Boundaries Between the Board and Management
– a UK perspective

How do we ensure that the business has a healthy future and yet is under prudent control?

Defining workable boundaries between and within boards and management is the key to ensuring the effectiveness of the total business. Yet the process for defining these boundaries effectively is highly dependent on both the legal entity of each business – commercial, governmental or charitable – and its ownership structure. As around 70% of the world uses a form of Common Law I shall restrict my comments here to this legal business framework. I shall not deal with the current mess of US law, nor the European Union, Code Napoleon, Romano-Dutch or any other frameworks.

The Basics

Boards of directors are appointed by the owners, usually shareholders, to ensure the delivery of the basic governance dilemma for any organisation – how do we ensure that our business has a healthy future and yet is under prudent control? – is revisited frequently and rigorously for them. Once appointed it is the directors who have the power to answer this dilemma until the owners decide otherwise.

> It is important to remember that shareholders do not 'own' the business. Since 1890 a company is a separate legal entity owned by no one. Shareholders have the rights to a dividend stream, if appropriate; they have the right to any residual assets if the company closes; and depending on the local law and the company's constitution they can appoint and dismiss directors, agree remuneration; and occasionally agree their approach to social and environmental issues. But shareholders do not own the legal entity despite many of them believing this.

At any given time properly appointed directors, registered with a national registration body, have two key powers. First, to direct their organisation so that it has a healthy future – their 'fiduciary' duty. Second, to appoint managers to carry out the board's agreed policies and strategies and to oversee the establishment and continuous performance of the business's prudent control systems.

Most businesses get these fundamental distinctions muddled and this leads often to increasing confusion and bitterness between the board, the managers and the shareholders. Ultimately this leads to organisational under-performance and the consequent loss of trust between the three parties involved. This can be especially true in family-dominated businesses, majority shareholder-dominated businesses, state-owned enterprises and personality-based charities.

Why Should This Be So?

My observations of dozens of boards on five continents is that a toxic mix of ignorance of these distinctions plus lots of ego builds until it becomes unacceptable to two of the three key parties – the shareholders, the board, or the managers. At this point two dissatisfied parties combine to oust the third. These are the simple dynamics of board politics. They are sometimes driven by genuine grievances, but often harbour deep differences of personality and aspiration. They are power plays.

However, there are often underlying elements of ignorance of the corporate legal framework that inflame such differences between the three parties and it is wise to turn again to the legal basics as a set of benchmarks before attempting to develop any more complex board dynamics.

The Seven Duties of a Director

I have already mentioned the 'Director's Dilemma' above. To this must be added the seven Duties of a Director found in the UK's Company Act of 2006:

1. To act within their powers i.e. to obey the company's constitution
2. To promote the success of the company
3. To exercise independent judgement
4. To exercise reasonable care, skill and judgement
5. To avoid any conflicts of interest
6. Not to accept benefits from third parties
7. To declare interests in proposed transactions.

Curiously, the law does not have a similar list for the duties of managers. This is an onerous list for any director to live up to. It is even more difficult if the director has also an executive position in the same company. The law deals with this in two ways. First, if the lead executive is also a registered director of that company, then they should be referred to as the 'Managing Director', not the Chief Executive. A Managing Director has the same responsibilities and liabilities as any other registered director and so is bound by the Seven Duties of a Director above. At law there is no such thing as an 'Executive Director' or a 'Non-Executive Director'. They are all treated the same.

Defining the Boundaries between the Board and the Management Systems: The Learning Board

Some twenty years ago I created the *Learning Board* model to give a framework by which directors and managers could agree their rights, duties, responsibilities and accountabilities. This saw the company as a learning system, trying to scan its external world to deliver its fiduciary duty – that its rate of learning was equal to, or greater than the rate of change in the outside world – and simultaneously ensuring that its internal control systems delivered or exceeded its desired performance.

This required the board to be seen as the central processor of the company's learning system that delivered actively the directors' dilemma, and not to see itself, or be seen by others, as an isolated group sitting at the top of a static organisational pyramid fed only with information that the managerial system chose to give it. To achieve this active governance role requires the combination of four different styles of thinking:

- Externally Orientated - generating Foresight and Policy Formulation
- Internally Orientated - monitoring the patterns of Managerial Performance in relation to Operational Expectations: the Board's Dashboard
- Long Term Orientated- to integrate the changing external Dynamics with the fundamental Purpose of the company
- Short Term Orientated - to ensure the Operational Effectiveness and Efficiency of the managerial control systems.

Figure 1 (insert here) shows the *Learning Board* model derived from this combination of necessary thinking styles for directors and managers. A simple reading of the model shows that the two right-hand quadrants, Policy Formulation and Foresight, plus Strategic Thinking, are the dominant areas of Board activity to deliver their fiduciary duty. The left-hand side quadrants, Supervision of Management, and Ensuring Accountability, are the areas of maximum input from Management and ensure the Board's prudent control of the whole. An additional reading of the model is that the top two quadrants, Policy Formulation and Accountability, are the areas of maximum public responsibilities of the Board whilst the bottom two, Strategic Thinking and Supervising Management are the areas for maximum co-operation between the Board and the managers. This is where the often overlapping boundaries between the Board and management need great clarity – usually in a document that spells out what is and is not included for each party.

More Detailed Analyses of the Boundaries between the Board and Managers.

A more detailed reading of the model shows that the board needs to benchmark and track the dynamics in the following areas:

Policy Formulation and Foresight:

- Ensuring the Clarity of the Purpose of the company
- Creating and sustaining the Vision and Values of the company
- Developing and monitoring the Culture of the company
- Developing and maintaining the Horizon-scanning processes of the company

The arrowhead between the Policy Formulation and Strategic Thinking quadrants is crucial to delivering the board's fiduciary duty. Horizon-scanning and turning such data into information for the board's strategic thinking (not 'strategic planning' which is a contradiction in terms) is the fundamental debate between the board and the managers. The managers often derive much of this data but the turning of this into the information for Board decisions is the Board's alone and determines the quality of their strategic thinking.

But the second arrowhead between Strategic Thinking and Supervising Management is also crucial. Many strategies are developed without considering whether the business has the resources, skills and motivation to carry them out. All are measurable and without all three strategic failure is highly likely.

In this short article I shall not go into the detailed differentiation between Board and managers in the Operational areas. I have said that the board needs to focus on the *Supervising* of management, not the second-guessing of it.

'Micro-managing' the managers from the boardroom table is a cardinal sin of many boards. That it happens is understandable as many directors have been, or still are, executives and feel that they know as much or better than the current managers. This is not proven. What is proven is their interventions signal a lack of trust in those managers. If there is then no clearly agreed statement of who does what, including the right to say 'no' by both sides, then underperformance of the whole company is guaranteed.

Professor R Bob Garratt
13 April 2016
Reference: *The Fish Rots From The Head,* Bob Garratt, profile Books, London, 2010.