What are company boards for now?

by Bob Garratt

In 1776 three publications, and one death, helped to shape our current company world. Adam Smith, published *The Wealth of Nations*, Jean-Jacques Rousseau published the *Social Contract* and a rebel group of British citizens published the American *Declaration of Independence*. Today these events remain highly relevant as we grapple with the question of what the post-Covid-19 company and board should be, whether private, public or not-for-profit.

Smith's work was not a red-in-tooth-and-claw demand for unbridled capitalism. Half the book is concerned with 'moral sentiment' in the generation and distribution of wealth. Smith was an economist and the world's first Professor of Moral Philosophy. He argued for a thoughtful balance between wealth generation and distribution. Rousseau, a Swiss philosopher, developed the concepts of 'civil society', the balance of 'rights and duties' between the individual and state power and the concept of the social contract. The American Declaration of Independence led to the writing of the US Constitution, within which is the key concept of the balance of the separation of powers between the legislature, the judiciary and the executive.

Reframing corporate wealth, justice and power

It is these balances of *wealth, justice and power* in our companies and societies that are now under reconsideration. How should we govern our companies? Internationally, citizens are demanding a new social contract: a reframing of our national and international institutions to ensure a fairer balance of wealth generation and distribution; the reframing of the rights and duties between individuals and the state; and the rethinking of corporate governance in terms of the relationship between wealth, justice and power.

And what of the death? This was of the English clockmaker, John Harrison, who solved the global problem of measuring longitude through the design of his chronometer. Harrison's model was used as a metaphor in the design of the US Constitution. His concept of 'the regulator' became accepted by many later democracies. It also became the design for effective companies: balancing boards, owners and legislators. Harrison's chronometer opened world trade through accurate maritime navigation, which greatly reduced business risks.

Companies — private, public and not-for-profits — are the corporate, civil bonds that hold our society together. So the question of *what a company is for now* is currently uppermost in the minds of a disillusioned public, disconcerted politicians, discomforted shareholders and stakeholders, and disconsolate directors. They have all lost confidence in the purpose of companies and their 'corporate governance'. They are asking whether all involved in the running and regulation of our companies know why they are there. Most directors secure their roles by accident and are not trained on governance duties or competence assessment. When this lack of knowledge runs up against the easy assumptions of politicians — that their latest legislation on corporate governance is both well known publicly and implemented effectively — then misunderstanding and general disillusion sets in. This further undermines our trust in companies, directors and regulators.

The crude twentieth century notion that companies were machines to generate and distribute profits to the advantage of only shareholders and executives is fallacious and under serious global scrutiny. This mindset is to the long-term disadvantage of customers, workers, suppliers, stakeholders and the environment. This is especially odd given that shareholders do not legally own companies. A perfect storm of growing public and political concern over the very purpose and ethics of companies, combined with mounting evidence of significant numbers of companies having a negative, even dangerous, effect on communities and the planet, calls for a major reframing of the whole concept of companies and their relationship with society.

The purpose of a twenty-first century company

So what are the new necessary mindsets, values and behaviours that will define the purpose of a twenty-first century company? The answer starts with the fundamental assertion that a company is a human organisation that bonds people together through a common purpose, be it the productions of goods, services or information, to create and distribute wealth in three forms: financial, social and environmental. In a dynamic and uncertain world the cement that holds it together is the learning and adaptive capacity of its people in relation to internal and external changes. The well-tested Reg Revans' axiom — *for an* *organisation to survive and develop its rate of learning must be equal to, or greater than, the rate of change in its external environment* — fits our present problems perfectly. The first two decades of the twenty-first century has seen sufficient disruptions to the old assumption of what a company is for, to not just to question this, but to junk it.

A company is a group of individuals gathering together to create more wealth than their individual inputs can generate. Such 'wealth' is created by a mixture of financial, social, environmental and regulatory inputs and outputs. The surpluses generated have a measurable impact for good or bad on their wider environments; the commonwealth. The limits of a company's purpose are set by each society's agreement on the fair distribution of such wealth.

The original notion of the word 'company' signifies a beneficial human activity: people coming together in common purpose, originally to break bread. It has grown away from this altruistic concept and has been biased increasingly towards valuing only the financial output. The triple bottom line concept was unbalanced. By the beginning of the twenty-first century the consequences for those excluded have created a general public distrust of *all* companies and a growing conviction that they always conspire to never share widely the generated wealth.

These excesses, and global shocks like Covid-19, have given the public both reason and energy to demand reconsideration of the purpose of our future companies. These demands offer directors, stakeholders and legislators a unique opportunity to create a new purpose for their company and to be audited on this. Such new purpose needs to be built on the foundation of those wealth outputs: financial, social and environmental impact. It is for the directors to decide how such surpluses should be shared, within the growing national and, increasingly, international social ethos and laws.

This ‘triple bottom line’, ‘integrated reporting and audit’ will better focus boards’ attention on their allocation of scarce resources. However, they must still generate a financial surplus to ensure their survival. This is very different from the previous fallacious view that the only purpose of a company is to create excess profits for the sole purpose of rewarding its owners the shareholders.

What shocks many people is that this is legally wrong, at least in countries working under the developmental pragmatism of Common Law. Since the 1890s and the Saloman’s judgement it has been clear — if not widely recognised — that shareholders do not own a company. Nobody owns a company. A company is created at law as a separate legal personality, which can sue and be sued in its own right. Shareholders have the right to own a ‘share’ document, which allows them to be paid a dividend, share in any rise, or loss, in the capital value of the company, receive any residual value if the company ceases trading, and have the right to vote at annual and extraordinary general meetings, including on the appointment of directors to the board. But shareholders are not as powerful as many assume and it is increasingly difficult for them to determine a company’s purpose. The question remains as to whom then *controls* a company?

Currently, the combination of enraged stakeholders, public opinion, and political and physical environmental pressures is forcing directors to reassert their control to rebalance their thinking on how these new forces can be used. There is much heated rhetoric about ‘sustainability’ and ‘zero carbon futures’ generated from politicians, directors, managers, trades unions, stakeholders, charities and pressure groups. Much of this energy is currently wasted trying to create new laws and regulatory code. Not enough is spent on ensuring that the existing ‘triple bottom line’ laws are implemented. This is because a debilitating combination of conflicts of interest between previous ‘owners’ and politicians more keen to argue left/right party politics rather than clarify this law has led public disenchantment.

Governance amnesia

The irony is that, in the UK at least, the necessary law already exists; it was passed in 2006 as a fundamental part of the new UK’s Companies Act. The trouble is that so few directors and politicians know this, or care about it. Few were around in 2006 and by 2008 the priorities were not on developing purposeful companies but on avoiding the cliff edge of the global financial disaster. The political focus changed firmly to rescuing banks rather than developing effective companies. The legal foundations for effective companies and boards were left in place but faded into obscurity as organisational amnesia set in. Section 172 of the Companies Act now needs testing in the High Court before directors, politicians and the public will give it full attention.

No political group or professional institution has had the nous to demand the implementation and testing of this key aspect of the 2006 Act in the courts. The result is that it has not developed as pragmatic case law. Instead a ragbag of corporate governance and financial codes and rules were imposed in parallel without a strong understanding of the original. This has led to the accumulation of more and more ineffective corporate governance regulation, jumbled with unnecessary banking and accounting regulation, and the creation of a cottage industry to protect the indefensible.

Section 172 should be engraved on the mind of every company director and board. It imposes on each director *a legal and general duty to act in a way that they consider, in good faith, would be most likely to promote the success of the company for the benefit of the company as a whole.* It binds every director to ensure the continuing, long-term, health of their company and all those ‘members’ of it. It never mentions shareholders specifically let alone their supremacy. Section 172 spells out the details of such a binding commitment and directors need to spend time to *show* that they have considered the following:

1. The likely consequences of any decision in the long term;

2. The interests of the company's employees;

3. The need to foster the company's business relationships with suppliers, customers and others;

4. The impact of the company's operations on the community and the environment;

5. The desirability of the company maintaining a reputation for high standards for business conduct; and

6. The need to act fairly between members of the company.

What better framework within which directors to decide the purpose of their company? In 2006 legislators had spent eight years getting this massive Act through Parliament. The arguments continue to rage, including: the reduction of shareholder supremacy, rebalancing these with wider stakeholder considerations; the rebalancing of financial inputs and outputs to better assess their impacts on the community and environment; and the future role of human learning in the company, especially those played by customers, employees and suppliers.

The key values underlying section 172 are accountability, probity (honest dealing) and transparency. These now demand serious board consideration and action in the UK where, from January 2019 all companies with a turnover above £36 million a year must provide an annual report outlining the consequences of board decisions in each element of Section 172. As directors write these new annual reports they need to ensure that they have clarified their financial, social and physical impacts on society and are committed to the new purpose of their company.

What Are Boards For Now?

Matters are changing fast; too fast for many boards who in these times of great turbulence are struggling to find what their ‘new normal’ role will be. Fast growing new board reporting and audit demands are so far away from the ‘old normal’ that many directors are confused. But it will become even more complex. New laws in such fields as social and environmental impact, diversity, modern slavery, money laundering and corruption, leave boards struggling to understand the hugely expanded breadth of their new responsibilities. The new social contract for companies is being rewritten before our eyes with very little say by directors. When the demands of activist owners, stakeholders, pressure groups, the cyber economy and changing customer behaviours are added these new demands can seem insurmountable. And yet the law states that directors have unlimited liability for their decisions.

Worse still is the unwise expectation by legislators and regulators that boards have instant knowledge of, and are able to make sound judgements in, such new areas of ‘human factors’ as behavioural economics, anthropology and ethics. Few have any background in one of these areas let alone all of them. Even worse, they will now be held personally and jointly accountable for this hugely expanded role through the rapidly developing system of rigorous integrated annual reporting and audit.

The board of directors was developed from 1600 to answer the two fundamental questions about running a business. First, how can a company see its way ahead to ensure that it has a healthy and sustainable future? Second, how can it keep under prudent control its complex day-to-day operations? By the late twentieth century these questions were often called the *directors' dilemma*. The quality of a board's answers measures both the board's effectiveness and the company's efficiency. This is far beyond the current simplistic concept of 'compliance'.

Rescheduling sufficient time and developing the right skills to resolve continuously this dilemma is the key challenge for the 'new normal'. It demands decisions spanning those two seemingly contradictory alternatives: designing a sustainable, long-term future set against controlling the turbulence and immediacy of present operations. The board is the balancing process between the two.

The continuing uncertainty challenges boards to be both humble about their skills and knowledge and yet imaginative in resolving these seemingly intractable problems; and to do this in real-time. It was always thus; the ancient Greeks had a word — *kubernetes* — from which our modern word *governance* is derived. It described the steersman of a ship and the need to give both direction (governance) and control (operational feedback on the consequences of that direction). The purpose of a board of directors is to ensure simultaneously the governance of a healthy future and the prudent control of the present operations and to be held accountable for their decisions. The problem is that many directors do not recognise this and do not understand their legal duty to deliver it. Many are horrified when they find out.

This explains why the public distrusts, even hates, boards and directors. They see media reports focusing on directoral competence coupled with excessive pay and bonuses. Boards and regulators have done little to educate the public as to the questions they should ask of them. Citizens do not yet have the necessary knowledge of governance to ask these critical questions. As a result, they have little oversight of a board's effectiveness. Neither, sadly, do most owners, legislators, regulators or even boards. There is a massive corporate governance educational gap in society.

The New Normal: the professional board

For millennia humans knew that it is better to apply more than one brain to an issue to ensure more effective problem solving. This is especially so if the owners of those brains have responsibility for the oversight of the complexity of a company and its impact on the financial, social and physical environments — the ecological system within which it exists. These diverse directoral brains are essential for the continual resolution of the directors' dilemma. Such brains, thoughtfully chosen and regularly assessed, help ensure sufficient diversity of thinking and experience to generate wise and subtle solutions. To survive and develop the board of directors needs become the *business brain* — the central processor — of a continually learning organisation. To be effective, both the board and the operational side of the company need to generate a sufficient rate of learning to be equal to, or greater than, the rate of change in their external environment. Few boards achieve this; even fewer sustain it.

Most people become 'directors' by default; they sign a form from Companies House, are given a short talk by the chair and company secretary, then given a pile of legal papers that spell out their onerous and legally binding directorial duties. These are then put aside as the director is overwhelmed by the day-to-day demands of their 'real' job. Directors rarely appreciate that they have now a second and more onerous real job; directing the company. This is very different from managing but they rarely allow the time to generate the intellectual energy and skills to learn how. It is only when a crisis happens that the wider world questions their lack of diligence in their directorial duties. Then the full extent of their legal responsibilities and liabilities become clear. By then it is too late because ignorance is no defence under the law.

When I use the phrase 'professional board' I mean one that fully understands its legal and governance duties, delivers them effectively, assesses them regularly and learns continuously. So as we develop the companies of the future how do we develop these professional boards? One thing we know is that they will be very different from the narrowly defined and relatively undemanding boards of the twentieth century. For example, the new demands of diverse stakeholders coupled with the loss of 'shareholder supremacy', the rapid growth of national and international legislation, and new audits about the social, environmental, governance and financial decisions of boards, all pose new challenges. These are intellectual, behavioural and emotional challenges rarely ever considered under the 'old normal' to be relevant to board competence. The old, simplistic issues of shareholder value priorities, the irritation at the rise of stakeholders, the nagging doubts as to the validity of assessing social and environmental impact, even the background debate on capitalism versus socialism; all now look increasingly minor when faced with the new global challenges. Boards will have to learn how to cope yet few feel capable or even motivated to do so.

Will we now need a raft of new legislation to cope with such immense demands? No. As I have argued above — and this may upset many legislators, pressure groups and regulators — at least in the UK, these issues were debated and agreed at national level by the start of this century with the passing of the 2006 Companies Act. This forms the legal basis of 'corporate governance' but which I still prefer to call 'board effectiveness'. The problem is that few directors, legislators, investors or regulators are aware of these duties or take them seriously enough to commit to them ethically and behaviourally despite them being law for 15 years.

The duties of a director

Section 171 of the 2006 Companies Act defines what a board is for, now and in the future. It gives the duties of a director and, so, the performance criteria for future directors. Each director should commit to these on their induction to their board. This is rarely done. In order to deliver on its purpose the Act says that each director has seven duties:

· *Act within the board's constitution;*

· *Promote the success of the company;*

· *Exercise independent judgement;*

· *Exercise reasonable care, skill, and diligence;*

· *Avoid conflicts of interest;*

· *Not accept benefits from third parties; and*

· *Declare interests in proposed transactions.*

If these duties sound easy to deliver, they are not. They require an intellectual and ethical stance way above what is required from day-to-day management. In this short paper it is not possible to go into great detail. But, as examples, here are just four challenges. First, in exercising independent judgement a director must rise above their often single professional discipline to consider the future health of the company as a whole. Second, it is unlawful for a director to act on behalf of a third party; any director acting merely as an agent of another is not fulfilling their duty of independent thought. Third, sufficient time needs be set aside to ensure that board decisions are taken jointly to demonstrate carefulness, skilfulness and diligence. Decisions taken beyond the existing competences of the board need to show that appropriate professional advice was sought. Fourth, boards and directors need be provided with suitable professional support to deliver their duties and so ensure their effectiveness.

And finally, the written declaration of conflicts of interests, offered or accepted benefits from third parties, or involvement in third party transactions must be produced well before any board vote on a proposal. While it is for the board to decide and minute whether the director involved attends, has a say in the meeting and is able to vote, they should not be in the room when the vote is taken. These issues need careful handling in specific circumstances, for example, when decisions are taken by the board of family companies where conflicts of interest can be complex.

Levels of board maturity

Given these complex new demands, who would want to be a director now? I am reassured by those who see the chance becoming professional in reframing their company within a more integrated and publicly agreed compact for their social community and its ecology. Most are willing to learn how to handle environmental, social and governance, and triple bottom line reporting. They want to become professional directors.

To take these ideas forward, a first key step is to benchmark the current level of a board's maturity. . I use a four level scale. At Level Zero we have *the Accidental Board*, where most directors have signed the papers but have little idea of what this means, or any inclination to find out. At Level One is the *Grudgingly Compliant Board*, where there is at least acceptance that there are legal obligations to deliver but where this is treated as an unnecessary burden of cost and red tape to be disposed of as quickly as possible.

At Level Two, *the Learning Board* treats the development of the role of directing as the key to company survival and development. The board's focus switches from merely oversight of the daily operational world, of supervising management, and ensuring accountability, towards serious board time being spent on evolving policy and foresight to ensure the company's continuing role in its changing external world. Effective strategic thinking can then be given to the deployment of the governance of its scarce resources to achieve its purpose and so deliver its social and environmental compact. This strategic thinking is then shared with the executives and developed by them to create plans and tactics to ensure that the daily operations learn fast and efficiently enough to deliver the future.

Finally, at Level Three there is the *Professional Board*, where learning flows generated from Level Two are consolidated into becoming a learning board within a learning organisation. At this level directing needs a larger allocation of time as directors are always thinking about their company's future and need to become comfortable at linking risk with emerging opportunities. In this professional board directors are assessed individually and collectively for their directorial competence and are signed up for assessed continuous professional development. They are paid equally through a contract for services. If they are also executives they have a separate contract of employment for the time spent in that role.

The unresolved shadow

This paper takes an optimistic view of how companies will develop and the willingness of boards to adapt to the 'new normal', responding positively to public and environmental pressures. However, there is an unresolved shadow side to current board responsibilities. Since 1890 no politician, professional institute or company has faced squarely these lingering legal sores, or had the courage to clarify what are meant by the 'limitation of liability' for directors, and what is 'the controlling mind' of the board.

Shareholders do not own the company but boards do have control. All directors are told on registration they have 'unlimited liability' for the consequences of their decisions and actions. This has rarely been tested, even in the lower courts. In serious cases, for example fraud, the courts have tended to seek a named 'controlling mind' in the board. This has led to failures in a number of recent cases. If we are serious about creating a new workable model of the purpose of a company and governance arrangements fit for the twenty-first century, we need to demand of politicians, professional institutes and the directors themselves a series of clarifying test cases on limitations of liability and the definition of the 'controlling mind' if necessary culminating in a Supreme Court decision. Only then can a board deliver effectively. Sections 171 and 172 and so ensure that public confidence is restored.

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