be sophisticated or complex ways of trading etc it would also be helpful to have non-executives with working experience in similar businesses.
- B12 *Is recruitment easy?* It doesn't appear easy, and is likely to get much more difficult if non-executive directors are going to find themselves increasingly in the firing line. There is a difficulty in appointing a non-executive who really contributes to the company. Very often dynamic boards do not wish to appoint "professional" non-executives who sit on a number of other boards and finding non-executive directors with industry specialisations can be difficult due to potential conflicts of interest arising. It might assist in making appropriate appointments if candidates were to sit in on board meetings as observers for a period before they took office so that they could make an assessment of the dynamics of the board and how comfortable they were with them, while from the board's side it might become more obvious during such a period whether a positive contribution was going to be made by the candidate.
- B13 *How to widen the available pool.* Without greater uniformity in international approaches to regulation etc., it may be difficult to increase the international element on UK boards: US citizens are increasingly wary of sitting on any boards, and

differing attitudes to regulation, and differing regulations country by country, make appointments from other parts of Europe, even now, culturally difficult.

- B14 *Rewards.* We believe that the remuneration of non-executive directors should be confined to cash (although there is no reason why the executive should not use that cash to subscribe for/buy shares). We believe that the amount of time that non-executive directors spend on companies' businesses is underestimated and that in any event the number of appointments which any one director can properly fulfil is limited. These two factors taken together with the liabilities that are faced by directors, which are increasingly subject of the grant of litigation, indicate that there should be a considerable increase in the amount that is paid to non-executive directors if the role is going to be filled in the future.

Perhaps if directors cost more they will be chosen more carefully.

- B15 *Risks and insurance.* The risks mentioned above can be mitigated to an extent by D&O insurance which all companies should take out for the benefit of the non-executive directors.
- C16 *Balance of contributions.* As to 'independent' please see our point on independently minded directors above. In general, we believe the Combined Code is working reasonably well but its interpretation has become too rigid and conformist (for instance we hear many more criticisms of the rigidity and unthinking criticisms made by PIRC than support for its position).
- C17 *Do recommended structures work?* For some small listed companies, the Combined Code is too prescriptive and not always workable. A board should not be so big that the onus is taken off each director to make a serious individual contribution. In a company which is the holding company of a group where a number of executive functions may need to be represented on the board, an increased number of directors may be justified but even so we believe that a maximum workable number would be about 10 and in most circumstances less.
- C18 *Audit committee.* On the whole audit committees seem to work effectively (although Enron and WorldCom demonstrate that audit committees do not - cannot - always work to spot irregularities). Sometimes, but this will depend on the character of the chairman of the audit committee, a committee's initial findings and decisions may need to be followed through more forcefully. The principal difficulty which faces audit committees (and non-executive directors generally) is that it is difficult for non-executives to have a full understanding of the Group's accounts when they are not involved in the day to day workings of the company and if an executive really wants to hide something, it may be extremely difficult to uncover it. More generally, they are entirely dependent on the material given to them by executive directors and the company's professional advisers. This, coupled with the increasingly "metaphysical" nature of the company's balance sheet - where almost no figure other than that for share capital represents something that would have been at the bottom of a traditional ledger but every figure will have been adjusted or nuanced, in accordance with different considerations in different ways - has, because such a mentality has become engrained, made it too easy for directors and auditors to feel comfortable with further nuancing. They should be brought hard back to the question: is the public being presented with a picture which is true and fair and gives an appropriate view to

shareholders and others on a common sense rather than on a highly conceptual basis? (Where UK accounting standards allow for a 'true and fair view override' bodies like FRRP are rigorously restrictive in allowing it to be applied).

The real test which non-executives can put to themselves occurs in relation to financial matters: do they trust the chairman/CEO/finance director? If they do not, they should not be or remain non-executive directors of the company. If this rule were actually followed by individuals and if only individuals having the appropriate qualities were to be selected as non-executive directors in the first place, many of the difficulties and liabilities that have sprung up over the last few years could have been avoided.

- C19 *Other committees.* See above.
- C20 *Objective-setting processes.* The nature of a company's objectives and processes for achieving them must vary from company to company. A reasonable time needs to be given between reviews of whether any benchmarks have been reached: a review on more than a half-yearly or yearly basis is not desirable.
- C21 *Strengthened performance reviews.* This proposal will either give rise to self-serving positions or the setting of targets which are attainable but not necessarily informative or appropriate. Neither the dynamics of board relationships, nor the ordinary characteristics of human behaviour, indicate that anything helpful could be produced under this head.
- C22 *Is successful challenge possible?* Yes, in general, but it seems likely that if non-executives who were appointed were specifically chosen because they had a greater knowledge of their company's trade(s) they might be quicker off the mark. As noted above, in a different context, non-executives are always in the difficult position, if they blow the whistle, of possibly precipitating a greater crisis in the company and a worse outcome for shareholders and creditors than might otherwise have been the position if they had not done so.
- D23 *Strengthening relationships.* A non-executive director might well accompany the CEO/FD when with their brokers they do the rounds of investing institutions. However, this would involve a greater time commitment than currently and non-executives may be reluctant to be put in the firing line to answer questions from institutions for which they may personally be held liable in due course.
- D24 *Chairman's role.* All the items mentioned (most of which are implied by our answer to A1 and A2 above).
- D25 *Relationships.* With directors, open and familiar. However, too "cosy" a relationship should be avoided if non-executives are to be effective. With senior management, not on the board, non-executives should take care that they do not undermine the authority of the senior executives on the board, nor become a gathering point for everyone else's grumbles and grouses and axes to grind.

It may not be necessary, and it may be inefficient, for all non-executives to have an open line to all the key advisors of the company, but it is certainly helpful for the leading non-executives to keep an open line to the company's solicitors and auditors

and brokers and (if different) financial advisers, and they might possibly be identified - but only informally - as the ones who can usually fulfil that role.

- D26 *Role of company secretary.* The role a company secretary performs in a company is very much dependent on their own personality as well as their specific qualifications. It would be much better for the non-executive directors to have direct relationships with the chairman/CEO/FD, but the company secretary should clearly be neutral and punctilious in the exercise of his or her duties, and should certainly resist any move by a chairman or chief executive to exclude or restrict the involvement of non-executive directors in matters which are properly their concern: he or she should be an equal servant of every director.
- E27/28 *Information training.* These must depend very much on individual companies but access to information should be unlimited.
- E29 *Training.* Yes, clearly, but the training should not be in too prescriptive a form.
- E30 *Guidance and feedback.* This must differ from company to company but a company's expectations of its non-executive directors, and their particular contributions to the company and the board, are things which non executives should establish with the chairman and CEO, prior to appointment.
- F31 *Smaller companies.* The application of the Combined Code to smaller companies along the lines suggested by QCA (formerly CISCO) points up any necessary differences and is generally sufficient to deal with them.
- G32 *Lessons from international experience.* Our own experience of dealing with German companies has led us to believe that supervisory boards are frequently kept at a very considerable distance from the executive boards of two-tier companies and their level of knowledge can be equally low and that an integrated board system such as that which prevails in the UK is a better one.
- G33 *Other models.* We are not aware of any that would be useful.
- G34 *Any benefit in international alignment.* What would be beneficial in the first place would be to improve UK practice generally so that our present system has characterised by the Combined Code can be tested on the basis of best performance, but an element of pragmatic common sense must be part of the woof and warp of any system.