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HOW UNDERSTANDING COMPANY LAW HELPS DEVELOP DIRECTOR'S STRATEGIC THINKING

This essay argues that many directors are never inducted and developed into their board directoral roles. By not understanding their legal roles and tasks as a director, as distinct from a manager, they can rarely extract themselves for long enough to become skilled at thinking strategically, assessing risks, and taking wise decisions for the future health of their company. The paper draws on many years experience of working with boards. It advocates the use of the Learning Board model, the Thinking Intentions Profile psychometric, reading newspapers and journals systematically and getting out more, as ways of creating the conditions in which strategic thinking can be developed effectively.

Most board directors never function properly in their directoral, as distinct from executive, role. They seem especially ineffective at thinking strategically. Whilst assuming happily the title "board (statutory) director" they have rarely any rigorous induction or development process to explain that directing is very different from managing and takes them into a wider world of which many are uncomfortable. Most companies, and the business media, fudge the distinction by referring to “senior executives” or “the management”.

Matters are made worse by the use of the same words to mean different things even in the Trans-Atlantic "Anglo-Saxon" world. Oscar Wilde had it right when he suggested that Britain and the US are countries kept apart by a common language. Since the rushed cut-and-paste transfer of parts of the English Company law into US Federal Law, and given the constant war between the States and the Federal Government, there has been semantic confusion in the arena now referred to as "corporate Governance". Here I use the term "director" as a statutory (legal) member of a board of directors. They are charged with a basic task of resolving on a regular and frequent basis the constant dilemma between driving the company forward (board performance) and keeping it under prudent control (board conformance). In the US the term "director" is often abused by using it to refer to two quite different jobs. On the one hand is the correct usage as a member of the board of directors. ON the other hand is its use to define an executive one level below a Vice President. As the US tends to be executive-obsessed in its business thinking it ends not to take boards seriously. This double use of the term "director" creates confusion in the minds of many, especially when related to strategic thinking.

The Main Differences Between Directing And Managing

First, directors are bounded much more tightly than managers by the law. The roles, tasks, duties and accountabilities of boards and directors are spelled out in great detail in Companies Acts and Ordinances around the world. Indeed the codification, dissemination and administration of such commercial laws are often seen as the symbol of a country joining fully the modern world. China is a case in point as it seeks to create its own commercial law drawing in part from the Common Law in Hong Kong. Managers must obey the law, but they are not bounded by such specific laws about their needs for skill, care and fiduciary duty as are directors. This is not to say that they have no responsibilities, just far fewer. If no clear directoral induction is offered to a new director, then many accept this blissful state of directoral ignorance, unwisely.

Second, many directors do not realise that a key differentiator between managing and directing is that managers are essentially action-orientated – they are paid to execute projects and delivery processes. Directors are essentially reflective thinkers and must develop the necessary attitudes and skills to think strategically and effectively beyond the executive planning demands. Moreover, directors have a legal duty to think *independently*. For directors who have been recently, or still are, managers this sets up a tricky dilemma. When "thinking strategically" should they continue behaving as a working "executive" and take their lead from their Managing Director/Chief Executive Officer as they have always done; or should they learn to do as the law demands use their critical, independent judgement on the issues before them? The law is very clear for Common Law countries, for example:

Or take a nominee director, that is, a director of a company nominated by a large shareholder to represent his interests. There is nothing wrong in that. It is done very day. Nothing wrong, that is, so long as the director is left free to exercise his best judgement in the interests of the company which he serves. But if he is put on terms that he is bound to act in the *affairs of the company in accordance with the directions of his patron, it is beyond doubt unlawful.*

Lord Denning's judgement in the case of Boulting and the Association of Cinematograph, Television and Allied Technicians 1963 2 QB 606.

A Career Threatening Opportunity For Executive Directors

I argue that it is not possible to develop effective strategic thinking in a director, or a board, unless they have the freedom and confidence to think independently and widely beyond the functional limits of managerial disciplines and so transcend them. Only then will they be able to challenge fully any proposition brought before them. The law may insist that they must not be "puppet directors" yet most are, either through ignorance of their duty or through acquiescence to a dominant figure on the board. If few understand this even fewer want to change the status quo.

Moreover, many see clearly that debating, let alone disagreeing with your boss, would be a truly "career threatening opportunity" especially for an "executive director". The problem here is that, despite all the rhetoric and common practice, "executive directors" and "non-executive directors" do not exist at law. There is only the term "director". All directors have one vote each around the boardroom table – they are truly collegial – and the Memorandum and Articles of Association, or equivalent, will state whether the Chairman has a casting vote. Chairing itself should be a neutral activity in this group of colleagues. If there is conflict then, as in the UK regulations, all directors of listed companies who are concerned about the processes around their boardroom table have a right under The Financial Reporting Council's 2003 Combined Code of

Corporate Governance (1) to take external legal advice paid for by the company. Not many people know this and most existing directors would fall about laughing at the idea of anyone debating with, or opposing, the existing power players in the boardroom. Yet that is what directors are meant to do on a regular and rigorous basis. For without this there is no true Policy Formulation or Strategic Thinking by the board.

Is there a way of restoring these original legal intentions and so allow more competent strategic thinking to develop? I believe there is and in my work my colleagues and I have been following a three part approach with our clients. This involves perceptual changes in the board, and each director, which involve the

- Legal aspects
- Attitudinal aspects
- Board Dynamics aspects
- Personal development aspects

which I describe below.

Two Key Documents: Legal Aspects To Understanding The Director's Role

Given what I have said above I pull the whole of the basic legal aspects of directing into two key documents which form the basis of the director's induction process to the board (now a mandatory requirement for UK listed companies). The first is the Board Manual - the key document for the Board Induction process. This spells out the legal basis by which one becomes, or ceases to be, a director of this company; the accountabilities, duties and tasks of the board and its individual directors, the roles of any committees, and any processes specific to this board. Director induction is the responsibility of the Chairman aided by the Company Secretary or Legal Counsel. They work through the Board Manual with the new director answering questions as they go.

But of equal importance is the second document – the contract for services *as a director*. This is usually a rolling one-year contract which spells out for all directors, whether called wrongly "executive" or "non-executive", the accountabilities, roles and tasks and specifies the amount of time annually for which they are contracted and paid to carry out their directoral duties. For companies which now take the directoral role seriously this would typically be for the equivalent of one day per week devoted to the company, but not all of this is around the boardroom table. Some will form the board's "homework". Should the director also be employed as an executive of the company, then he or she would have a separate contract of employment in the normal way which would spell out the amount of time to be spent as an executive and their remuneration.

Having the two contracts makes it much easier for all directors, and especially the chairman, to insist that when each enters the boardroom they are contracted to drop their executive role and to focus on directoral decisions for the good of the company as a whole. Executive aggrandisement and turf wars have no place in the boardroom. It takes an effective chairman and company secretary to ensure this rule is not broken. And it takes some months of learning for "executive directors" to leave their executive hat at the boardroom door. When they do the whole dynamic of the board as a group of effective direction-givers changes noticeably for the better. They cease to try continually to "micro-manage" the company from the boardroom table usually for the benefit of their division or function.

Changing Director's Attitudes To Facing The Fundamental Board Dilemma: Balancing Board Conformance With Board Performance

But losing such executive power leaves many board members with an empty feeling. What do they do now? The obvious answer – to think strategically and so give long-term direction to their business – can seem intimidating. How on earth do we do that? There are some answers. First, directors and boards have to address continually the fundamental directoral dilemma – how do we drive this enterprise forward whilst keeping it under prudent control? This is never resolvable for any long period of time, which is why we have boards of directors meeting regularly to exercise their duties of Care and Skill to deliver their Fiduciary Duties i.e. to ensure that the business has a healthy future. The "prudent control" systems which the executives run give us our "board conformance" – compliance to the national and international laws and regulations which bound our company. Directors need systems for monitoring the output patterns of executive performance, not for trying to micro-manage them. Current work on "Directoral Dashboards" (2) show interesting ways ahead here.

However, the biggest problem for most directors is not just in keeping their hands off the existing executive control systems even though this is a constant temptation. A deeper strategic issue is in knowing how to "drive the enterprise forward" effectively. To my frequent surprise the future long-term health of a business is often not the major interest of the appointed directors and tends to be left to one or two power figures to determine what is needed. There seems to be two basic reasons for this strange state of affairs. First, a lack of agreement of what the business is for – its Purpose. It is all very well having fancy Mission Statements and beautifully printed Value Statements, but is the fundamental reason for its existence agreed with the owners and the stakeholders? Without wishing to go too deeply into this debate here I advocate the *Added Shareholder Value* proposition of Sir Brian Pitman:

“added shareholder value is the economic value added after taking into account the reasonable short-term demands of the owners, the cost of capital, and ensuring the long-term future of the business”. (3)

Thinking Strategically

Directing by thinking strategically is all about assessing risks and giving directoral judgement. It is a highly skilled process and in these three sentences a board’s judgement of what are the “reasonable short-term demands of the owners"; how much should be paid for "capital"; and how to "ensure the long-term future of the business” are put to the ultimate test. Get them wrong and your owners will fire you. But from the time they appoint you as a director your primary duty is *not* to them, but to the company as a separate legal personality. Directing is all about paradox and dilemmas and an F Scott Fitzgerald sums it up for me:

The test of a first class mind is being able to hold two opposing views simultaneously and still be able to operate.

The Breakdown 1936

Classical Greek Gives Us The Four Tasks Of A Board

Policy

To give clarity to any board I use the Learning Board model originally expounded in *The Fish Rots From The Head: The Crisis In Our Boardrooms* (4) to create a conceptual framework adapted from Bob Tricker's seminal work on Corporate Governance (5). I have gone back to the original Greek words on the working assumption that most business schools are illiterate and given to undue praise of Tweedledum and Tweedledee (6) - they want to be the master and make words mean what they want them to mean. I am more purist and point out that the Greeks had a simple hierarchy for human organisations at the top of which is "Policy" (7) coming from the word "polity" referring to the wide political world beyond the organisation and all those unknown forces which will push upon the future ecological niche in which our company survives. "policy" is not the rules and regulations of an organisation regardless of what many business schools think.

Strategy

Below Policy in the organisational hierarchy is another ancient Greek word "Strategy". This refers originally to the world of the military general (8) and his five basic decisions of how best to achieve the objectives given him by the politicians – Hold your ground; advance, retreat; make alliances; withdraw. The European and Chinese approach to strategy can differ markedly from the US's on the interpretation of these. The former often take more of a "soft" strategy approach as characterised by Sun Tzu. This allows pragmatism, flexibility and co-opetition compared with the frequent "hard" US approach seen currently in the “six killer strategies” – unleash massive and overwhelming force; exploit anomalies; threaten your competitor’s profit sanctuaries; take it and make it your own; entice your competitor into retreat; break compromises – in *Hardball* (9) Nowadays “strategy” usually refers back to original Greek - “the broad deployment of scarce resources to achieve your Purpose” - and that is how I use it here. Whilst using Tricker’s original framework in 1985 I reversed his positions of Policy and Strategy to create the *Learning Board* model (10)which we have developed in five continents and many organisations.

Figure 1 here

In the Greek hierarchy there follows “tactics” nowadays usually referred to as “Operations”.

I need to declare a personal position here. I am with Henry Mintzberg (11) in differentiating between “strategic thinking” and “strategic planning”. I see strategic planning as a dangerous oxymoron, a contradiction in terms, like “fun run” and “friendly fire”, which combines unhelpfully aspects of directing and managing. I use “strategic thinking” as the directoral processes which must occur *before* the planning cycle starts. So in my book there is no such thing as "strategic planning".

The Learning Board

My key argument is that a board's role is to address the directoral dilemma of driving the enterprise forward whilst keeping it under prudent control. This is achieved by delivering four directoral tasks:

- Formulating Policy
- Thinking Strategically
- Supervising Management
- Ensuring Accountability.

Note that these are all active verbs. Directing is a proper job and not a sinecure. It requires time, skill and judgement and an annual rhythm to a board's year to develop these. I argue that Policy Formulation and Strategic Thinking give us "Board Performance"; whilst Supervising Management and Ensuring Accountability give us "Board Conformance", or compliance.

A current problem with the present "Corporate Governance debate" is that it is over-focused on board conformance because this is an easy area for legislators and regulators to audit to show their constituents that they are doing their job in promulgating new laws and rules to keep misbehaving boards and directors under control. But this is having two unwelcome effects. First, it is pushing more company legislation away from civil law and into criminal law. This is very dangerous as it both puts people off wanting to become a director, and it misses the point that there exist perfectly adequate fraud laws. In its extreme form this can be seen in the US's Sarbanes-Oxley Act (12) where following the Enron scandal and in the politicians' desperate and rapid search for always having someone to blame, they fixated on the idea of a "single point of accountability". Now a nonsensical amount of time and money has been spent by corporations trying to redesign control systems to allow any decision to be traced from top-down and bottom-up. The very human consequence is that everyone tries to cover their backside with these systems. The unexpected consequence is increasingly to create in US corporations a risk-averse culture. This is the antithesis of capitalism; and the negation of effective organisational learning. One is tempted to ask "is SOX anti-American and anti-capitalist?" It is a double irony that a second unexpected consequence is that the very people who were meant to be disciplined by this law - especially auditors and lawyers - seem to be the ones benefiting the most financially from it.

Board Dynamics Aspects: Can Boards Think Strategically?

Second, there is a consequent under-playing of the crucial role of "board performance". Board conformance is by definition necessary but not sufficient. Sufficiency comes from a competent board skilled in their strategic thinking, risk assessment and wise decision making. From my experience many boards are not interested, nor competent, in these areas. Using the Thinking Intentions Profile (13) I have surveyed some 300 UK directors and found that just over eighty percent are locked into managerial thinking patterns. They over-emphasise their preferences for sensing and prioritising their immediate emotional relationships with their colleagues and direct reports, following this rapidly with a strong preference for rationality and logic. Put more simply they are strong on fighting the business's micro-politics (the "soft facts") and often brilliant at post-rationalising what they have just done to their colleagues. At the mid-points most have only modest interest in either Vision or Values for their company. Their least preferred forms of thinking are Hard Facts (which are usually seen as inconvenient to the micro-politics) and Ingenuity (which is crucial in developing and especially implementing strategy). This is a discouraging, even alarming, picture of the state of most boards (14). My work is reflected in Ram Ramakrishnan's experiences of developing the Director's Dashboard. (15). He found to his surprise that in the major Asian corporations with whom he was working there was a surprising lack of interest in the future, specifically about the source of their future income streams. The tendency to want to micro-manage the executives was much stronger. With so many directors still seeking comfort in their old executive roles one needs to create a new board dynamic to break into sustained strategic thinking at board level. And that means board homework.

Personal Development Aspects: Developing Director's Strategic Thinking

There are three key conditions to be met before it is possible to achieve this. First, agreement around the boardroom table that they will accept as essential board selection, induction, training and development, annual appraisal of the board and each director. Second, that the Board Chairman is fully committed to these, including his or her own 360 degree annual appraisal and is backed strongly by a truly independent Company Secretary or Legal Counsel. Third, that all directors have the same annual contract for services which spells out the time they need to devote to their crucial direction-giving role.

Once these are in place I start the "poor man's PPE process". PPE is the Oxford degree in Philosophy, Politics and Economics. Put in such stark terms most directors will immediately shy off and say that they have no time for such stuff, and drop back informally to the comfort of being an executive. So I ask them to make two key behavioural changes initially for a period of three months. First, to take a daily broadsheet newspaper each morning and to be seen to read it at their desk for thirty minutes before they deal with the overnight e-mails, phone calls, and staff wanting to see them. This is usually greeted as totally impractical and, if tried, often ends up with the paper being stuffed under the desk if someone enters the office. They are afraid of being found to be “not really working”. But scanning the changing external environment and sensitising your board to both the strong and weak signals from those changes is a key part of the directors job - it is the board's homework.

It is helpful to reinforce such environmental scanning – changes in our markets – by using “buddy pairs” to undertake the task rigorously. Two directors, or a director and a senior executive, or a director and key customer or shareholder, will take one of the six aspects of the venerable PPESTT analysis – Political, Physical Environmental. Economic, Social, Technological, and Trade – and track it jointly for three months. Using the annual rhythm of the Learning Board model, they report back with no more than four sides of paper to the quarterly Strategic Thinking Awayday of the board. All six aspects are debated in relation to what is changing externally which may affect our changing markets and our “licence to operate” in those markets. Risks are assessed and strategic decisions taken to be tested no later than the next strategic thinking awayday. But one more thing then happens. The “portfolio” of the buddy pair is then changed so, for example, those tracking the Political environment hand this on to another pair whilst they take up the Physical Environmental portfolio. Mechanical and simplistic as this may sound within eighteen months all members of the board will have covered all six elements of the PPESTT and will see a marked improvement in the quantity and quality of time they spend on thinking strategically. If this is under-pinned by board and personal psychometrics like the Thinking Intentions Profile to track their progress confidence can be built rapidly. Even better is the encouragement that directors should "get out more" and understand better their markets, their customers, their owners, their suppliers, their staff, and other "stakeholders".

Further Development of Strategic Thinking

Once these basic conditions are met then one can help a board use all the wonders of modern strategic thinking - anything from the venerable SWOT analysis through to scenario thinking and complexity theory. But without these basics there will never be an integrating theory and practice for strategic thinking on a board. Board directing is becoming an accredited profession, as the rise of the *Chartered Director* award in London and Tokyo is showing (16). It may take a decade before the majority of directors take this notion seriously but it will happen. Understanding the legal roles and demands on a director is the first building block in becoming a professional director. Without that it is not possible to think strategically nor to implement strategy effectively.

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