



Outside Directors: A Broader Role

External, independent directors are a prominent aspect of corporate governance. Their primary responsibility is focused on protecting the interests of shareholders (and where appropriate other stakeholders) by ensuring the decisions of management are well informed and properly thought through.

It can be argued that law firms have limited requirements for such outside directors. All shareholders (equity partners) are or at least should be sufficiently informed about and involved in their firm to make separate independent oversight of management unnecessary and in any case, the partnership culture and limits on the authority delegated to management means that more significant decisions tend to be subject to consultation with and endorsement by partners. And of course, in some firms (in particular larger non-US ones) there is a governance structure in which there is a form of 'Supervisory Board' of elected partners who do not fulfill any management role and whose primary responsibility is to ensure that management is acting in the overall interests of the partners (shareholders).

The fact that equity partners are capable of protecting their own interests is, we would argue, taking a rather narrow perspective on the benefits that outside directors can deliver.

A Broader Role

Outside directors in law firms fulfill a broader role than being a 'check and balance' on management and it is through this they can add considerable value. Such directors can bring an independent, dispassionate and objective perspective and considerably enhance the capabilities of boards.

The argument against outside directors has been that such a perspective is not required and in the past this may have been the case. Law firms have largely operated in a stable, benign environment where year on year increases in demand and, until recently, prices, have been the norm. Furthermore, there was little in the way of change brought about by disruptive innovation or the emergence of new competitors. Challenging orthodoxy is not required in such an environment.

More recently, however, the legal sector has come to much more closely resemble other sectors of the economy; in particular in terms of heightened competition and far more significant change - in terms of both speed and magnitude.

Benefits

In such an environment effective outside directors can bring an invaluable diversity of thought and experience.

- First, they can provide a wider perspective and thereby constructively challenge and contribute to the development of strategy; in particular in this respect they can bring expertise to complement that existing within the firm and an all important 'outside-in mindset'. They can bring a complimentary perspective on trends within industry sectors of interest and fresh insight into the changing expectations and needs of clients.
- Secondly, they can make major contributions to key activities such as audit, risk management, compensation and management succession planning. In such areas both the objectivity and independence of outside directors can be of particular value (although it may also be appropriate to seek out individuals with particular expertise and experience in such relatively specialized areas).
- Thirdly, they can help encourage and act as catalysts of change. In particular we have seen examples where outside directors have stimulated entrepreneurship, innovation – including both process improvement and the introduction of new services – and a more enterprising and forward thinking approach to the use of technology.
- Fourthly, they can monitor and help enhance the performance of management in achieving its goals and as a key

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aspect of this help make boards work more effectively. As part of this they can help ensure that egos and personal or parochial interests do not inappropriately affect decision making. As one managing partner put it to us recently "We simply run our board meetings more professionally now, holding ourselves collectively and individually to each other more effectively to account".

Clearly, some of these benefits can be reaped by bringing in outside specialist advisers and expertise rather than appointing outside directors. And in some circumstances this may be an appropriate approach. The primary drawbacks of such an approach are two-fold: first it tends to be more short-term and task oriented in its focus and secondly it does not demonstrate the same level of commitment as having outside directors.

Experience

It is fair to say that early experiences in law firms with outside directors were not universally successful. In part this seems to be because neither party (the law firm nor the outside director) was sufficiently clear on what the role was and what was expected and in part (and related to this) because those appointed did not have the skills and experience required. In particular there was a focus on outside directors being from a professional services background including recently retired partners (often with management experience) from other law firms and accountancy practices. Such appointments tended to provide value for only a short period with their historic experience and views becoming obsolete with the passage of time and their perspective and experience not being that different to that available within the firm. Furthermore, they seemed to get drawn into operational issues rather than focus on strategic matters.

More recent experience, however, seems much more positive. Unfortunately there is currently no quantitative data on outside directors within the legal sector but there are now firms that have experience of having them for more than a decade and discussions with them indicate high levels of satisfaction. It also seems that more law firms are appointing or at least considering outside directors recognizing that such appointments can bring: a valuable independent and objective perspective; impartiality; wider experience; special expertise including insight into particular market sectors and/or areas where change is required; and personal qualities that can help make management more effective.

Future Trends

This growing success seems to be underpinned by two factors in particular: first the growing complexity of both law firms and the markets within which they compete and the benefits that outside directors with diverse and complementary expertise bring; and second the greater clarity that exists around the role law firms wish their outside directors to fulfill.

We see both these factors being long term in impact and so turning to the future make four predictions:

1. The appointment of outside directors will increase – not overnight nor for all firms, but over time as more and more law firms recognize the value that can be delivered.
2. Outside directors will be more effectively used and thereby add greater value; this will be driven by clearer expectations of the role and how the contribution can be maximized.
3. They will be subject to more formal appointment processes and required to demonstrate they do make a real difference – subject to annual appraisal as to the value added and if they merit re-appointment.
4. They will be more diverse in terms of their background and experience – selected to bring in complementary experience and expertise based on the strategic priorities of the firm; independence, new ideas, fresh thinking and differing, objective perspectives will be recognized as of ever increasing value.

In a future Insight later in the year we shall return to this topic exploring in greater detail the effective recruitment and appointment, induction, usage and compensation of outside directors.

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