

Role of non-executive directors

Board composition

A non-executive director is one who is not employed by the organisation. This is not the same as an independent director who is one who is not only not employed by the organisation (non-executive director), but also has no relations with the organisation other than being a director. Current good practice recommends that a majority of directors on listed company boards be independent non-executive directors.

All directors, whether executive or non-executive, must comply with basic legal requirements under the *Corporations Act 2001* (Cth). It must be emphasised that there is no room for a sleeping director on a board – a person who is there just to make up the numbers and takes no active role in the board's work. The courts have emphasised that they will be liable for breaches of directors' duties.

Non-executive directors are not expected to have the same level of detailed operational knowledge about their organisation as executive directors. However, the core duties for both executive and non-executive directors are the same. As stated by Justice Middleton in the *Centro* case:¹

“Directors are required to take reasonable steps to place themselves in a position to guide and monitor the management of the company. A director must become familiar with the fundamentals of the business in which the corporation is engaged; a director is under a continuing obligation to keep informed about the activities of the corporation; directorial management requires a general monitoring of corporate affairs and policies, and a director should maintain familiarity with the financial position of the corporation...It is clear that an objective standard of care is applicable to both executive and non-executive directors.”

The UK's Higgs Review² describes non-executive directors as “custodians of the governance process”. In Australia, it is considered good practice from a governance perspective for a majority of directors on a board to be non-executive and independent, especially in listed companies.³ Proxy advisers are increasingly rating companies on the independence of the board as a sign of their adherence to principles of good governance.

¹ *ASIC v Healey* (2011) FCA 717 at 166; 172.

² Higgs D, *Review of the Role and Effectiveness of Non-Executive Directors*, Department of Trade and Industry, London, 2003, p 11.

³ ASX Corporate Governance Council, *Corporate Governance Principles and Recommendations 3e*, Australian Securities Exchange Ltd, 2014, Recommendation 2.4, p 17.

What does the role entail?

A non-executive director's responsibilities will normally be outlined in the corporate governance charter and may also be touched on in a director's letter of appointment. Specific terms will vary from organisation to organisation, but will usually cover a director's responsibility in relation to:

- effective governance of the organisation;
- formulation of the organisation's strategic direction;
- recruitment and performance of the CEO;
- reviewing, approving and monitoring the business plan and annual budget;
- contribution to the development of board and organisational policies;
- compliance with the legal requirements of being a director;
- compliance with legal and regulatory requirements of running a business;
- monitoring risks facing the organisation;
- any specific requirements in relation to stakeholders and networking on behalf of the organisation;
- involvement with a board sub-committee; and
- identifying skills required by the board and potential candidates;

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The charter might also refer to minimum standards of behaviour expected of a non-executive director. The Australian Institute of Company Directors' *Code of Conduct* provides guidance on this.

How does a non-executive director add value to a board?

The perceived advantage of non-executive directors is their independence and objectivity – their ability to act in the best interests of the company is not compromised. Other ways in which non-executive directors add value include:

- bringing an independent and fresh perspective to decision-making;
- demonstrating relevant competency, experience and ethical behaviour;
- challenging, questioning and monitoring the CEO and senior management;
- their external networks which are of use to the company; and
- supporting and mentoring the CEO.

It should be noted that having a majority of non-executive directors is no guarantee against corporate failure. Also, there are studies which question whether the presence of independent directors really improves company performance and board effectiveness.⁴

Are non-executive directors also independent directors?

An independent director is a non-executive director who is not a member of the organisation and who is free of any business or other relationship that could materially interfere with – or could reasonably be perceived to materially interfere with – the independent exercise of their judgment. The ASX Corporate Governance Council provides the following *Box 2.3: Factors relevant to assessing the independence of a director*, in its *Corporate Governance Principles and Recommendations 3e*:

"Examples of interests, positions, associations and relationships that might cause doubts about the independence of a director include if the director:

- *Is, or has been, employed in an executive capacity by the entity or any of its child entities and there has not been a period of at least three years between ceasing such employment and serving on the board;*
- *Is, or has within the last three years been, a partner, director or senior employee of a provider of material professional services to the entity or any of its child entities;*
- *Is, or has been within the last three years, in a material business relationship (eg as a supplier or customer) with the entity or any of its child entities, or an officer of, or otherwise associated with, someone with such a relationship;*
- *Is a substantial security holder of the entity or an officer of, or otherwise associated with, a substantial security holder of the entity;*

- *Has a material contractual relationship with the entity or its child entities other than as a director;*
- *Has close family ties with any person who falls within any of the categories described above; or*
- *Has been a director of the entity for such a period that his or her independence may have been compromised.*

In each case, the materiality of the interest, position, association or relationship needs to be assessed to determine whether it might interfere, or might reasonably be seen to interfere, with the director's capacity to bring an independent judgement to bear on issues before the board and to act in the best interests of the entity and its security holders generally."

Rather than define independence in terms of commercial or stakeholder interests, the AICD and some notable commentators such as the late Sir Adrian Cadbury⁵ believe that it is more helpful to base independence on behaviour and mindset. This requires a board culture where intelligent inquiry and independent opinion are encouraged and where the views of experts on the board or dominant board members are not automatically deferred to without investigation. The difficulty with this approach is that it is not possible for people outside the boardroom to know whether a director is exhibiting these behaviours.

⁴ See, for example, Dalton, D.R., Daily, C.M., Elstrand, A.E. & Johnson, J.L., 1998, 'Meta-analytic reviews of board composition, leadership structure, and financial performance', *Strategic Management Journal*, vol 19, no 3, pp 269-290; Bhagat, S. & Black, B., 1999, 'The uncertain relationship between board composition and firm performance', *Business Lawyer*, vol 54, no 3, pp 921-963; Rhoades, D.L., Rechner, P.L. & Sundaramurthy, C., 2000, 'Board composition and financial performance: A meta-analysis of the influence of outside directors', *Journal of Managerial Issues*, vol 12, no 1, pp 76-91; Kiel, G.C. & Nicholson, G.J., 2003, 'Board composition and corporate performance: How the Australian experience informs contrasting theories of corporate governance', *Corporate Governance: An International Review*, vol 11, no 3, pp 189-205.

⁵ Cadbury A, *A Report of the Committee on the Financial Aspects of Corporate Governance*, Burgess Science Press, London, 1992.

What are particular challenges facing non-executive directors?

Neil Young QC, in a presentation to the 2008 ASIC Summer School entitled *Has Directors' Liability Gone Too Far or Not Far Enough?*, made the point that non-executive directors can face particular challenges in satisfying their obligations of care and diligence.⁶ Those challenges include:

- Obtaining enough information and the correct type of information to make reasonable and diligent judgments and to adequately monitor the performance of the corporation and its senior management;
- Declining or delegating tasks and responsibilities that a non-executive director lacks the time to undertake with appropriate prudence;
- Understanding the corporation's often complex compliance systems, financial and technical information and commercial risks well enough to make reasonable business judgments;
- Grappling with disclosure obligations and the adequacy of proposed disclosure statements, without the same access to information and control that a CEO or chair might have.

The greater the proportion of non-executive directors on a board, the greater their reliance on management for information about what is happening in the organisation and the issues arising. It is the board's responsibility to ensure it receives all necessary information to fulfil their obligations and it is management's responsibility to bring important issues to the board's attention.

Typical shortcomings in information presented to directors include it being too detailed, operationally-focused, silo-based rather than whole-of-business-based. Information that non-executive directors need to allow them to properly discharge their duties should be governance, risk or issues-based, related to decision making, with major performance information to enable the board to monitor and evaluate success.

Are there special roles for non-executive directors?

Aside from the general corporate governance preference for non-executive directors, there are some areas where there is a specific mandatory role for non-executive directors. For example, if a listed company is in the S & P/ ASX 300 Index, Listing Rule 12.7 requires that for the company to comply with the Corporate Governance Council's recommendations as to the audit committee's composition, the audit committee should consist only of non-executive directors and a majority should be independent non-executive directors.

For APRA-regulated organisations (for example banks, credit unions, insurance companies) Prudential Standard CPS 510 'Governance' (January 2015) requires that a majority of directors present and eligible to vote at all board meetings must be non-executive directors.

Should a director's number of directorships be limited?

Some investor groups have called for a limit to the number of non-executive directorships that can be held by one person.⁷ This is sometimes referred to as overboarding. However, other research suggests that it is not the absolute number of boards on which a person sits, but rather a complex interaction of a director's ability, other commitments, the challenges facing each organisation on whose board they sit and the specific competencies they bring to the board which determines how many boards are enough. This research also suggests that an important role is played by directors who sit on multiple boards in disseminating good governance practices throughout boards.

Generally, each organisation and individual will vary in their needs and abilities. This highlights the importance of using evaluations of both boards and individual directors to measure performance.

⁶ Young N, 'Corporate liability versus directors' personal liability - have we gone too far or not far enough?', *Our Financial Markets: The Big Issues*, ASIC Summer School 2008 Report, 8-20 February 2008.

⁷ Australian Shareholders Association, *ASA Voting Guidelines for ASX 200 Companies*, 2016.

An increasing commitment and personal liability?

A non-executive director in Australia is currently a part time role, with a time commitment considerably less than a senior management position. This is being affected by the fact that there are more than 600 state and territory laws which impose personal liability on individual directors for corporate misconduct. That is, directors are liable simply because they are a director, even where they may not have had any personal involvement in a breach. In some States, the onus of proof is reversed, removing the presumption of innocence, and there are very narrow legal defences and limited rights of appeal.

This has had an inevitable impact on the time required and the remuneration demanded. It has also altered the balance the non-executive role more towards that of an executive one as non-executive directors attempt to meet their growing responsibilities.

This increasing time commitment is consistent with the position under the *Corporations Act 2001* that there is no distinction between non-executive director and executive directors in the application of the core aspects of the duty of care – ie understanding company's financial position and being in a position to monitor the company's affairs. As a result, non-executive directors must largely rely upon the business judgment rule and 'delegation' defences in the Corporations Act in leaving the day-to-day management of the company to the company's executives. Nonetheless, a real time commitment from a non-executive director is required.

Commonwealth, state and territory governments are undertaking legislative reviews to harmonise laws on director liability after conducting audits of their legislation on the basis of benchmarks agreed by the Ministerial Council for Corporations (MINCO), which is now the Legislative and Governance Forum for Corporations (LG Forum). However, as yet, progress has been slow with these reviews. The Australian Institute of Company Directors also believes that there is a need to extend the business judgment rule and have proposed the 'honest and reasonable director defence'.

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