

A Portrait of Professional Directors: UK Corporate Governance in 2015

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Picture the scene: It is July 2015 and the AGM has just finished. The board is congratulating itself quietly. The shareholders are happy as well they should be. From a standing start in 2004, the directors have delivered consistently shareholder added value of 15 per cent every three years. The staff are happy, as they are well paid by the industry standards, their conditions are good and their pensions are secure. The suppliers are happy as, although the company are hard bargainers, they pay dead on time. The fund managers are happy as they have a consistently good investment. Only the analysts are a bit grumpy and demanding more, but then as they are analysts what more can you expect?

Considering their rocky state in 2004 an outsider would be puzzled as to how this transformation came about. After all, the company started from a low point for corporate governance with problems of “fat cattery”, grossly inflated salaries for grossly deflated executive director performance and a general feeling that, whilst UK corporate governance self-regulation was theoretically world beating, the awful truth was that UK boards were generally not up to it. Peter, the chairman, looked back with a mixture of wonder and pride at what they had achieved from such an ignoble start. He mused that it had been in part those basic human drivers of greed and fear which had triggered the transformation. Their greed had led to such shareholder anger with director and executive remuneration that the board decided that something must be done. The mainly “executive directors” had heard Jonathan Charkham talk at a private dinner and winced painfully when he said “in a situation where the Remuneration Committee has

a loaded wallet and the executive directors have loaded revolvers, guess who wins every time?” This led to a series of informal board discussions initiated by the non-executive directors. These coincided with the impending retirement of “the old man” (the long-term “executive chairman”) and three of his colleagues, all of whom had been around so long that they were “conflicted” under the new 2003 Combined Code.¹ But to give the old guard their due, they pushed the other directors into the first serious long-term thinking about their roles and duties they had done in years.

To everyone’s surprise the outcome was first to dissolve the Remuneration Committee and to face the shareholders as a united group of statutory directors. They now were willing to argue jointly for linking their pay and conditions with clear performance indicators without seeking cover from outside experts. To stress their public commitment to the company they did three other things. First, they agreed that all directors would buy a minimum stake of £100,000 in the company equity (now £200,000). Second, they dropped all stock options as these were seen to distort sensible longer-term strategic thinking. Third, they wanted to be seen accepting openly that long-existing tenet of company law that there is only the term “director”,² and to accept that they are of them equally accountable and liable collegially around the boardroom table.

Their consequent rejection of the terms “executive director” and “non-executive director” upset supporters of the Higgs Committee,³ but it went down well with the shareholders. What caused more public comment was the fact that to reinforce this point they took seriously what Bob Garratt had been

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batting on about for years and decided on a common one-year *contract for services* for all directors (whether previously “executive” or “non-executive”). This specified that they were contracted as directors to spend 20 per cent of their working time on board and business development, for which they had their previous remuneration doubled. It was spelled out clearly that even for someone who was a “full-time” professional director, they would not hold more than four directorships at any one time.

For directors who were also executives of that company, they had in addition a separate *contract of employment* as an executive. This was for 80 per cent of their time. It was spelled out that they had to time-budget in such a way that they honoured their directoral contract for services for the other 20 per cent of their time, and would be appraised separately on both contracts annually. They would be expected to “leave their executive hat at the boardroom door” and to think and act directorally when in the boardroom. If they were found to be defending their executive position when around the boardroom table, the chairman was expected to intervene hard, tell them that they were “conflicted”, and remind them of their position under their directoral contract for services. If they continued only down their executive route, then the board would vote on whether they had to stay silent on the item under discussion and whether they could vote on it.

This caused some early confusion and mistakes around the boardroom table. But it did raise the issue of their need for directoral “professionalisation”. It had to be admitted that fear rather than pure altruism was a major driver here. Once it was established in 2005 by the courts that a new board could sue a previous board for lack of skill and care, lack of fiduciary duty and lack of competence,⁴ then the directors had begun to worry seriously about their personal, as well as corporate, positions and wealth. They assumed that aspects of the US Sarbanes-Oxley Act, especially the possibility of a chief executive or chief financial officer⁵ getting both a maximum personal fine of US\$5 million and 20 years in jail was a political nonsense which would not transfer in the UK as we had a perfectly good Fraud Law. They were right, but following the furore from a number of plc boards saying that “the Combined Code did not apply to them”, the FSA and DTI made an example of the next transgressor in 2006.⁶ This was followed by many other cases in the UK and US and caused in the board a fundamental rethink about the nature of being a director both personally and professionally. It was realised

quickly that directing was now a proper job in its own right, not just an add-on to a successful executive career.

But this raised a number of uncomfortable thoughts about those who were directors. They commissioned some research and found that, as the IoD had long contended, only some 15 per cent of UK directors were ever inducted or given even one day’s training to do this crucial job.⁷ They found to their horror that most people who become directors have little interest in the longer-term future.⁸ This was partly age-related, as most were in the “male, pale and stale” category. But it reflected also an inability to break out of the executive background of the vast majority of directors – where an over-fixation on short-term results and the micro-politics of executive jostling had diminished their intellectual interest in the nature of their company’s future. Indeed, from Ram Ramakrishnan’s work⁹ it was obvious that many current directors had little interest even in the source of future income streams.

These findings were reflected clearly on Peter’s board. But what could be done? Luckily, this questioning coincided with their implementation of the seventeen Main Principles 2003 Combined Code of Corporate Governance. Compliance with the structural parts – board composition, length of service etc. – was easy to install, yet the directors realised that these were necessary but not sufficient. What was sufficiency in this new directoral world? This is where the idea of their focusing on *Board Performance*¹⁰ grew. It happened in two ways. First, one of the directors became seriously worried about the lack of long-term perspective within the board. She finally came up with Sir Brian Pitman’s definition of “shareholder added value”: *the economic value added after taking into account the reasonable short-term demands of the owners, the cost of capital, and the longer-term needs to ensure the survival and development of the business.*¹¹ This excited the other directors as it gave more meaning, clarity and balance to their directoral roles. It reinforced their primary duty as directors to rebalance continually their fundamental dilemma of “how to both drive the business forward whilst keeping it under prudent control”.

But how were they to put this into practice? What was the organising model? The idea of the *Learning Board*¹² had been around for some 12 years and had been seen to be effective when applied. So it was decided to experiment with both its content:

- Policy Formulation and Foresight
- Strategic Thinking
- Supervising Management
- Accountability

and with the board's *annual rhythm* demanded by it; starting the year with a Policy Awayday, at least quarterly Strategic Thinking (not strategic planning) Awaydays, monthly numbers reporting (which were never allowed to exceed one hour), and at month nine an Accountability Awayday to ensure full compliance under the 2003 Combined Code. These dates and topics were put into the director's diaries a year ahead and it was stressed that they were expected to turn up fully briefed, their "homework" complete, and ready to participate at each of them. It was for this that they were being paid and for which a personal development budget was agreed following their annual appraisal led by the chairman. This allowed those who felt that they needed coaching or mentoring to have it.

But how could they learn to do this professionally? There were three major clues already in existence – the 2003 Combined Code, the changing position of the Directors and Officers' liability insurers, and the development of the Chartered Director national (UK) award. The UK's 2003 Combined Code was then unique globally in turning its focus from purely "board compliance" to recognising the importance of "board performance", and the consequent regulation to assess the competence of the board and its individual directors. Nowadays this is the norm and even the US has come into line following their great and rumbustious "Shareholder Suffrage" debate led by Bob Monks,¹³ with everything from splitting the Chairman and Chief Executive roles to annual board reviews now being agreed. But back in 2004 it all seemed impossible to deliver. It was those damned Main Principles 4–7 of the 2003 Combined Code which proved both the problem and the answer. For the first time the Financial Reporting Council's Regulations for UK listed companies spelled out that boards had to have a transparent selection process; have timely and accurate information for their decision making; have proper induction and development process for each director; have ways of regularly refreshing the board; and, most difficult of all, ensure annual appraisal of the board, its committees and each director.

Peter remembered the early board meetings where such things were talked about with mild interest and little urgency – "we just have to be seen complying with the basics of the Combined Code, that's all" was the majority view. In 2006 things suddenly became much more serious. The then government were threatening to bring in more serious legislation to reinforce their wish to make more directors liable under a range of *criminal* laws. The battle to remove director's unlimited lia-

bility had already been lost as there was no public sympathy for this, indeed quite the reverse. First the credit rating agencies, and then the Directors and Officers' liability insurers, began to make ominous noises. The credit rating agencies developed new scoring systems¹⁴ and indexes for the quality of corporate governance in listed companies. This began to worry many directors as it could directly affect their cost of capital. In the short term, it was bad luck for the agencies and good luck for directors that the agencies scored a number of own goals by being seen to be conflicted because of their own consultancy offerings in this area. They did manage eventually to build better Chinese Walls around these, but in many cases their thunder had been stolen by the insurers. These had realised that Directors and Officers' liability insurance was now a big issue as premiums rose rapidly. In 2003 the average rise for such insurance for all directors in the UK had risen 300 per cent (and in the US 3000 per cent). Although the rate of increase tailed off slightly after 2004, the issue was suddenly on board's maps as a significant cost which needed controlling.

This brought Peter to the whole education and development issue for boards. The insurers pointed out quite reasonably that if the *competence* of a board, and a director, could be demonstrated, then it would be much easier for a broker to sell the case of a specific board to an underwriter and get a much better rate for that insurance because of the reduced risk. Whilst this seemed blindingly obvious to many, it proved very difficult to deliver. What was "competence"? Did directoral competence differ from managerial competence? Two trends helped to resolve this over time. First, the notion of "competence" in terms of board and director development was defined as the necessary knowledge, attitudes and skills which allowed effective direction-giving and risk-taking. Happily this is reinforced with the director's legal duties to ensure Care and Skill in ensuring their *fiduciary duty* (something which is not applied so strictly by the courts to managers). Second, the rise of the *Chartered Director* national award¹⁵ blazed a trail whose success surprised everyone and was later copied internationally. Whilst the *Chartered Director* award does not claim to offer directoral competence, as it covers knowledge and attitudes but not skills, it was valued as a huge step forward. As the notion of "director competence" being wider than just knowledge and skills focused became accepted it reinforced two key aspects of corporate governance. First, that the fundamental values of effective corporate governance –

Transparency, Probity and Accountability – must be embedded in the evaluation of a board’s competences. Second, it encouraged the attitude that directing is primarily two key skills – the skill of risk-assessment leading to the skill of judgement, for which there is never a single right answer. It is for these that directors are rewarded.

Sensing a new market segment, many boards, consultants and search firms jostled for their own brands of induction and development process to become the “gold standard” for delivering both *board conformance and performance*. But the gold standard had already been delivered. A small group of people at the Institute of Directors Professional Standards Board had since 1994 been working voluntarily on the creation of a national award which tested the knowledge and attitudes of directors and boards. Although opposed originally by some professional institutes, and derided as totally impractical by many directors, they battled on and in 1999 had the agreement of the Privy Council and the Department for Education that such a national award should be launched, and administered by the IoD London. It had started slowly with just some 60 people a year going through the tough written and more arduous oral examination of three years’ experience as a true “director” (this latter being based on the four aspects of the Learning Board model mentioned above).

Peter had been only mildly interested in this until the new board changes were being made in 2005. One of the new directors said that they wished to go through the Chartered Director process, as it was now creating some 600 a year, and she wanted to be one of the first generation of “professional directors”. He had been a bit condescending and offered to pay half her fees if she passed. She said if he could pass the trial exam papers then she would pay the full whack herself; but that if he failed then he should pay the whole of her fee. He failed, miserably. This set him thinking about the professionalism of all his board, who were still dominated by the old “executive director” mindset. And he began to think of his role as Chairman. During the first mandatory annual board appraisal the feedback had been that his chairing was only just adequate, and that he had a tendency to over-talk individual contributions and begin each topic with his solution and then challenge the other directors to disagree. He was particularly stung by an anonymous piece of feedback from a fellow director that “it was a career-threatening opportunity to disagree with him”. He had always seen himself as a model chairman. So, in the spirit of the new board he attended a

training programme for Chairmen, and was so shocked by what he found – that he was the “boss of the board”, not of the company; and that chairing is an essentially neutral process – that afterwards he took a personal coach for six months whilst he readjusted his role. He was glad that he did, as when in 2008 the Dominant Director Index¹⁶ was extended from only the financial services industry to all UK listed companies, they were well ahead of the game.

He smiled as he remembered the ridicule with which this approach was viewed by many of his contemporaries. But other board members decided that, as they swapped onto the full unitary board contract of service for all directors, they too should honour their new remuneration packages and become more professional themselves.

The rest is history. They were well ahead of the game when the regulators decided that each listed company board should have a minimum of two Chartered Directors. They now spent their time truly directing the business, especially learning how to be much more effective at thinking strategically on a regular basis; and restricted the monthly “numbers” session to that maximum of one hour per month so that they did not micro-manage the business from the boardroom table. The shareholders and staff are now proud of them and Peter has faced up to his obligation to regularly refresh the board. But now he must stand down. And he leaves the company with a unique problem – how do they choose a successor from *inside* the company when there are so many good folk to choose from?

Author’s comment: all of the above issues are based on issues existing in 2004, most of which have not yet been addressed by the majority of boards. The only imagination used is when events actually occurred.

Notes

1. 2003 *Combined Code of Corporate Governance*. Financial Reporting Council, London,
2. *AWA Case*, 1994. High Court of New South Wales.
3. *Higgs Review of the Role of the Non-Executive Director* (2003) Department of Trade and Industry, London.
4. *King Report (2) of Corporate Governance for South Africa 2002*. Institute of Directors of Southern Africa – as an example of the director’s duty of Skill and Care.
5. Sarbanes-Oxley Act, 2002, Washington DC.
6. Purely speculative.
7. *1992 and 1999 Reports on Director and Board Training*. Institute of Directors, London.

8. Garratt, Bob (2003) *Thin On Top: Why Corporate Governance Matters*. Nicholas Brearley Publishing.
9. Ramakrishnan, Ram (2003) Directing Strategic Thought Towards Effective Value Added. In Bob Garratt (ed.) *Developing Strategic Thought* chapter 15. London: Profile Books (first published 1995).
10. Garratt, Bob (2003) *The Fish Rots From the Head*. London: Profile Books (first published 1997).
11. Sir Brian Pitman, Opening Address at the Henley International Corporate Governance Conference, October 2001.
12. Garratt, Bob (2003) *The Fish Rots From the Head*, *ibid*.
13. Bob Monks, Closing Address at the Henley International Corporate Governance Conference, October 2002.
14. Standard and Poor's corporate governance scoring system.
15. *Chartered Director award*. Institute of Directors, London.
16. Financial Services Agency *Dominant Director Index for Financial Services Companies*, London, announced September 2003.

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"Listed companies play a significant role in the economic and financial system of the UK. It is therefore a matter of public interest that their boards are accountable to shareholders, who are the owners." *Voting Made Simple*, NAPF, January 2005