AUSTRALIAN INSTITUTE of COMPANY DIRECTORS

DIRECTOR TOOLS

Role of executive directors

Board composition

Executive directors wear two hats: that of a company employee, usually a senior executive, and that of a board member. On top of their full time executive position, they are appointed to the board.

At law they have the same duties and responsibilities as other directors. In the United States, executive directors are sometimes known as inside directors and are quite common there relative to Australia. One or two executive directors are found on the boards of some Australian listed companies due to their large scale enterprises and operations.

How do executive directors add value?

Executive directors can add value to boards through their:

- deep knowledge of the business, its strategy and direction;
- deep knowledge of the industry and the competitive pressures;
- technical expertise in their functional area, for example finance, accounting, law;
- greater access to company information than non-executive directors.

Through their deep understanding of the business, executive directors can make the board aware of important issues and ensure a thorough examination of them.

What challenges do executive directors face?

The most common challenge raised in the literature for executive directors is role confusion.[1] Boards must govern in the best interest of the corporation and are ultimately appointed by, and must be aware of the interests of, shareholders. Boards primarily set strategy and monitor management. Management implements strategy and reports to the board. Therefore, an executive director is both governor and manager: employer and employee.

It has been held that executive directors are a wasted vote on a board since:[2]

- Management brings proposals for the board to approve, and it is generally expected that management will support its own proposals.

[1] Kiel G, Nicholson G, Tunny J A and Beck J, *Directors at Work: A Practical Guide for Boards*, Thomson Reuters Australia, 2012.

[2] Ibid.

- Executive directors cannot be present or vote on any resolution concerning themselves, such as remuneration.
- Contemporary good practice suggests that the senior management team should be involved with the board in the development of strategy. This applies whether or not they are directors.
- In the case of CEOs, a key role of the board is the management of the CEO. This is a role to which a managing director cannot contribute.
- There is a natural inherent conflict between the owners of a company and the managers of a company. A key role of the board is to oversee management in the best interests of the owners.[3]
- CEOs and other senior executives will be present at board meetings as the board may require and can add value to the discussion without being a director.

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The CEO is the most likely member of the management team to be an executive director. Sometimes another executive such as the chief financial officer (CFO) may also be appointed to the board. This can potentially create challenges if the executive is too timid to disagree with or question a strong CEO, knowing that their performance as a company executive is appraised by the CEO. To deal with real or perceived conflicts of interests, executive directors in practice may absent themselves from parts of board meetings. Executive directors are not usually present for board proceedings when the CEO's performance or remuneration are being discussed or for board meetings with the external auditor.

Subject to certain exceptions, an executive or non-executive director of a public or proprietary company who has a material personal interest in a matter that relates to the affairs of the company must give the other directors notice of the interest. In addition, an executive or non-executive director of a public company who has a material personal interest in a matter before a directors' meeting must not be present while the matter is being considered at the meeting or vote on the matter, subject to a limited number of exceptions.

There are some roles on a board that are inappropriate for an executive director, for example a CFO serving on the audit committee.

Whether or not a CEO is a director, they will be an 'officer' under the *Corporations Act 2001* (Cth) ('Act') and therefore subject to many of the same duties as a director under that Act, for example the duty to act in good faith, the duty to act for a proper purpose and the duty to act with care and diligence. It should be noted, however, that managers, including CEOs, who are not directors do not fall within the scope of section 588G of the Act, which deals with directors' personal liabilities in cases of insolvent trading.

[3] Jensen N, and Meckling W, 'Theory of the Firm: Managerial behaviour, agency costs and ownership structure', *Journal of Financial Economics*, vol 3, no 4, 1976, pp 305-360.

Do listed companies have executive directors?

Good corporate governance in Australia heavily favours independent boards, especially for listed companies, meaning that non-executive directors are preferred. The ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations 3e* (2014) Recommendation 2.4 proposes that the majority of the board be independent. If the board decides not to follow this recommendation, it must explain why. The theory is that directors should be free of any relationships which could:

> *"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."*

By definition, executive directors cannot be independent directors.

The most common executive director in listed companies is the CEO/managing director. Only a small number of listed companies have more than one executive director or an executive chair.

There is no conclusive evidence that boards with only independent directors perform better than those with a mix of directors.[4]

What is usual for unlisted public, proprietary companies and not-for-profits?

In unlisted public and proprietary companies, it is often more difficult to separate the roles of managing and governing a company. The owners of a smaller company often manage it as well, so technically they are executive directors. It is not uncommon for boards of smaller unlisted public companies and private companies to contain solely executive directors.

Executive directors are much rarer in not-for-profit organisations for the reasons set out above as to why executive directors may be a wasted vote.

Do executive directors have extra responsibilities?

The Act does not distinguish between the duties and responsibilities of executive directors and non-executive directors. Under that Act, all directors in general have the same level of responsibility.

Court cases such as Vines,[5] James Hardie[6] and Centro,[7] however, suggest that executive directors may have a greater level of responsibility than non-executive directors. In the executive part of their roles, executive directors have a much more detailed knowledge of a company and its issues, greater access to information, plus a range of measurable technical skills and knowledge, for example accounting. Therefore, they may be reasonably expected to raise matters for discussion with the board.

Should executive directors have directorships elsewhere?

The chief advantages of an executive director holding multiple directorships are that it broadens their knowledge and experience base as well as making new contacts. This can benefit both the individual in question and their main board.

On the other hand, there are concerns about time burdens and possible conflicts which need to be managed. Executive directors already have a full time position plus board responsibilities, so additional time commitments must not result in their primary work suffering. Any additional directorship(s) may also involve conflicts of interest or duty, which have to be managed.

Ideally, every board should have a policy for dealing with such matters so that all directors and senior executives are aware of the company's position. It might come down to deciding on a case by case basis if the benefits to the company outweigh any potential negative impact of the executive's additional responsibility.

As a separate issue, executive directors must be mindful of any prohibitions on involvement in other directorships (whether in competitive companies or not) contained in their employment agreement as well as confidentiality provisions.

[4] See, for example, Kiel G C and Nicholson G J, 'Board composition and corporate performance: How the Australian experience informs contrasting theories of corporate governance', *Corporate Governance: An International Review*, vol 11, no 3, 2003, pp 189-203.

[5] Geoffrey Vines was the CFO and executive director of GIO Australia Holdings Ltd. See *ASIC v Vines* [2003] NSWSC 1095; (2003) 48 ACSR 291 for the judgment and *Vines v ASIC* [2007] NSWCA 75; 73 NSWLR 451 for the April 2007 decision in the NSW Court of Appeal.

[6] For the judgments, see *ASIC v Macdonald* (No 11) (2009) 230 FLR 1; 256 ALR 199; [2009] NSWSC 287; *ASIC v Macdonald* (No 12) (2009) 259 ALR 116; [2009] NSWSC 714. For the appeals, see *Morley v ASIC* (2010) 247 FLR 140; 274 ALR 205; [2010] NSWCA 331; *Shafron v ASIC* (2012) 86 ALJR 584; [2012] HCA 18; *ASIC v Hellicar* (2012) 86 ALJR 522; [2012] HCA 17.

[7] For the Centro judgment, see *ASIC v Healey* (2011) 196 FCR 291; [2011] FCA 717. For the penalty decision, see *ASIC v Healey* (No 2) (2011) 196 FCR 430; [2011] FCA 1003.

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