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THE ROLE OF NON EXECUTIVE DIRECTORS IN THE GOVERNANCE OF COMPANIES: REFERENCE TO THE UNITED KINGDOM COMPANIES ACT 2006

BY

OJIBARA HAMEENAT BUKOLA*

INTRODUCTION

The relevance of Directors especially the Non executive Directors is one important issue that has come to light and been in contention especially with the collapse of major world companies in the advanced nations. This paper discusses the historical roles of Non-executive directors (NEDs) starting with the Cadbury (1992) code of best practice and their role in the contemporary corporate governance regime. It goes further to examine the managerial and governance functions of the Non-executive directors on the board, the changes in composition and governance roles brought about by recent reforms and how these reforms have altered the duties, objectives, composition or incentives of the board. Also, the difficulties faced by Non-executive directors in fulfilling their roles and whether the corporate governance reforms are likely to produce significant improvements to the governance of these companies and possible future developments. This paper is based on the UK corporate governance system, but will draw on examples from other jurisdictions for comparative purposes.

HISTORY OF NON EXECUTIVE DIRECTORS

Non-executive directors have been in existence since the inception of corporations whereby most directors were non-executives because they were also owners of the company. Later NEDs were appointed from the royal family or amongst the elite or prominent ones and it became an honorary position. This was done to boost the status of these companies and a form of enticement to potential investors. NEDs were later brought to the spotlight as a central figure in UK as a result of business scandals.

Non-executive directors have grown in importance over the years with the emergence of Corporate Governance in the UK markets during the 1980s and 1990s focused on the role of directors and the standards that can be expected from them.¹ This is as a result of the high-profile corporate financial scandals involving highly entrenched CEOs, acquiescent boards, inadequate disclosure and auditing failures which made it apparent that the UK corporate governance system was failing in the protection of investors. Example of these companies with striking similarities is Maxwell and Polly Peck in the UK, Parmalat in Italy and more recently Enron, WorldCom, Xerox in the US.

In the US, a swift government action was taken with the use of the Sarbanes-Oxley legislation and the new NYSE listing rules in 2002 and many top level officers were prosecuted. In light of this, the UK wanted to proffer a quick solution and precaution and also head-off potential consequences for British companies listed in the New York Stock Exchange.² The UK operates a unitary board system with the

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¹ E Ferran, *Company law & Corporate finance* (1st edn, OUP, Oxford, 2007) 207.

² I Jones, 'Understanding how issues in corporate governance develop: Cadbury Report to Higgs Review' ESRC Centre for Business Research, University of Cambridge working paper No. 277 (December 2003).

main responsibility of implementing business strategies on behalf of shareholders and to ensure business activities are conducted in accordance with the law and other requirements, this system is unambiguous.³ This necessitated the financial authorities and the government to put a mechanism in place and led to the following: Promotion of Non-executive directors (PRO-NED) 1982, the Cadbury Committee (Committee on the Financial Aspects of Corporate Governance) 1992, the Greenbury Committee 1995, Hampel 1998, Turnbull Report 1999, Smith Report 2003, Higgs report 2003.

The Promotion of Non-executive directors (PRO-NED) 1982 was also as a result of financial scandals like the 'Guinness take-over of distillers' and as such, the increasing need to impose more shareholder control over the activities of company directors. They produced a code of practice which provided for a category of persons suitable for appointment and also guidelines for NEDs in carrying out their duties.⁴ This later led to the Cadbury committee of 1992.

The Cadbury committee under the Chairmanship of Sir Adrian Cadbury was the first major step in UK towards the evolution of a broad framework of the role of Non-executive directors in corporate governance. This was set up mainly by the Stock Exchange Council, the Financial Reporting Council and the accounting profession. It is known as the listing code and it specifically endorsed that the remuneration and audit committees should comprise at least three non-executive directors to review the companies' financial operations.⁵ It stipulated that a majority of NEDs should be independent and selected by the whole board.

The Cadbury Report was followed by a Report of the Study Group on Directors' Remuneration initiated by the UK Confederation of Business and Industry on corporate governance chaired by Sir Richard Greenbury in 1995 and known as the Greenbury Report. The Final Report of the Committee on Corporate Governance in 1998 was chaired by Sir Ronald Hampel and known as the Hampel Report. The Greenbury and Hampel Reports were based on the foundations of the Cadbury report with some major refinements like the remuneration committee should comprise solely of non-executive directors with relevant experience and also stipulated that an annual report should be provided to shareholders.⁶

The Cadbury, Greenbury and Hampel Reports had their committees comprised of representatives from industry and investment sectors and were self regulatory. Their recommendations, albeit without enforceable sanctions, companies are given the opportunity to 'comply or explain' reasons of non-compliance. The committee also depended on the power of investing institutions to move funds from non-compliant companies who had no substantial explanations or a failure to give any reason whatsoever.⁷ However this led to an enhancement by the London Stock Exchange with the adoption of a Combined Code that encapsulates the recommendations of the three reports in 1998. The Higgs Report (2003) and the related Tyson Report were also clear knee-jerk responses to the considerable impact of the ineffectiveness of directors.⁸

³ M Ezzamel & R Watson, 'Board of Directors and the Role of Non-Executive Directors in the Governance of Corporations' in K Keasey, S Thompson and M Wright (eds), *Corporate Governance; accountability, enterprise and International comparisons* (John Wiley & Sons, Chichester 2005) 99.

⁴ I Stratton, 'Non-executive directors: are they superfluous?' [1996] *Comp. Law* 162

⁵ Cadbury code paras 4.3

⁶ E Ferran, *Company law & Corporate finance* (1st edn, OUP, Oxford, 2007) 218

⁷ E Ferran, *Company law & Corporate finance* (1st edn, OUP, Oxford, 2007) 218

⁸ J Solomon, *Corporate Governance and Accountability* (2nd edn, John Wiley & Sons, Chichester) 82.

The Combined code was first issued in 1998 and has been reviewed and updated in 2003, 2006 and 2008. It is the most influencer amongst other codes or reports with radical yet realistic proposals. The Combined code 2008 is the current version of the code and contains broad principles and provisions on issues such as remuneration, accountability, board composition, and audit and relates to shareholders. It provides that a letter of appointment should set out the expected committed time and also NEDs should undertake appropriate induction, update personal knowledge and skills from time to time and also amplification of information. A new revision of certain provisions of the code was proposed by the Federal Reporting Council (FRC) in 2009 and consultation proposals have been submitted early 2010. The revised code will be known as the Corporate Governance Codes and will apply to financial years beginning from 29th June, 2010.

Notable changes to be found in the revised code includes: a renewal of restriction on an individual chairing more than one FTSE 100 company; and also allow an independently appointed company chairman of a company outside the FTSE 350 to sit in the audit committee. Also, all companies listed in the London Stock Exchange (LSE) market are to report a compliance of the combined code in their annual reports and overseas companies are required to disclose ways in which their corporate governance practices differ from the code. This has changed under the Financial Services Authority revised listing regime as at April 2010, in which all companies with premium listing are required to report how the code was applied irrespective of where the company was incorporated. Recommendations of the Cadbury code are now incorporated in the Organisation of Economic Co-operation and Development (OECD) principles of Corporate Governance 1999 and other Corporate Governance codes like the Cadbury code 2000.⁹

UK statutory law is silent on the definition of NEDs and the composition of the Board of Directors. Their duties are not separated from those of the executive directors and they are both responsible for the management of the company. The need for a law on these duties for clarity, accessibility and certainty and also the need to improve corporate governance standards and keep up with changes from globalization led to its codification in sections 171-177 of the Companies Act 2006. The role and duties of non-executive directors are derived from various sources: Common law principles, the Companies Act 1985, the combined code and Companies Act 2006. These sources highlight the additional and distinctive role of NEDs.¹⁰ Also, the Higgs Report stipulated four main roles of NEDs and will be discussed in subsequent paragraphs. They include: Strategy, Performance, Risk and people and encompasses earlier recommendations from other reports.

RELEVANT PROVISIONS IN THE COMPANIES ACT 2006

The Companies Act 2006 also did not define the word non-executive directors nor differentiate them from their executive counterparts. Nevertheless, irrespective of the different roles they play, they have a common goal which is to act in good faith towards the success of the company. However, the Companies Act has a remarkable effect on non-executive directors, its new provisions on directors' duties are relevant and provides sufficiently as a guide to their involvement in the affairs of the company.

⁹ <http://www.frc.org.uk/corporate/combinedcode.cfm> accessed 1st May, 2010.

¹⁰ S Kiare, 'Non-executive directors in UK listed companies: are they effective?' [2007] ICCLR 17

Section 172 provides for a duty to act in good faith in promoting the success of the company. Thus, where a non-executive director relies solely on another, it would be difficult to determine whether he acted in good faith for the company's benefit.

The case of *Lexi Holdings Plc v Luqman*¹¹ illustrates that a director will not be able to rely on their lack of involvement as an excuse to avoid the imposition of liability. This position was previously considered in *Westmid Packaging Services Ltd (No.3), Re*¹² where the Court of Appeal gave a distinction between a delegation and division of responsibility from a total abrogation of duties, in which the former was held to be permissible and the latter is not.

However, non-executive directors are expected to exercise their own discretion and initiative and so a defence of manipulation would not suffice but would be a breach of duty. They must neither be credulous nor gullible, and must instead be vigilant in examining the company's affairs'.¹³

On the other hand, section 174 provides that a director has a duty to exercise reasonable care, skill and diligence, as is expected of a person carrying out the functions with such general knowledge and experience that a director has. A duty of care and skill is found both in common law and equity. The existent case law on this principle differs in the extent of involvement of a director. A director who has never been to board meetings or has not been regular cannot be held liable as it is deemed that he does not have knowledge of what is going on. This has changed under the Companies act 2006, and the duty of care and skill is now a matter of competence and it also distinguishes this duty from a fiduciary quality of honesty and loyalty in relation to a director's powers.¹⁴

In *Dorchester Finance Co Ltd v Stebbing*¹⁵ two non-executive directors (who were chartered accountants) left the running of the company in the hands of the third director (who had considerable accounting experience). They did not attend meetings or monitor the company's transactions; all they did was sign blank cheques to be countersigned by the active director. It was held that the non executive directors were negligent and in breach of the duty to act in good faith and in the interest of the company. Also liability for wrongful trading is based on what a director ought to have known and so they should act at all times to take such care as a prudent man would on his own behalf.

The purpose behind the appointment of NEDs to the board of the company and the function they will perform, are obviously different. Typically, NEDs are appointed by virtue of their knowledge, skill and experience to contribute both expertise and objectivity in evaluating decisions. The extent of their duty will depend upon the facts and it is conceivable that the circumstances maybe such as to require him to act in exceptional cases.¹⁶

In the UK and US, non-executive directors are now expected to take to undertake two distinct and contradictory roles. They are expected to be full members of the top corporate management team for the formulation and management of corporate strategy as their executive counterparts and at the same time be

¹¹ [2009] EWCA Civ 117

¹² [1998] B.C.C. 830

¹³ Ji Lian Yap, 'Hear no evil, see no evil, speak no evil: the total inactivity of non-executive directors' [2009] ICCLR 413

¹⁴ M Hsaio, 'A sprouting duty of honesty and loyalty? Companies Act 2006' [2006] ICCLR 306

¹⁵ [1989] BCLC 498 (case decided in 1977)

¹⁶ M Arnold, 'Company Directors- Duties, Liabilities and Remedies' in S Mortimore (ed) (1st edn, OUP, Oxford 2009) 301

independent of these same colleagues.¹⁷ These dual roles have been difficult to fulfil. Non-executive directors are referred to as 'outside directors' and 'independent directors' in US.

An issue of wider significance is whether the role of non-executive directors is best characterised as a contributor to the overall strategic direction and direction or that of a monitor of the executive management, or both. Some commentators have queried whether it is possible for them to perform the monitoring duty and also co-operate with the same executive directors in the strategic development of the company.¹⁸

NEDs should be hired outside the normal conventional business circle to include retired civil servants, academics, professionals and training them would add to their already existing skill and make them more efficient. Also, with globalisation and diverse market, NEDs should be made to include: women, young and disable persons that are under-represented in boards.¹⁹

MAJOR ISSUES/ PROBLEMS FACED BY NON EXECUTIVE DIRECTORS

A major criticism of non-executive directors is their background and the process of selection for their appointment. A typical non-executive director of a large UK company is commonly an executive director of another company or a former director of the company itself. This raises an eyebrow as to whether non-executive directors are truly 'independent'. The quality that is required of non-executive directors and whether other persons other than those with significant managerial experience can realistically be expected to have them is an important factor to be considered.²⁰ NED appointed outside the executive or managerial group are believed to lack the necessary knowledge and skills required to perform these enormous duties.

Another factor that contributes or affects the independence of non-executive directors is superficial 'scratch my back and I scratch yours' principle. Executive directors would want to favour their non executive counterparts because whatever decision they take might also apply to them where they are non executive directors. For example the process of setting remuneration includes the use of a comparison of remuneration levels in other companies to the relative performance of the company. This however gives non-executive directors personal interest in their decision on the level of executive pay, since the data is used in the long run to determine their own pay as executive directors of other companies.²¹

Also concerns have been raised about whether non-executive directors can realistically be expected to give an objective opinion of the company's affairs, given the limited time they devote to the company. As a result, their views are largely formed on the flow of information provided by the executive directors; meaning the information might not be precise and they may seek to avoid antagonistic situations that may result in conflict between them, the executive directors and management. The Higg's report emphasises the need for clarity and transparency of information but this has been down played by the combined code to 'timely information'.²² Conversely, the

¹⁷ M Ezzamel & R Watson, 'Board of Directors and the Role of Non-Executive Directors in the Governance of Corporations' in K Keasey, S Thompson and M Wright (eds), *Corporate Governance; accountability, enterprise and International comparisons* (John Wiley & Sons, Chichester 2005) 98.

¹⁸ E Ferran, *Company law & Corporate finance* (1st edn, OUP, Oxford, 2007) 220

¹⁹ S Kiarie, 'Non-executive directors in UK listed companies: are they effective?' [2007] ICCLR 19

²⁰ S Kiarie, 'Non-executive directors in UK listed companies: are they effective?' [2007] ICCLR 20

²¹ E Ferran, *Company law & Corporate finance* (1st edn, OUP, Oxford, 2007) 223

²² S Kiarie, 'Non-executive directors in UK listed companies: are they effective?' [2007] ICCLR 19

executive board may deliberately withhold important information that is deemed business secret from NEDs because of their multiple directorships and so the fear that this information could be released to third parties unwittingly.²³

Another fundamental issue is that a step up in responsibilities and management decisions exposes non executive directors to personal liability and a vast pay of damages. This tends to discourage qualified and experienced individuals and most of them may decline the post. In order to curb these excesses and limit exposure to liability, costs and benefits of raising standards should be carefully measured in any future development of the law relating to duties of care and skill.

Also, the fear of litigation could make directors become more averse in decision making thereby they tend to decline potentially valuable investments with high risk proposals for a safer and less potentially profitable investment.²⁴

Non-executive directors are taunted by a low level of pay, which is smaller than their executive counterparts despite their dual and tasking duties. They are also not entitled to benefits like pension schemes, share option or surplus share. This is a less morale or disincentive for them. Their attitude to work is sloppy and they tend to do little or no research before making important decisions.

Enforcement is another problem faced in this area. There are no sanctions or enforcement rules as to their accountability to shareholders. No redress where displeased with poor performance by directors which could affect the corporate structure and value of the company. This has led to resignations by non-executives and this can be used as a strategy by executives to get efficient and vigilant non-executives off their backs.²⁵

IMPORTANCE OF NON EXECUTIVE DIRECTORS

Irrespective of the fact that they are prevalent in big companies, they are nevertheless useful in small and medium companies thereby providing expertise, broadening business horizons and strategic planning to enable their growth and elevate them to been listed.²⁶ The cost of hiring NEDs and the fear of losing control has been a stump block for small and medium companies.

The roles of non executive directors are therefore important in corporate administration. They are posed with the duty to resolve internal disputes by bringing an impartial and rational outlook, thus, enabling the board to rise above board room politics thereby facilitating change. They bring a wider and objective perspective into the boardroom as a result of their diversified field, skills and experience. They are able to see potential risk and opportunities and give valuable advice with regards to important investments and decision making.

They serve as a check on CEOs powers and ensure managers maintain discipline and compliance with procedures. Board meetings become more productive, because they are scrutinised and so they get to prepare adequately for meetings.²⁷

SUMMARY/CONCLUSION

The role of NEDs differs from one company to another and continues to evolve over time with the changing business environment and developments in EU laws. Any attempt to define its exact role could hamper its development.²⁸

²³ I Stratton, 'Non-executive directors: are they superfluous?' [1996] Comp. Law. 164

²⁴ E Ferran, *Company law & Corporate finance* (1st edn, OUP, Oxford, 2007) 237

²⁵ S Kiarie, 'Non-executive directors in UK listed companies: are they effective?' [2007] ICCLR 21

²⁶ S Kiarie, 'Non-executive directors in UK listed companies: are they effective?' [2007] ICCLR 19

²⁷ S Kiarie, 'Non-executive directors in UK listed companies: are they effective?' [2007] ICCLR 17

Non-executive directors are in more cases than not beneficial. Despite challenges and inadequacies, NEDs still have a very important role to play in companies; large, medium and small. It is however ill-timed that they are often called upon when a company is in distress rather than when it is at its best performance but their ability to rescue and contribute positively gives them a fair representation. Companies with non executive directors add credibility and prestige to the company because these companies are deemed transparent, code compliant and well managed as a result of their presence thereby creating a favourable corporate governance image.

RECOMMENDATIONS

However, there have been valuable suggestions as to possible solutions and reforms. Appointment which is an important aspect as it guarantees an effective board with the appropriate mix of skills and experience should be well made. As a result of globalisation and diversity, hiring should be made outside the conventional business circle to include academics, professionals, civil servants, and women, young and disabled persons who are underrepresented in boards.

There should be a contract of employment between the company and the NEDs and also an undertaking to meet a certain time of commitment dedicated to professional development and training. Also, the appointment of full time executives as NEDs should be reduced so that adequate time would be devoted to company activities.

²⁸ Ibid 18