Who wants to be a competent director?

An evaluation tool of directors' knowledge of governance principles and legal duties

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Abstract *Awareness of the need for board and director performance evaluation is growing, but implementation has been both partial and slow. It is unusual for boards to undertake evaluations of their own performance, and more so to evaluate individual directors. Directors often feel that individual director evaluation has several drawbacks including undermining collegiality in the boardroom. There is thus a perceived attractiveness of director self-assessments rather than peer review or outsider assessments. Self-assessment, even though subject to a higher degree of biases than a combination of self-assessment and peer assessment, is less likely to give rise to defensive routines and can provide a psychologically safe environment for a director to evaluate their own knowledge. Bearing in mind the above, we developed a 20-question self-assessment tool, which aims to assist directors in evaluating their understanding of important governance concepts and principles, as well as their legal duties as directors.*

Awareness of the need for board and director performance evaluation is growing (Cadbury, 1999; *Chief Executive*, 1995; Garratt, 1999), but implementation has been both partial and slow. It is unusual for boards to undertake evaluations of their own performance, and more so to evaluate individual directors. In 1996, one in four public companies in the USA reported to have evaluation practices for the whole board; and only one out of ten companies evaluated, in addition to the CEO, the board and individual directors (Conger *et al*., 1998). More recent data indicate that only around one fifth of boards in the USA have a formal process for evaluating individual director performance, and around half, the performance of the whole board (Spencer Stuart Board Services, 2000).

The responsibility for board and director evaluation is part of the developmental role of the chairman (Parker, 1990; Phan, 2000). Several directors, however, feel uncomfortable with board or individual evaluations. Some companies decide not to institute individual director evaluation, such as Motorola or General Motors. General Motors' corporate governance guidelines, for example, make it clear that its evaluation is for the whole board, and not for individual directors:

> The Committee on Director Affairs is responsible to report annually to the Board an assessment of the Board's performance. This will be discussed with the full Board. This should be done following the end of each fiscal year . . . This assessment should be of the Board's contribution as a whole and specifically review areas in which the board and/or management believes a better contribution could be made. Its purpose is to increase the effectiveness of the Board, not to target individual Board members (Phan, 2000, p. 128).

Several directors feel that individual director evaluation may undermine collegiality in the boardroom, that it is difficult to decide who should evaluate individual directors, that uniform evaluation criteria may not capture directors' unique contributions, and finally, that group evaluations are more appropriate given that the board functions (or should

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function) as a team (Conger *et al*., 1998; Kazanjian, 2000). These may be reasons contributing to the perceived attractiveness of director self-assessments rather than peer review or outsider assessments; and also for the fact that boards tend to carry out board evaluations on their own, without the help of external consultants (Spencer Stuart Board Services, 2000). Motorola directors, for example, have consciously chosen to use self-assessment rather than peer assessment (*Chicago Tribune*, 2001). Self-assessment, even though subject to a higher degree of biases than a combination of self-assessment and peer assessment, at least is less likely to give rise to defensive routines (Argyris, 1991) and can provide a psychologically safe environment for a director to evaluate their own knowledge, behaviour and/or performance.

> **"The self-assessment tool aims to assess directors' knowledge, rather than behaviours or performance in and out of the boardroom"**

Bearing in mind the above, we developed a 20-question self-assessment tool (see Appendices 1 and 2), which aims to assist directors in evaluating their understanding of important governance concepts and principles, as well as their legal duties as directors. This tool aims to assess directors' knowledge, rather than behaviours or performance in and out of the boardroom. It is aimed at the initial stages of getting directors to acknowledge that the job of directing is different to the job of managing, requires different knowledge, competencies and skills, and has different legal duties; and that such directoral competencies are developable and assessable (Garratt, 1996, 1999). Getting directors to acknowledge these propositions, and to do something about them, is one of the most fundamental stumbling blocks to more effective governance. One assumption underlying this questionnaire is therefore that the first step to directoral competence is awareness of key concepts and duties by directors. The first ten questions relate to board functioning and effectiveness. Questions 11-20 then relate to directors' legal duties and liabilities.

Question 1

What often tends to be forgotten is that managers are employed to manage on behalf of the owners of the enterprise, who are the shareholders, and that there is an agency relationship between these two parties (Berle and Means, 1934). Dispersed ownership however tends to hide this fact, because many smaller shareholders prefer to sell out rather than argue their case, if they see managers taking poor strategic decisions. Proxy Web sites, however, aim to aggregate shareholder votes to increase their power, and their effects will be more strongly felt in the future. On the other hand, institutional investors are currently very influential. US institutional investors managed US$18.6 trillion in 1999, nearly three times the amount of US$6.3 in 1990. Almost half the US equity market is controlled by institutional investors (*Conference Board*, 2000). Rather than sell out after problems have surfaced, and thus push the value of their investment even lower, they are increasingly more vocal, criticizing what they see as deficient governance, under the philosophy that they have to be proactive rather than reactive in protecting their investments. Accordingly, institutional investors see the monitoring of management as an important task of the board; ensuring that management takes strategic actions that improve rather than squander shareholder value.

Question 2

Directors in theory get elected by shareholders; the reality, however, is that often the CEO/Chairman decide, or have a lot of influence on who becomes a director, not necessarily based on the competencies required at the board but based on personal connections (O'Neal and Thomas, 1996). Under the common law that is practiced in the Commonwealth jurisdictions, however, once a director is elected, their main legal duty is to the company; not to the person who has brought them to the board, and not to the individual shareholders. For further elaboration on this point, please see explanation to question 14 below.

Question 3

Following from question 2, according to the London Institute of Directors' Standards for the Board (Institute of Directors, 1995, p. 22), "the key purpose of the board is to ensure the company's prosperity by collectively directing its affairs and meeting the legitimate interests of its shareholders and other interested parties". There are still CEO/Chairmen who believe that the board is there to support their own positions; this is detrimental to the interests of the company because directors' independent judgement is impeded and the company's future is over-dependent on a single individual. Similarly, in quoted businesses that are majority family-owned, many directors believe that they should follow the wishes of the family in deciding on the company direction. This risks the interests of minority shareholders, and relevant lawsuits, especially if strategic actions involve related party transactions.

Question 4

All four answers here can be true, based on the particular situation. The main reason, however, that the board needs to monitor management is that management often make strategic decisions that serve their personal interests. This is the crux of the agency problem. Managers are agents of the owners and they are supposed to safeguard the owners' interests, without engaging in excessive on-the-job consumption or strategic actions designed to direct more money their way. Acquisitions are a good example. Research shows that most diversifications will dissipate shareholder value and that the greater the diversification activity the lower the returns (Porter, 1987; Palich *et al.*, 2000). Why do managers keep on acquiring? There may be the problem of hubris (over-confidence in their abilities to make it work), plus the bandwagon effect once industries start consolidating. But the more pertinent reason is that CEO compensation is more highly influenced by firm size, and whether they also hold the post of Chairman, rather than long-term firm profitability (Callahan and Rutledge, 1995; Fosberg, 1999). Stock options are another example of managerial on-the-job consumption. The practice of options repricing severely weakens the argument that they help to align the interests of managers and shareholders. In this sense, there is no downside for managers if the stock price goes down, but huge potential benefits if the stock price goes up. In that case, shareholders' investment gets diluted and shareholders indirectly pay for the huge cost of managers' stock options (Monks, 1998).

Question 5

Again, all four answers can be true based on the situation. However, the distinguishing feature of an independent director is independence of personal judgement (Phan, 2000). Even nominee directors representing key creditors can exercise their independent judgement by realizing when they are in a potential conflict of interest, disclosing this fact to the board, and abstaining from relevant deliberations and voting. In this perspective, non-executive directors who are closely connected to the CEO or Chairman may be less independent than executive directors who exercise independence of judgement. This is one problem of institutional investors' insistence of having more outsiders on the board: structural criteria do not necessarily capture what it means to be independent and to act independently (Heracleous, 2001).

Question 6

Following from the above question, directors representing the parent company should realize when they may be faced with a conflict of interest and abstain from deliberations or voting. Indeed, it would be a breach of a director's fiduciary duty if he decides to do his job of representing the parent company by voting accordingly (answer b) or argue in favour of the interests of the parent company in board deliberations (answer c). A choice of answer d is possible in theory but difficult to do in practice.

Question 7

The board can carry out the functions of monitoring management, bringing to the company linkages and access to useful outside resources, or bringing types of expertise that the board would have otherwise lacked (Dalton and Daily, 1999). Many believe that non-executive directors are of limited usefulness because they do not know the details of the business. But they miss the point that the board is there to lead, not to manage. The best consultants command extremely high premiums for their time, and it is not because they know the details of each clients' business, or because they are necessarily smarter than their clients; it is because they contribute such things as knowledge of best practice methodologies and independence of judgement unimpeded by company politics or culture. These are the same qualities that can make non-executive directors valuable to the board. These are reasons for which the *Cadbury Report* (Cadbury Commission, 1992) suggests that "the board should include non-executive directors of sufficient calibre and number for their views to carry significant weight in the board's decisions''.

> **"The audit committee should be strongly independent and not influenced by executives, since it is there to indirectly monitor executives' actions"**

Question 8

Answers a, b and c are things that the chairman should in fact not do. The audit committee, for example, should be strongly independent and not influenced by executives, since it is there to indirectly monitor executives' actions. The compensation committee should also be strongly independent since they have to recommend the CEO's salary (in the USA the CEO is also the chair about 70 percent of the time). Also, the chair (as well as the whole board) should ensure that there is a sound strategy development process in place, probe the logic of suggested strategic actions, and in this way contribute to strategy development; but it is not their responsibility to actually develop strategy, this is the management's responsibility. Third, selection of non-executive directors should be made on the basis of competency fit between what the board needs and what the person can bring in, not on the person's personal connections with the chair or CEO (which might make it hard for this person to exercise independent judgement and challenge the chair/CEO where appropriate). The chair, as the boss of the board, must make sure that there is an effective process for board development, in addition to other functions that can include acting as a figurehead, giving strategic leadership, and ensuring effective board processes such as board evaluation, selection, agenda setting and meeting management (Parker, 1990; Phan, 2000).

Question 9

The answer here is d, as all of the above apply. The buck stops at the board, as the board has no-one else to blame for company misdeeds. Ethically, it is the right thing to do to pay attention to the legitimate interests of relevant stakeholders. This is an important consideration given that several actions that are legal may not be so ethical. Lastly, as consumers are getting more sensitized to ethical issues, and their purchases are influenced accordingly, ethical behaviour becomes, in fact, good business (Cochran and Wood, 1984; Verschoor, 1998). In this sense, it is unfortunate that even though the absolute amount of corporate charity has risen considerably, the relative amount has declined from 2.3 percent or pretax profits in 1986 to 1.1 percent in 1997 (*Conference Board*, 1999).

Question 10

It is true that the jobs of the CEO and chairman have different foci (the CEO is the boss of the business and the chair is the boss of the board) and require different competencies, and that a person who holds both positions may develop over-confidence in their abilities leading to wrong strategic decisions. The main reason, however, for which institutional investors aim for separation of these two roles, is based on the agency perspective (Eisenhardt, 1989). Since the board is there to monitor management, being both the boss of the board and the boss of management leads to a conflict of interest: how can the CEO monitor themselves in their dual role as chair? This is the reason that the *Cadbury Report* (Cadbury Commission, 1992) recommends that "there should be a clearly accepted division of responsibilities at the head of a company, which will ensure a balance of power and authority, such that no individual has unfettered powers of decision".

Question 11

The answers to all the sub-questions are "yes". Under Companies Act 1985, section 741(1), a director is defined as including "any person occupying the position of director, by whatever name called". A person who has accepted the responsibility as a director by being called as such, be it "executive", "non-executive", "independent", "alternate", "substitute" etc., is subject to a variety of directorial duties and liabilities. Although his/her scope of statutory and contractual duties may differ in accordance to the kind of director he/she has been appointed, he/she owes the same fiduciary duties and duty of care, skill and diligence to the company. In addition, if the functional role of a person is similar to that of a director, he/she may be considered as a director in law even if he is not formally appointed as one (i.e. the situation in Q1(f) above). He/she is what the law considers as a director in fact or *de facto* director. Finally, the person in situation Q1(g) is considered as a "shadow" director, as being "a person in accordance with whose directions or instructions the directors of the company are accustomed to act" (Companies Act 1985, section 741(2)).

Question 12

Companies Act 1985 does not specify any education requirement for a person to be appointed as a director of a company. The law leaves it entirely to the wisdom of the shareholders of a company to elect, in their view, the most competent person as the director during the general meeting. However, a director's personal qualifications and experience will influence the level of skill he/she is expected by law to display in conducting the affairs of the company. It is also a factor to be taken into account in determining the liability of a director in a situation where the company has been wound up for insolvent liquidation (Insolvency Act, 1986, section 214).

Question 13

Everybody should know that ignorance of the law is no excuse. A director can sue his/her lawyer afterwards for negligence if the latter has given him/her wrong legal advice. However, there is no escape from personal liabilities as a director.

Questions 14

The common law position is that directors, by virtue of their office, owe fiduciary duties to the company. The "company" in this case has been interpreted by the courts to mean the shareholders as a whole, and not the individual shareholders (e.g. *Percival* v. *Wright* [1902] 2 Ch 421; *Greenhalgh* v. *Arderne Cinemas Ltd* [1951] Ch 286, 291 *per* Evershed MR). Although by statute, the directors are required to consider employees' interests, the paramount duty of the directors is to consider the interests of the shareholders in discharging their duty to act in the interests of the company (Companies Act, 1985, section 309). Cases have shown that this identification of the company's interests with those of its shareholders shifts to those of its creditors when the company's financial stability is in doubt (e.g. *West Mercia Safeywear Ltd* v. *Dodd* [1988] BCLC 250).

Question 15

The law requires the director to exercise his discretion *bona fide* or in good faith in what he considers, and not what a court may consider, is in the interests of the company (*Re Smith and Fawcett Ltd* [1942] Ch 304, 306 *per* Lord Greene MR). If he has done so, then he has discharged his duty. The courts in general will not question the soundness of a business decision made by the directors unless it can be shown that the directors were not genuine in their belief concerning the company's interest.

Question 16

The answer to this question may come as a surprise. The law requires all directors to act in the interests of the company, and the company only. A director is not to consider the interests of individual shareholders in making his decisions, even if a particular shareholder, for instance, the major shareholder, may have nominated him to protect his/its interests in the company in the first place (*Scottish Co-operative Society* v. *Meyer* [1959] AC 324). In situations where the interests conflict, the director is required by the law to promote the company's interest at the expense of those of his nominator. Undeniably, this rule is not easy to apply in practice.

Question 17

There is no rule against a person being a director of more than one company, even if the companies may be in the same line of business. It is quite common for a director to sit on the boards of a group of companies that are related to each other. The obligation on a director in such a case is that he must consider the interests of the company individually, and must not sacrifice the interests of one company in favour of another.

Question 18

Although it is widely accepted that as a fiduciary, a director must not make a profit from his position unless this has been duly authorised by the company, the position is less clear-cut where there may be a possibility of conflict but no actual profit gained by the director. On one hand, English courts have allowed competing directorships (e.g. *Bell* v. *Lever Bros Ltd* [1931] All ER 1, 17 *per* Lord Blanesburgh). On the other hand, it would seem impossible for a director to act for very long for two competing companies before he would find himself in an intolerable position. Cases have shown that English courts take a very strict view on the no-conflict rule. It is not necessary to prove that there is an actual conflict of duty and interest or that the director has profited from his position. It is sufficient if there is a real sensible possibility of one (*Boardman* v. *Phipps* [1967] 2 AC 46, 123 *per* Lord Upjohn). The best action for a director to take in this situation is for disclosure to the board, and to the shareholders at the general meeting. Some companies simply include a provision in their articles precluding directors from occupying directorships in competing companies.

Question 19

This is a difficult question and the answer may not be exactly easy as well. English courts have generally taken a stricter standard as compared to that in other commonwealth jurisdictions (see *Regal (Hastings) Ltd* v. *Gulliver* [1942] 1 All ER 378 and *Industrial Development Consultants* v. *Cooley* [1972] 2 All ER 162 and contrast with the Privy Council decision in *Queensland Mines Ltd* v. *Hudson* (1978) 52 ALJR 399 and also with the decision of the Canadian Supreme Court in *Peso Silver Mines* v. *Cropper* (1966) 58 DLR (2d) 1). Despite the fact that there is no longer any real possibility of conflict, it is undeniable that the opportunity to take up this job or contract had come to the director in his capacity and by virtue of his position as a director of the company. Such an opportunity is regarded as a corporate asset that a director cannot therefore appropriate to his own use without proper disclosure and authorisation by the board and the company.

Question 20

Directors, unlike partners in a partnership, are not agents for each other and thus are not liable for each other's act. Courts have held that a director is not liable for things done in his absence from board meeting or fraud of his fellow directors (e.g. Re Montrotier Asphalte Co (Perry's Case) (1876) 34 LT 716, 717; *Ramskill* v. *Edwards* (1885) 31 Ch D 100). However, the situation is more complex when the director becomes acquiescent with the unlawful act afterwards. Is there a positive duty on the part of the director to take action against the transgressor? The answer to this question should be in the affirmative. ■

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Appendix 1.

Questions 1-10: please choose the most appropriate answer for each question

(1) Company managers are agents of the:
- (a) board of directors;
- (b) government;
- (c) shareholders;
- (d) key creditors.

(2) Directors' main duty is to:
- (a) key creditors;
- (b) company;
- (c) shareholders;
- (d) themselves.

(3) The key purpose of the board is to:
- (a) support the CEO/chairman;
- (b) ensure the company's prosperity;
- (c) follow family owners' wishes regarding company direction;
- (d) implement the directives of management.

(4) The board needs to monitor management because:
- (a) they may be incompetent;
- (b) the board can usually make better decisions;
- (c) management can make decisions that serve their own personal interests;
- (d) board members miss their jobs as senior managers.

(5) An independent director:
- (a) exercises their personal judgement;
- (b) is unmarried;
- (c) is a non-executive director;
- (d) represents the company's key creditors.

(6) When a subsidiary board is deliberating or voting on issues that concern its parent company, directors representing the parent company should:
- (a) abstain from board deliberations and from voting;
- (b) do their job of representing the parent company by voting accordingly;
- (c) argue in favour of the interests of the parent company in board deliberations;
- (d) vote but in doing so try to exercise independent judgement.

(7) Non-executive directors can contribute to the board by:
- (a) being members of board committees that have to be composed of independent directors;
- (b) supporting the CEO/chairman's position;
- (c) airing opinions not influenced by company culture and politics;
- (d) acting as spokespersons for the company.

(8) The chairman's key responsibilities include:
- (a) chairing key board committees;
- (b) deciding on the company's strategic direction;
- (c) selecting non-executive directors;
- (d) ensuring effective board development.

(9) The board of directors should be concerned with business ethics because:
- (a) the buck stops at the board;
- (b) it is the right thing to do;
- (c) ethics is good business;
- (d) all of the above.

(10) Institutional investors argue for separating the roles of CEO/ chairman because:
  - (a) one person could not have sufficient ability to carry out both roles effectively;
  - (b) these two roles require different competencies and have different foci;
  - (c) separation of power at the top is a good thing;
  - (d) one person having both roles is in danger of over-confidence in themselves.

Questions 11-20: please answer with a yes or no

(11) Which of the following is regarded as a director in law and therefore will have to bear all the duties and liabilities as one:
  - (a) An executive director.
  - (b) A wife who puts her name down as a non-executive director in her husband's private company but does not receive any remuneration from the company.
  - (c) An independent director who is not involved in running the company but is a member in the company's audit committee.
  - (d) A person who sits in as a director only when one of the director goes on leave, i.e. a substitute director.
  - (e) An alternate director.
  - (f) A person who does not want to be formally appointed as a director but has been allowed to attend the board meeting and act on equal footing with the directors in directing the company's affair.
  - (g) A major shareholder whose views the board of directors will follow in their board decision.

(12) Only a person with at least a "O" level qualification can become an executive director in a company under the law.

(13) A director need not know about his legal duties so long he has a good lawyer.

(14) When the company is on a going concern, a director owes his paramount duties in law to:
  - (a) the company or shareholders collectively;
  - (b) individual shareholders;
  - (c) creditors;
  - (d) employees.

(15) As long as a director makes an honest decision in the interest of the company, it does not matter that the decision turns out to be bad in the business sense.

(16) A nominee director must take into account of the interests of the person or body who has appointed him in making board decision and should take all steps to protect the interests of his nominator.

(17) A person can be directors of two companies even though they are in the same line of business.

(18) A director need not disclose to the board of directors that he is a director of another company which is in competition with the first company as long as he is honest and does not profit from his position.

(19) A director can set up his own company to take up a job which has been rejected by the company without necessarily informing the board.

(20) A director need not take responsibility for things done in his absence from board meetings, e.g. loans approved by the board made in his absence.

Appendix 2

A score of 16 or more questions out of 20 signifies that a director is well versed in the governance area. Scoring from 12 to 15 indicates an adequate level of knowledge; 8 to 11 indicates that improvement is required; 7 or lower: if we were shareholders in this director's company we would get severely alarmed.

Answers

(1)	C	(11)	1a-1g Yes
(2)	B	(12)	No
(3)	B	(13)	No
(4)	C	(14)	14a yes; 14b-d No
(5)	A	(15)	Yes
(6)	A	(16)	No
(7)	C	(17)	Yes
(8)	D	(18)	No
(9)	D	(19)	No
(10)	C	(20)	Yes