

2015 Cambridge - McKinsey Risk Prize Bio-sketch and Photo Page



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The creation of the Contrarian Director and their role in achieving workable board independence and better risk oversight

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The creation of the Contrarian Director and their role in achieving workable board independence and better risk oversight

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March 2015

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“To prevent any rash decisions concerning miracles or virtues of the candidate...it is his duty to suggest natural explanations for alleged miracles”

(1708, The Promotor Fidei, the most important official in the Roman Congregation of Rites)²

Introduction

Since 1587, the devil’s advocate attracted vehement disfavour. Affirmers and propounders, on the other hand, naturally attracted popular support. Over time, the importance of the role of the devil’s advocate, as an important safeguard against error, became more recognized. In 1708, the Catholic Church institutionalized the position of *Advocatus Diaboli* (‘Devil’s Advocate’) and awarded him the most important office in the Roman Congregation of Rites³. A lawyer by training, the Promotor Fidei’s official role was to *‘argue against the canonization of a candidate in order to uncover any character flaws or misrepresentation evidence favouring canonisation’*⁴. The role was created and re-enforced to ensure that the Church was ‘eager to affirm certainties and slow to credit doubtful matters’⁵.

This paper examines the economic, social and psychological forces propelling directors on boards towards collegial consensus and suppressing real independence from each other. It develops the concept of a ‘Contrarian Director’, inspired by the original devil’s advocate but modeled also on the Advocate General of the European Court of Justice. The paper recommends one Contrarian Director be appointed to every public company board. This director should have an express duty to consider a complete range of outcomes (including ‘extreme’ scenarios), question herd decision-making, fully investigate issues without bias and recommend a course of action that is truly independent and impartial. This paper propounds a structure and process to appoint and support this director.

In the current economic climate marked by volatility and uncertainty, risk oversight by boards is increasingly important. The function of boards to ensure a healthy balance between risk-taking and risk avoidance is critical to the success of the company and the stability of the economy. The changes suggested by this paper go directly to improving this position.

Importance of Independent Directors

Recent regulation assumes that independent directors provide objective, shareholder-minded monitoring and that increasing their presence reduces agency problems and improves firm performance⁶.

The importance of the *perception* of independent directors has been empirically demonstrated by measuring the effect on company value from a sudden death of an independent director; the death of an independent director significantly reduces firm value by 0.85%⁷. The size of this value in each case depends on his/her perceived

² Unamsactamcatholicam, History and Role of the *Advocatus Diaboli* (“Devil’s Advocate”), www.unamsanctamcatholicam.com, 2013

³ *Ibid* 2

⁴ *Ibid* 2

⁵ *Ibid* 2

⁶ Cohen, L, Frazzini, A and Malloy C, ‘Hiring Cheerleaders: Board Appointments of “Independent” Directors’, *Management Science* Vol 58, No 6, June 2012, pp1041.

⁷ Nguyen B and Nielsen K, ‘The Value of Independent Directors: Evidence from Sudden Deaths’, *Journal of Financial Economics* 30 October 2009

independence as well as on individual and company characteristics⁸. At the same time, there is an abundance of research demonstrating that *in reality* the effect of independent directors on firm value is either insignificant or negative⁹. It is widely agreed that independent directors who are powerful certainly elevate shareholder wealth¹⁰. However, more often than not, independent directors are not powerful enough to achieve this duty¹¹.

Failure of Independent Directors

After the Global Financial Crisis, regulation focused on the independence of boards¹². In the US, 'independent' directors make up 66% of all boards and 72% of S&P 500 company boards, according to The Wall Street Journal¹³. Despite the regulations mandating "independence of directors", boards have routinely been failing. Some of the worst disasters reflected an inability to question and investigate. In the Deepwater Horizon oil rig explosion in the Gulf of Mexico¹⁴; a US investigation commission attributed it to the inability 'of individuals involved to identify the risks they faced and to properly evaluate, communicate and address them'¹⁵. In 2008 most financial institutions were more than compliant with the requirements for independent directors and at the banks that failed and at Enron and Worldcom, 80% of the board members were independent¹⁶.

Post the Global Financial Crisis, the criticism of independent directors has concentrated upon their lack of specialised experience, particularly in relation to the banking industry. As a result, more regulations were introduced in the US which required independent directors of listed companies to disclose qualifications, skills and experience) and in the UK a new code required boards to balance the chosen directors' skills, experience and knowledge of the company with director independence. These regulations are fiddling at the margins. The central focus should be on the culture of the board and its ability to actually perform its risk oversight function independently.

The February 2015 report by McKinsey & Company records "Boards aren't working"¹⁷. Only 14% of the 692 directors and executives surveyed selected "a reputation for independent thinking" as one of the key criteria that public company boards consider when appointing a new director¹⁸, whereas independence and the ability to 'question herd decision-making' are one of the most important characteristics of a director¹⁹.

Independent thinking has been lost on boards in part because of the systemic failure of both the selection process and board culture. These are examined below.

⁸ Ibid 7

⁹ Ibid 7

¹⁰ Ma and Morck, 'Powerful Independent Directors', Finance Working Paper No 404/2014, January 2014; *Harvard Law School Forum on Corporate Governance and Financial Regulation*, 'Powerful Independent Directors', R Small, May 19 2014, <http://blogs.law.harvard.edu/corpgov/2014/05/19/powerful-independent-directors/>

¹¹ Ibid 10

¹² Refer Securities and Exchange Commission Release No 34-67468, File No SR-NASDAQ-2012-062, 2012, Sarbanes-Oxley Act in US, UK Code of Best Practice, Cadbury Report

¹³ Burns, J, 'Everything You Wanted to Know about Corporate Governance...' *The Wall St Journal*, October 27, 2003

¹⁴ Kaplan, R and Mikes, A, 'Managing Risks: A New Framework', *Harvard Business Review*, June 2012

¹⁵ Ibid 14

¹⁶ Ibid 6

¹⁷ Barton, D and Wiseman M, 'Where boards fall short', *Harvard Business Review February* 2015

¹⁸ Ibid 17

¹⁹ Ibid 6

a) Selection Process

CEOs often select independent directors for their 'impotence'²⁰ and not for a reputation for independence of those directors²¹.

Research has shown that people confronted with unethical or inept behavior have three choices: to exit, to voice their concern or loyalty²². An independent director selected for impotence has only two choices: to resign or become a very loyal and popular 'yes man'²³. Resignations are seldom chosen. A highly qualified and sought-after director explains the problem²⁴:

"I have one friend that's just greatest agreeer that there ever was, and he is on a dozen boards. I know other fellows that have been recommended to some of the same companies as directors, but have never gotten anywhere on the list to become directors. Because if a guy is not a yes man – no sir, he is an independent thinker – then they are dangerous to the tranquility of the board room. Company presidents are afraid of them – every damn one of them"

Warren Buffett sums it up: *"They do not look for Dobermans. They look for Cocker Spaniels and then they make sure their tails are wagging."*²⁵

b) Confirmation Bias

Research has shown that people are often overconfident about their forecasts and risk assessments and consequently assess the range of possible outcomes too narrowly²⁶. History is too heavily extrapolated from²⁷. This is exacerbated by confirmation bias, which drives people to supporting a one-sided position (typically predictive of success) and suppressing information that contracts their position (typically predictive of failure)²⁸. When events unfold which are different from those envisaged, this leads to even more irrational commitment and suppression of contradictory evidence²⁹. Objective risk mitigation is anathema to such groups, it is beyond their institutional capacity. The chief systems engineer at Jet Propulsion Laboratory, a division of NASA explained his biggest challenge was "to get project teams to feel comfortable thinking and talking about what could go wrong with their excellent designs". As he explains, "risk mitigation is painful, not a natural act for humans to perform"³⁰.

The current economic environment is turbulent and future outcomes are harder to predict, there are many unknowns³¹. This is particularly true in the financial sector where new risks and new regulatory regimes are regularly emerging³². New research by Professor Jochen Runde, Professor Christophe Loch and Dr Alberto Feduzi at University of Cambridge has highlighted the shortcomings of the traditional risk

²⁰ Ibid 10

²¹ Ibid 17

²² Ibid 10

²³ Ibid 10

²⁴ Mace (1976), Ibid 10

²⁵ A Crippen CNBC, 'Warren Buffett: Didn't want to 'go to war' with Coca-Cola, 3 May 2014

<http://www.cnbc.com/id/101639390>

²⁶ Ibid 14

²⁷ Ibid 14

²⁸ Ibid 14

²⁹ Ibid 14

³⁰ Ibid 14

³¹ A Feduzi, C Loch, J Runde, 'Reasoning with the Unknown' (unpublished research).

³² Ibid 31

management tools employed by even the most intelligent decision-makers³³. The traditional risk management tools often involve an interpretation of “evidence in ways that are partial to existing beliefs, expectations or a hypothesis in hand”³⁴.

The authors propose that in environments where there are many unknowns, business decision-makers should test the likely outcomes of the action on an ongoing basis³⁵. Decision-makers should run eliminative tests on an ongoing basis to monitor ever-changing risks using counterfactual reasoning rather than disconfirmation³⁶. The authors use the following quote to explain³⁷:

“How often have I said to you that when you have eliminated the impossible, whatever remains, however improbable, must be the truth?” (Sherlock Holmes to Watson, Doyle, 1980).

This method offsets behavioral bias, that is, the psychological tendency to interpret ‘evidence in ways that are partial to existing beliefs, expectations or hypothesis in hand’³⁸. The research illustrates this point by explaining that prosecutors work to collate evidence to confirm a working hypothesis; these tasks necessitate bias, in particular the one-sided collection of evidence to support a one-sided goal³⁹.

Confirmation bias spreads like an infectious disease in the presence of groupthink.

c) Culture of Groupthink

Groupthink is extremely contagious. Groupthink can override the decision-making abilities of the most esteemed experts. This is the group it was first used to describe by psychologist Irving Janis who investigated four high-level disasters: the defence of Pearl Harbour, the Bay of Pigs invasion and escalation of wars in Korea and Vietnam; Janis demonstrated that conformity among those most skilled working in these fields was the root cause of disaster in each case⁴⁰.

Groupthink on boards is destructive and endemic. Groupthink is most likely once a strategy or decision has gained initial support within the team, those yet to decide tend to suppress their objections and agree⁴¹. This is the stage at which independence is most critical.

Groupthink thrives where the leader is ‘overbearing or overconfident... and wants to minimize conflict, delay and challenges to his/her authority’⁴². Independent directors who are powerful enough in fact will veto economically unsound transactions⁴³. The veneer rather than the reality of independence is the reason so many companies overlook risks⁴⁴.

³³ Ibid 31

³⁴ Ibid 31

³⁵ Ibid 31

³⁶ Ibid 31

³⁷ Ibid 31

³⁸ Ibid 31

³⁹ Ibid 31

⁴⁰ Janis, ‘Victims of groupthink: A Psychological Study of Foreign-Policy Decisions and Fiascoes’, Oxford, England: Houghton Mifflin (1972).

⁴¹ Ibid 6

⁴² Ibid 6

⁴³ Ibid 10

⁴⁴ Ibid 14

Many companies have a culture that equates dissent with disloyalty⁴⁵. An Enron executive described the corporate culture as an 'atmosphere of intimidation' within which many could anticipate problems but no one dared to confront the CEO⁴⁶.

Warren Buffett speaks of the social pressures on independent directors to conform: *"even 'independent' directors aren't really all that independent because they often want to keep a prestigious job that pays well and has relatively few duties."*⁴⁷ He does not exclude himself from criticism: *"too often I was silent when management made proposals that I judged to be counter to the interests of shareholders. In those cases, collegiality trumped independence."*⁴⁸

It is human tendency to be a loyal 'yes man'⁴⁹. This was shown dramatically by Millgram's 1974 experiment when he observed subjects administering electric shocks to another and explaining their actions as *'doing what was expected of me'*, *'not making a scene'* and *'loyalty to the experimenter'*⁵⁰.

The instinct to support the CEO is strong and widespread⁵¹. Independent directors are not fulfilling their duties to bring independence and impartiality to the board's decision making. The selection process, whom it selects, and on the job incentives must be addressed if the problem is to be solved.

It is useful to consider the solution the European Court of Justice ('**ECJ**') has institutionalized to ensure all relevant information is gathered, synthesized and objectively evaluated by an independent officer bearer.

Advocate General of the European Court of Justice

The ECJ exists to settle legal disputes between EU governments and EU institutions⁵². Individuals, companies or organizations may also bring cases before the court⁵³. The Judges must reach a decision based on the evidence and arguments of the two opposing parties. In this way, the ECJ is faced with a similar challenge to that of boards; to reach the best decision based on incomplete information.

The role of each of the opposing parties inherently involves bias, as explained by Professor Runde et al in 'Reasoning with the Unknown'⁵⁴. Each side collates evidence to confirm their hypothesis: a one-sided collection of evidence to support a one-sided goal⁵⁵.

An Advocate General plays a critical, unbiased role in this process. Their role is to present an impartial and independently reasoned opinion on cases⁵⁶. Whilst their

⁴⁵ Ibid 10

⁴⁶ Ibid 10

⁴⁷ A Crippen CNBC, 'Buffett: Didn't want to 'go to war' with Coca-Cola, 3 May 2014 <http://www.cnbc.com/id/101639390>

⁴⁸ Monks, R. & Minow, N. (2008) Corporate Governance. Chichester: Wiley, p.226

⁴⁹ Ibid 10

⁵⁰ Ibid 10

⁵¹ Ibid 10

⁵² Court of Justice of the European Union, http://europa.eu/about-eu/institutions-bodies/court-justice/index_en.htm

⁵³ Ibid 52

⁵⁴ Ibid 31

⁵⁵ Ibid 31

⁵⁶ http://www.eu-oplysningen.dk/euo_en/spsv/all/51/

opinion is not binding in any way, it is estimated that the judges follow the opinion of the advocate general in about 80% of cases⁵⁷.

The process is as follows. Cases brought before the courts are processed in two stages: first, both sides prepare a written statement and secondly, an oral hearing is held⁵⁸. The oral hearing is held in front of a panel of judges (3,5 or 13 judges or in front of the whole court depending on how complex the case is)⁵⁹. At the hearing, lawyers from both sides put their case to the judges and, in cases raising a new point of law, an advocate general who can question them⁶⁰. The advocate-general delivers his or her detailed opinion and discusses the case with the judges before the judges give their judgment⁶¹. The opinion of the Advocate General carries great, but not binding, weight⁶².

The Advocate General holds the same qualifications as the Judges of the Court of Justice⁶³. The Advocate General is appointed by common accord of the governments of the member states for a renewable term of 6 years⁶⁴. They are chosen from lawyers with the highest judicial offices in their respective countries⁶⁵. Every 3 years, the Advocates-General are partially replaced⁶⁶.

It is notable to consider Advocate General Francis Jacobs. He has been reported as 'ideally suited to the role of Advocate General'⁶⁷. His background was as a Professor of Law at King's College (University of London) as well as an occasional practitioner. His opinions were described as encompassing serious consideration of the parties' submissions, a meticulous analysis of existing ECJ case law and relevant literature and reasoned, authoritative and robust conclusion.

The Contrarian Director

This paper develops the idea of a Contrarian Director (**CD**) and proposes a strategy for the appointment of them. In this context 'Contrarian' has a meaning similar to its literal translation into Greek: to otherwise wonder or speculate and describes 'a person who (habitually) opposes or rejects prevailing opinion or established practice'⁶⁸. It is a role inspired by the devil's advocate but modeled also on the Advocate General.

The introduction of the Contrarian Director institutionalises the ability to stand outside the tide of Groupthink and effectively warn and caution the board.

1. Role of CD

The company could, by board resolution, adopt a charter for the guidance of its CDs along the following lines. A CD has a duty, in respect of every recommendation to the board of substance to give careful consideration to the possible case, if any, against the

⁵⁷ Outlaw.com, How often does the ECJ follow Advocates General? Or should that be CJEU?, <http://www.out-law.com/page-11458>

⁵⁸ Ibid 52

⁵⁹ Ibid 52

⁶⁰ Ibid 52

⁶¹ Ibid 52

⁶² <http://esharp.eu/jargon/advocate-general/>

⁶³ http://www.eu-oplysningen.dk/euo_en/spsv/all/51/

⁶⁴ http://europa.eu/legislation_summaries/glossary/eu_court_justice_en.htm

⁶⁵ Ibid 62

⁶⁶ Ibid 62

⁶⁷ 'The European Union: Dedicated to Advocate General Francis Jacobs: Article: Commentary on Selected Opinions of Advocate General Jacobs', 29 *Fordham International Law Journal* 690 (April 2006)

⁶⁸ Oxford English Dictionary, <http://www.oed.com/view/Entry/250753?redirectedFrom=contrarian#eid>

recommendation. The CD must then prepare for the Board a written report, which outlines the case or possible case against the recommendation. This report must be circulated to all members of the board and be the subject of discussion at the next board meeting. The written opinion of the CD would be non-binding on the board and CEO.

Where there is insufficient information, the CD has a duty to seek further information from management or external advisers where necessary and to warn of information insufficiency. The CD must immerse themselves in the case, spend time in the trenches of the business and discover all that is reasonably required of them to reach an independent decision. A CD shall not only ask questions but also require more information when there is insufficient evidence to form a view⁶⁹.

In the event that the Board resolves to adopt a recommendation upon which the CD has reported, the CD shall prepare a further report stipulating whether he/she is satisfied that the Board has sufficiently considered each of the matters identified in the report and circulate that report to every member of the board.

The CD has an ongoing general risk management obligation. The CD should alert the board to any developments in relation to the company, its business environment or management which increases the risk of adverse events or outcomes and which he considers the Board should consider. This should be done on at least a semi-annual basis.

The CD also has a duty to encourage best practice risk management throughout the board and organization. It should be made clear that the CD's role does not assume the risk function of the board but is a focusing function to assist all members of the board, CEO and senior management to consider risk management as part of their function.

The CD should be educated in decision theories, in particular the use of Bayesian algorithm to improve decision-making⁷⁰. By applying this algorithm to decision-making, the probability that more scenarios are considered (thereby decreasing the chance of surprises) would be maximized⁷¹. It would reduce the likelihood that the company will be struck with the unexpected and it reduces cognitive biases⁷².

The role of the CD is more impartial and unbiased than the role of the devil's advocate, because he remains a member of the decision making board. Whilst a devil's advocate role is focused on collating evidence to confirm a particular (negative) hypothesis, the CD's role is designed to assess the strength of the negative hypothesis to assist the board to form a balanced opinion⁷³.

2. Contrarian Directors part of a different Club

A separate body, the Institute of Contrarian Directors (**ICD**), should be established. This body would maintain a list of Contrarian Directors. A chair should be appointed to head up this body. The chair should be an eminent person of high reputation and training, skilled in independent thought and action. The chair should not have any conflicting interests. It should not be a member of a public company board but could be for

⁶⁹ 'Independent Directors Need to Step Up or Step Off', *Harvard Business Review*, July 2011.

⁷⁰ A Feduzi, J Runde, 'Uncovering unknown unknowns: Towards a Baconian approach to management decision-making', *Organisational Behaviour and Human Decision Processes*, 124(2) 2014

⁷¹ Ibid 70

⁷² Ibid 70

⁷³ Ibid 31

example a retired professor, or judicial officer or armed services chief. In a pure model, this chair would be selected by an automatic process that removed any possibility of jockeying for position with the concomitant debt to those who supported the candidate. A simple such model would stipulate that a vacancy in the chair should be filled by the first person to accept commencing with the third last officeholder such as a judge of a superior court to have retired and moving downwards to the fourth and so on. Such a random, automatic process ensures that the person is selected solely for their eminence and independence and not for their popularity. The tenure should be for a short period, say three years.

A panel of selectors would be appointed by the Chair. These panel members would have similar qualities to the chair. Existing or past directors of public companies should be excluded.

A company may request the ICD recommend a Contrarian Director to its board; the chair would appoint a panel to make a recommendation. The recommendation will then be presented to the company. If the company does not make the appointment, the Institute of CDs will not provide any further recommendations for the next 5 years. This prevents the company shopping for an amenable CD.

3. Qualities of Contrarian Directors

These directors should have a demonstrated in practice strong independence and the capacity to question and act as a CD.

The CD should be appointed from a different pool of potential directors and be someone whose qualifications and experience allows them to have high skills in analytical criticism. Such a director may come from an adversarial background, academic background or one which has involved rigorous objective investigation. The focus must be on an ability to think and the strength to argue as a CD.

The Contrarian Director must not include anyone who:

- a. has previously served as a public company director, except as a Contrarian Director;
- b. having previously been appointed as a CD pursuant to a recommendation of the Institute of CDs has served more than a single term as director of the client company;
- c. has held an appointment as an Institute of CD panel member or as the chair of selectors.

These restrictions are to ensure, so far as possible that a CD has nothing to fear and nothing to hope for except recognition as an outstanding CD. His sole objective is to excel as a CD for a single term and hope for possible further CD recommendations by the ICD for appointment to other companies based upon his demonstrated independence.

4. Term and payment of CD

CDs should be appointed for a single, non-renewable term. The CD will not have any incentives to jeopardise his/her independence; his reputation does not depend on his popularity with the directors' club but upon how well he has served as a CD. He is a member of a different club.

The adopted board charter should provide that the CD should resign if the company does not, by formal resolution of the board, direct him to discharge all of the duties

stipulated by the charter or at any time directs him, in any manner formally or informally, not to discharge any one or more of such duties. A CD resigning in such circumstances should by the charter make a public statement that he has resigned “as a result of having become unable to act effectively as a CD”. This protects him with a strong institutionalized aversion to interference.

The CD should be entitled to charge for his time on a professional basis and it should be expressly contemplated that his role is a time consuming one.

5. Charter of Institute of CDs

When the company accepts the Contrarian Director, it should adopt the Institute of CDs recommended charter, which should mandate the above duties and rules.

6. Benefits of this structure

The structure of this model is very simple and does not require companies to make any constitutional changes. The structure of the Institute of CDs is very simple and may include a broad range of people who are markedly different to the usual director. Conflicts of interest and possible patronage/friendships influences have been negated.

To protect against the potential for CDs to be captured by companies, the structure includes a powerful sanction attached to accepting reappointment to the company board. The director loses his status with the ICD.

This new structure does not require any legislation but instead relies on companies wanting to be seen to have improved their corporate governance and risk oversight processes. Companies are therefore incentivized by market perception to accept this proposed structure.

Conclusion

This paper notes the significant failings of boards. The economic, social and psychological incentives propel directors towards collegial consensus. Acting as a devil’s advocate in the boardroom is currently a dangerous career path. Loyalty and agreeability are rewarded.

In the current uncertain economic environment, risk oversight on boards should be elevated to Code Blue. The function of boards to ensure a healthy balance between risk-taking and risk avoidance is critical to the success of the company and the stability of the economy. The time is ripe for change and there is much scope for improvement.

The paper offers an innovative solution that is simple yet has the ability to significantly increase the board’s ability to discharge their corporate governance and risk oversight duties. It proposes that a Contrarian Director be appointed to every listed company board. The Contrarian Director’s appointment and role is designed to protect and encourage independent thinking and questioning and also to promote the same by others on the board and in senior management. This independence is protected by several key systems and processes. This does not require legislation (although if not achieved voluntarily this may be necessary) but instead, similar to the corporate governance recommendations contained in the Cadbury Report, through incentivizing the company. The result of these proposed changes would be a change to culture on boards and deliver a radical improvement in the risk oversight function by boards.

There is scope for further papers, in particular to refine the implementation in different industries and jurisdictions.