SUBMISSION TO THE BUSINESS, ENERGY AND INDUSTRIAL STRATEGY COMMITTEE ON CORPORATE GOVERNANCE
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Written evidence submitted by Charlie Geffen in his personal capacity.

Introduction

Charlie Geffen chairs the corporate practice at Gibson, Dunn & Crutcher LLP in London. He was previously Senior Partner at Ashurst LLP. He has many years' experience advising public and private companies on their governance arrangements.

Executive Summary/*Recommendations*

Directors' Duties

1. ***There is no need to change the law on Directors duties but to consider how the intent of the law might more effectively be enforced***. Absent obviously bad behaviour the Courts will not interfere with bona fide commercial decisions by a Board. Directors are already required to act in the best interests of their company.

2. The challenge is to ensure Boards have the confidence to recognise that the interests of their company are not the same as the interests of just the current shareholders. Shareholders owe no duties to the companies they own – and by their nature are transient owners of the company. They have the power to change the Board and sell their shares. Directors are responsible for the long-term interests of the company – the distinction matters.

3. ***More research is required on what culture is and what drives it – it is much more than "tone from the top"***. Difficulties are often rooted in cultural issues. The culture of a business is derived from its management structure, internal systems, clarity of reporting lines, KPIs, compensation systems and the data circulated to managers. It is much more than strong interpersonal skills.

4. ***Imposing an obligation on companies to have an employee director will reduce the chances of an open and functional Board***. It is hard enough to create a diverse open Board discussion - imposing a "constituency" culture would be harmful – Boards should not be political. It also risks the creation of a de facto parallel Board. There are practical difficulties for large international companies in identifying the right employee.

5. ***In some cases it may be helpful for subsidiaries to have their own non-executive director independent of their holding company-particularly in the case of large privately owned companies***.

Stakeholder Committees

1. ***The establishment of a Stakeholder Committee*** would help Boards focus on the best interests of their company, as opposed to the short term interests of some shareholders and assist them in engaging with their communities. Boards would remain accountable to shareholders and Stakeholder Committees would sit "alongside" Boards and not "above" them.

2. The Stakeholder Committee could comprise representatives of shareholders, employees, pension funds, customers, suppliers and other community interests. Members could be proposed by the Board and approved by shareholders and would have a right to be consulted on major Board decisions but no right of veto. They would challenge Boards and afford them the cover they need to resist pressure from shareholders for short term results rather than the long term interests of the company.

3. Stakeholder Committees would be a more effective mechanism to engage wider interests than having employee directors and could operate on a "comply or explain" basis – without the need for primary legislation.

Executive Pay

1. ***Lessons can be learned from the professional services industry where senior executives/partners share in a profit pool with their percentage share set at the beginning of the year***. They are incentivised to grow the whole profit pool and not just achieve personal targets set for an individual bonus.

2. ***It should not be controversial to have binding shareholder votes on the profit split between senior executives (after basic pay) and shareholders but it is for Boards to decide how that is split between individual executives.***

3. There is much debate about "reward for failure". Whilst it is true that in contractual terms it is difficult to define failure (thereby allowing contracts to be terminated without compensation) Boards should be encouraged to exercise an element of discretion. Also they could certainly be more robust about switching the burden of proof by requiring executives to sue their former employers for compensation in the more egregious cases rather than quietly settling.

4. ***Compensation payments should be paid in monthly instalments and cease upon the executive finding a new job***.

Composition of Boards

1. ***The debate should focus more on differences of experience rather than equality – this would make the argument for quotas easier***. Boards have no difficulty in having notional quotas to ensure they have diverse geographic representation - ensuring gender diversity should be no different. Progress is being made but Darwinism could do with a helping hand.

2. ***Ensuring Nomination Committees (as well as Boards) have a high proportion of female members and have a deeper involvement in approving senior executive appointments would also assist***.

3. ***Public targets should be set showing how many women hold senior executive positions.***

Directors' Duties

1. There has been considerable academic debate about directors' duties in particular around s172 Companies Act. The Committee will be appraised of the arguments about whether the legislation is "fit for purpose." However it is not possible for there to be enforceable legislation that requires Boards to take into account particular factors in making a decision. The current legislation sets out some matters but it is clear that no Court will overturn the decision of a Board unless "no reasonable Board could reasonably have made that decision." The idea of applying some concept similar to judicial review of commercial Board decisions is unthinkable. In any event that is a matter for shareholders. The challenge is to find a way in which the intent of the law might more effectively be enforced.

2. Requiring Boards to have employee directors, or indeed directors representing any particular constituency, will likely damage their commercial effectiveness. The two principle reasons for this are:

   - All directors need to be focused on what is in the best interests of the company as a whole - the discussion should not be about reconciling competing interests within the company.

   - Forcing companies to appoint a director not of their own choosing risks damaging the fragile dynamic of robust, open and honest debate without fear of recrimination. It is no accident that the skills of an experienced Chair are highly valued and relatively rare. If there is a member of the Board who does not have the full support of the other directors then debate will be stifled and there is risk that key discussions will take place outside the Board.

3. Fundamentally the issue is a question of culture. Many people find culture difficult to describe in a practical way. The culture of an organisation is different to the personal chemistry of the people who work in the business. Culture is not created by the strong interpersonal skills of the leaders. Whilst "tone from the top" is important it does not create or establish a culture. Rather culture is the outcome of how the business is organized and its systems. Three important drivers of culture are:

   - Clarity between the interests of the Company and the interests of shareholders - they are different. So, for example, when a trading company borrows money in order to finance the payment of a large dividend was that decision truly taken by the Board of the trading company or imposed by the majority shareholder? Similar questions arise when subsidiary companies are asked to guarantee the obligations of other group companies. Those who manage international groups will be familiar with local laws which require Boards to act in a more independent way than the parent company may desire. Much like the rule of law to a functioning society the distinction between Boards and shareholders can feel technical until it matters. And then it really does. Chairmen and CEOs need to ensure that the distinction is respected and reporting lines reflect that reality.

   - The information circulated amongst executives and managers and KPIs are a big driver of behaviour and peer pressure. Is the data focused on the success of the business as a whole or just a local division or profit centre? So in a supermarket are the most respected managers those who negotiate the biggest discounts from suppliers or is footfall in a store as equally important. In a theme park are managers awarded bonuses dominated by financial KPIs or customer satisfaction surveys? This information flow is critical to individual and team behaviour. What matters most is getting more of the right customers through the door. Whether they buy one profit centres' product or another's doesn't matter - as long as they do.

   - The compensation system - see below under Executive Pay.

4. In order to protect trading subsidiaries from overbearing shareholders in private companies it might be worth considering appointing a non-executive director to some subsidiary companies.

Stakeholder Committees

1. It would be helpful for Boards to have a mechanism that enables them to stand up for what is, in their view, the best interests of their company and resist short term pressures from shareholders. Shareholders do not owe any duties to the companies they own - there is no need for them to do so given that ultimately they have the ability to appoint and remove the Board or sell their shares. Directors' primary duty is to act in the best interests of their company. The difference between shareholders and directors needs sharpening and clarifying.

2. It is neither practical nor desirable to have any kind of mechanism that seeks to second guess Board decisions. Equally it is not helpful to impose on Boards a requirement for employee directors for the reasons mentioned above.

3. There has already been some discussion about the concept of Shareholder Committees and Ethics Committees. The risk of the former is that it clouds even further the distinction between shareholders and Boards and some companies already have an ethics committee as part of their internal governance.

4. A Stakeholder Committee could provide a useful mechanism for Boards to explain both why they wish to resist short term pressures from shareholders and to engage more effectively with their communities and stakeholders. Its members, appointed by the Board, could be a mix of shareholders and representatives of employees, pension funds, customers, suppliers, and other members of the community. It should not have powers of veto but there may be some issues on which the views of the Stakeholder Committee should be sought and in some cases its views explained and reported on. Its work can be described in Annual Reports. It would also be able to support changes that are needed to improve culture and assist with the "tone from the top".

Executive Pay

1. The traditional method of rewarding executives with a mixture of base salary and short and long term bonus schemes has become far too complex. What is missing is a greater examination of what actually drives individual behaviour - simplicity will be much more powerful than the current complex mix of incentive schemes.

2. The professional services industry provides an interesting alternative approach. Many professional services firms operate a simple system where at the beginning of the year the senior people, usually partners, are given a percentage share in a profit pool for the coming year. As a result they are incentivised to make the profit pool as big as possible. Individuals' percentage share can be varied depending on previous years' performance - thereby encouraging longer term thinking and behaviour. This encourages teamwork, cross selling and collaboration. The share of the profit pool is after a basic salary for participating executives.

3. Large bonuses determined at the end of the year based on personal financial targets can encourage selfish behaviour and risk - too much upside belongs to the individual and any collateral damage is suffered elsewhere. Of course there needs to be balance and there may be room for some individual year-end bonuses but there is no reason in principle why the professional services model of profit sharing cannot be applied to other industries.

4. If this model is followed then at the end of each year the Board, having consulted the Stakeholder Committee, would as it usually does now, allocate how much gross profit should be allocated to the profit pool for executives and how much to shareholders/reserves. That allocation can be

subject to a binding shareholder vote but it must be for Boards to decide on the allocation amongst executives.

5. The debate around "rewards for failure" needs to be considered carefully - for example turnaround situations will require different incentives. It is difficult, absent obviously bad behaviour, to prove "failure" justifying dismissal without compensation. The most important determinant of compensation is the notice period and the common practice of one year feels fair for the most senior executives. Employers also need to be mindful of establishing a reputation for being capricious which will make it harder to recruit talent. In those relatively rare cases where there is clear failure (short of fraud etc justifying summary dismissal) Boards should be encouraged to exercise an element of discretion. They can also always force an executive to sue for breach of contract following announcement of dismissal rather than agreeing terms privately before announcement. Even then the financial outcome is unlikely to be materially different and so that course would be driven by "positioning" rather than the contractual terms. In any event there is no reason why compensation payments can't always be paid monthly until the executive finds another job.

Composition of Boards

1. There has already been considerable debate and research on diversity - both gender and otherwise. Progress is being made although it is slow. International groups have no difficulty in ensuring their Boards and executive teams have geographical diversity so it is hard to see the rational arguments against ensuring balanced gender on Boards given the proportion of women who work in companies.

2. It follows that the debate should shift away from demands of "equality" and move to demands for "difference" or diversity. Arguing for equality is almost certainly unwinnable and allows for argument about "the best" candidate. That argument is defeated if the criteria for candidates is based wholly on the need for differing experience-whether cultural, gender or otherwise.

3. If these arguments are accepted then quotas should be less controversial - Darwinism needs a nudge.

4. Peer pressure would also be assisted by companies establishing and publicising targets for the number of women in senior executive positions.