

# BOARDS IN CHALLENGING TIMES: EXTRAORDINARY DISRUPTIONS

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Case Study: BAE Systems Total Performance Cultural Transformation

**ALVAREZ & MARSAL  
and  
HENLEY BUSINESS SCHOOL**

JOINT RESEARCH PROGRAMME ON BOARD LEADERSHIP

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## RESEARCH CASE STUDY

# BAE SYSTEMS TOTAL PERFORMANCE CULTURAL TRANSFORMATION

This case study is the result of analysis of interviews conducted with the following participants who were involved in the transformation of BAE Systems:

- **Ian King** | Chief Executive Officer | *BAE Systems, plc*
- **Sir Richard Oliver** | Former Chairman of the Board | *BAE Systems, plc*
- **Philip Bramwell** | Group General Counsel | *BAE Systems, plc*
- **Sir Roger Carr** | Chairman of the Board | *BAE Systems, plc*
- **Sir Peter Mason** | Former Senior Independent Director | *BAE Systems, plc*

## INTRODUCTION

The Al-Yamamah arms deal between BAE Systems and the Kingdom of Saudi Arabia had been in place for decades when allegations of bribery started appearing in the media in 2001. The following year, whilst already suffering from damage to its reputation, the company faced losses of hundreds of millions of pounds from problems with the Astute submarine and Nimrod aircraft programmes for the U.K. MoD. The Al-Yamamah deal then became an almost permanent topic in the media and with protest groups and was increasingly undermining the company's reputation.

*"[BAE Systems] was not believed by regulators, it was not believed by the public and increasingly it was not believed by politicians. So we were, in some senses, in something of a death spiral."*

BAE Systems was facing a 'Reputational Disruption' that could ultimately undermine the company's license to operate.

In 2004, the U.K. Serious Fraud Office (SFO) initiated a formal investigation into the allegations responding to national and international pressures, only to be discontinued in 2006 for the sake of "U.K. national interest" in the words of the then Prime Minister Tony Blair. This intervention by the U.K. government was seen as unacceptable by the U.S. government and the Department of Justice (DoJ) initiated

its own investigation in 2007. The investigation culminated with BAE pleading guilty to not keeping correct 'books and records' and receiving what was then a record fine of \$400 million. The company was not convicted for bribery and thus escaped blacklisting for future contracts.

In a bid to respond to these serious challenges and recognising that the company's business development structure required a complete change, the company initiated global ethical and business practices transformation across all aspects of its business late in 2006.

## RECOGNISE THE DISRUPTION: A CIVIL PERCEPTION PROBLEM OR RISK OF LOSING LICENCE TO OPERATE?

When Dick Oliver began his role as Chairman on July 1, 2004, the problem was being framed as a "civil society perception problem" and not a serious reputational disruption that could ultimately threaten the company's licence to operate.

There were talks of a U.S. break-up bid for the company and continuous leaks to the press about the ongoing SFO investigation. Politicians were frustrated that the company's



reputation was declining *“from national champion to national disgrace.”* The company was losing trust and influence.

*“It had been so widely pilloried it had no legitimacy in the eyes of the media. Years of silence had left it basically rendered without a voice.”*

The prevailing view was that the constraints arising from the large number of classified defence and intelligence programmes run by the company were incompatible with the principle of being more transparent. As such, it was thought that the problem, particularly in so far as it related to government-to-government programmes, should be resolved at governmental level. This appeared to leave the company drifting without a clear strategy.

We were told how Chairman Dick Oliver was not constrained by the past and was able to ‘call out the issue’. In his first annual report to shareholders, he announced the establishment of a Corporate Responsibility Committee (CRC), chaired by a non Executive , as:

*“Social, environmental and ethical aspects of a company’s business operations are increasingly of interest to a broad stakeholder community.”*

He then followed a persistent, yet measured, approach over the following three years to make fundamental changes to the Board, the Executive team and the way in which the company engaged with regulators, politicians and the public.

*“In my opinion the Chairman, is at that point the accountable Executive, because the reputation of the enterprise is at risk.”*

## REALISING BOARD ALIGNMENT AND PIVOTING THE ISSUE

When Dick Oliver was appointed as Independent Chairman in July 2004, the Board comprised six Executive directors and six Non-Executive directors, one of whom had been on the Board for 10 years.

Over the next 18 months, Dick led a fundamental refresh of the Board. He appointed three new Non-Executives during 2004, one in 2005 and a further two in 2006. Five Non-Executives retired over this period.

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During 2005, two of the former Executive directors left the company and in 2006 a further three departed. Dick reported to shareholders in February 2008 that the current chief Executive would be retiring later that year as he had reached his normal retirement age after 42 years with the Group. Over the three and a half years since his appointment the new chairman had led a complete refresh of the Board so that only one Non-Executive and one Executive director (the CFO) remained.

Dick Oliver had also encouraged the hiring of a new external General Counsel, Philip Bramwell, in 2007 with a mandate to restructure BAE’s legal team and to help develop a plan for BAE to regain control of the agenda. This wholesale changing of the Board was clearly a difficult and time-consuming step. None of the top team was accused of any wrong-doing. Dick Oliver and Philip Bramwell counted on the strong experience of Non-Executive Director Peter Mason to help reshape the Board composition.

*“I understood that the Chairman had no power to do anything until and unless they had a Board aligned with them.”*

*“I was determined that we were going to have a world-class Board.”*

Secondly, he encouraged the CEO to undertake an external review of the top 50 Executives in the business to ensure that the most effective were being identified and promoted, and appropriate action was being taken on those who were no longer performing at the required level. This had a major impact on the top level Executives in the business and is a process which BAE continues to use today.

Thirdly, Dick Oliver initiated an independent review of the company's standards of business as a means to regain control of the agenda and enable regulators to be engaged in an appropriate and constructive manner. In 2007, prior to the commencement of the U.S. DoJ investigation, he went outside the world of both defence and business, and approached Lord Harry Woolf, former Lord Chief of Justice, to conduct the review. Lord Woolf's unimpeachable integrity and high profile gave the company the opportunity to regain credibility and be taken seriously in its efforts to reform. Whilst Lord Woolf was initially apprehensive, given his lack of defence sector experience, he put together a powerful review committee which included the former CEO of Coca Cola, Doug Daft, the much respected banker and former chairman of Barclays David Walker, and the Director of the Institute of Business Ethics Philippa Foster Back.

"Once we'd got the Board engaged and aligned, we had a two prong strategy: 1) to fix the company; 2) to engage with the forces outside the company who'd started to shape its destiny, instead of this being done by the Board and the Management."

All Board Members were asked to sign irrevocable written resolutions committing to support the agreed strategy and prior to the start of the Woolf Committee's work, Dick Oliver announced publicly that BAE would commit to implement all of the recommendations of the Committee's Report when it was published.

Headlines in the Financial Times reflected exactly the desired effect. On the 6th of May 2008 the Financial Times announced: "Woolf hands BAE a weapon to fend off critics" and in the following day the chairman's convictions were underlined "Chairman hopes Woolf findings will usher in cultural revolution."

"You need an absolute resolution and an inner calmness to execute a change like this."

## IT WAS YOURS TO CONCEIVE, ITS MINE TO IMPLEMENT: BAE SYSTEM'S TOTAL PERFORMANCE

The Woolf Report was completed and released in May 2008 and comprised 23 far-reaching recommendations and over 1,000 discreet change items. Following some debate, it was

ultimately agreed that the required cultural change was best led by the CEO and the Executives.

"So there was a need to do something, to culturally do something; to change perception of the company; to change perception of the industry. To step out and boldly go where perhaps you wouldn't want to go and be seen as a leader."

Informed by the external review of top talent, the board had identified Ian King as a potential future CEO, and following benchmarking with external candidates promoted Ian to CEO. In addition to his strength as a performance manager, they considered that he had the requisite qualities to design and implement a major cultural change program. Ian personally led the implementation throughout the company, subsequently refreshing it to keep it current.

"Boards cannot implement culture. Boards need to incentivise and catalyse Executives in the culture."

"If it's a cultural change and it's important, then the CEO has to lead it because at the end of the day the only person who can do trade-offs between functions and trade-offs between businesses is the CEO. If it's not owned and led by the Chief Executive then it isn't going to happen."

The Board monitored the implementation by the Executive team through the Corporate Responsibility Committee. Regular independent reports were also provided to the U.S. Department of Justice by Lord Gold, who had been appointed as 'Corporate Monitor' following the Company's settlement.

The company's values were changed to "Trusted, Innovative and Bold" to reflect a new era. They were signed off by the Board and disseminated throughout the company.

Ian King and his team had crafted a detailed cultural change program around the notion of "Total Performance" whereby every decision taken at any level or region needed to consider all aspects of business equally. The Economist cited "Mr. Clean, Ian King wants to transform the way the world's third-biggest defence company does business."

"You have an equal obligation as a leader in this company to satisfy all aspects of your business not just what we do financially, how we're meeting our programs, how we're satisfying our customers, and the other stakeholders; but also how we do business ethics, the acceptable business conduct. The 'everything' matters."

This principle emanated from the Board throughout the business and a number of initiatives helped to make the program a reality. There are now distinct roles and

responsibilities at board level and all incidents are reported to the Board under the Corporate Responsibility Committee (CRC). The CRC also reports externally via the Annual Report.

All processes and policies were reviewed and signed off by the Executive team. There is a living list of 'acceptable' countries in which to do business that is updated every year. The company trained its 90,000 employees in the new Code of Conduct which is regularly revised and re-issued by the Board.

The company introduced Ethics Officers throughout the organisation and established Ethics Help Lines. Employees are now encouraged to self-report every doubt or incident and have the freedom to withdraw from deals in which they feel 'uncomfortable'. A culture of trust was built by the CEO and Executive team and employees explained how they now feel safe in bringing potential issues to the attention of management without fear of punishment or unfair treatment.

*"The company moved from being rules-based to a culture of being principles-based, where employees are trusted to apply their own judgment as to the extent to which the company is adhering to its values."*

The fact that BAE was a highly process-oriented company, with deep engineering and accountancy skills sets, meant that there was already a culture of discipline, which was important to the success of the program. The CEO was able both to let go of much of the old legacy, yet build on existing strengths to shape the future.

## CELEBRATING SUCCESS AND LEARNINGS FOR THE FUTURE

The real test of a business ethics programme is when a company has to turn down business. The company effectively refused to do business in certain regions unless ethical standards were met.

*"We walked away from several hundred million of business, as we could not execute it in our way."*

They also declined to supply some operational air forces unless they changed their terms of business. BAE held strong to its principles and customers that initially resisted have now realised that they may have to change themselves.

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*"We have changed international business models in military procurement by taking a stand."*

Today the company explained how it tries to be in a permanent state of awareness and readiness to prevent ethical standards being overlooked. For example, when the financial crisis started in 2008, BAE doubled its awareness and internal communication and tightened all processes and procedures.

Yet maintaining a permanent state of awareness is difficult. Sustaining it and not letting it fade from corporate memory is hard work and never ending.

*"How do you keep it current? How do you keep it so that people are proud of it? How do you add something to it that's evolution not revolution because what we did before was revolution, so we've done that. Now we're going to have to evolve and positively evolve."*

*"...what was done, was done with considerable rigour and in such a way that it became part of the DNA of the company... if you look at the ten years that has elapsed since this actually occurred, I would say at every level in the business there is a total understanding of the way we do business."*

A board committee structure now exists to own each internal aspect of BAE Systems' Total Performance initiative to ensure it is aligned with the company's mission and permanently on the Board's agenda. The Chairman, NEDs and members of the CRC also conduct independent visits to operations, especially in high-risk areas.

Having implemented a fundamental transformation of its culture and business practices, BAE Systems is now approached for advice by other firms with similar reputational challenges. The change is impressive: it has successfully turned its standards around from a situation where they threatened the ability of its major U.K. and U.S. customers

to do business with them to define a new standard, and the U.K. and U.S. governments have regained confidence in the company's standards of conduct.

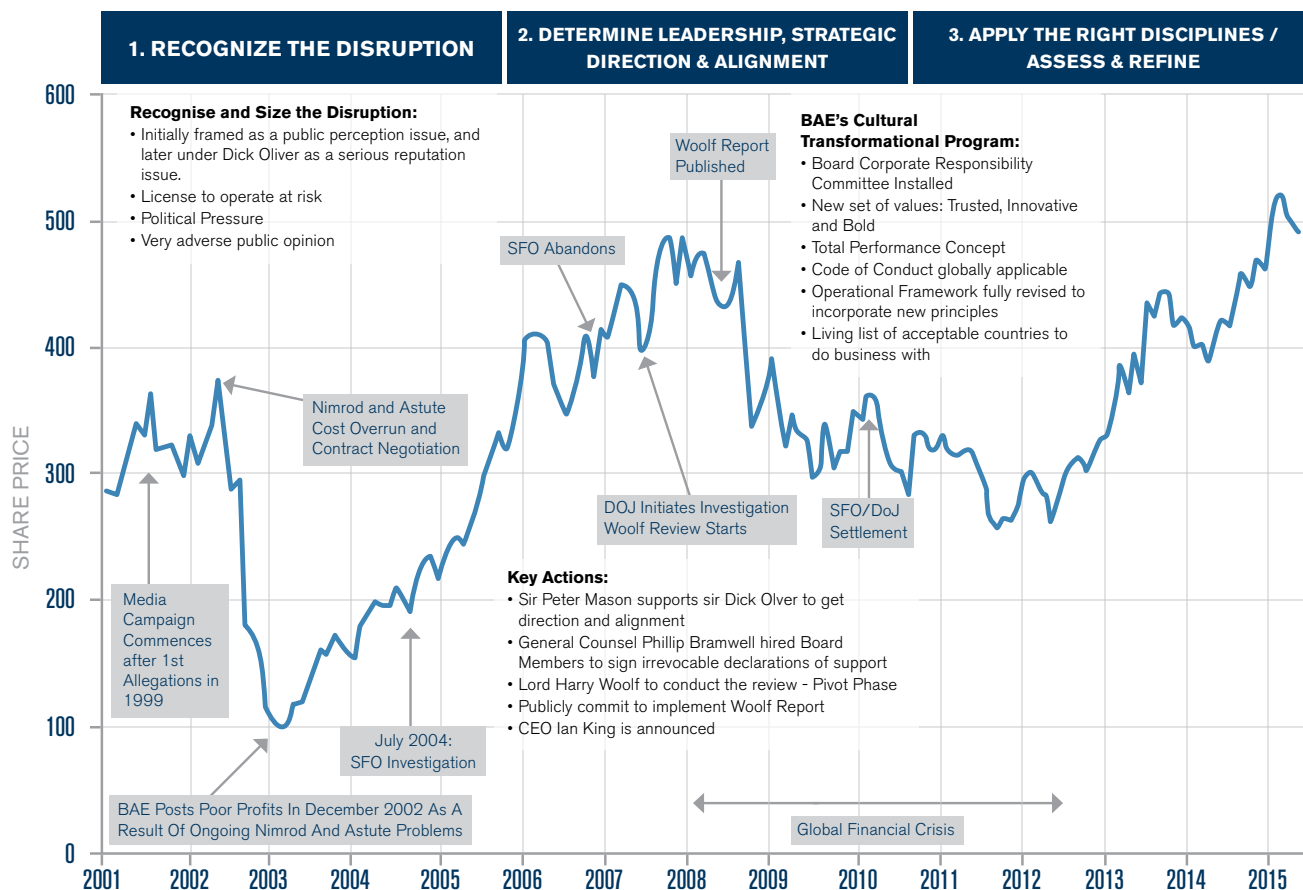
“...every time I spoke to large groups of people all over the world I reinforced the message about it's not just how much money we make, it's how we make money and that's a reinforced message so everybody knew that the change in chair didn't change the standard.”

## APPENDIX A: BAE'S TIMELINE OF EVENTS

TIMELINE OF EVENTS	LEADERSHIP RESPONSE	% PHYSICIANS SAMPLED BY U.S. WORLD NEWS
<b>1999:</b> First Allegations  <b>2001:</b> Media campaign commences	<b>Board:</b> <ul style="list-style-type: none"> <li>• Defensive of the past</li> <li>• Denial</li> <li>• Leadership Vacuum</li> <li>• Astute submarines / Nimrod aircraft issues</li> </ul>	<b>Drift Phase</b> <ul style="list-style-type: none"> <li>• Public perception very adverse</li> <li>• Political pressure</li> <li>• Licence to operate at risk</li> </ul>
<b>July 2004:</b> SFO Investigation  <b>Dec 2006:</b> SFO abandons KSA aspects  <b>July 2007:</b> DoJ initiates investigation Woolf Review Starts	<b>Chairman Dick Olver leads:</b> <ul style="list-style-type: none"> <li>• New General Counsel Philip Bramwell</li> <li>• Hired Board alignment</li> <li>• Lord Harry Woolf to conduct a review</li> </ul>	<b>Pivoting Phase</b> <ul style="list-style-type: none"> <li>• Media / Activist campaigns continue</li> <li>• Political pressure intensifies</li> </ul>
<b>May 2008:</b> Woolf Report is published  <b>May 2008 – Present:</b> Woolf Report is implemented  <b>February 2010:</b> DoJ/SFO settlement...	<b>CEO Ian King leads:</b> Global cultural transformation based on the Woolf Report recommendation: <ul style="list-style-type: none"> <li>• CEO Ian King is appointed</li> <li>• Corporate Responsibility Committee</li> <li>• New set of values</li> <li>• Total performance</li> <li>• Code of conduct</li> <li>• Operational framework</li> </ul>	<b>Recovery Phase</b> <ul style="list-style-type: none"> <li>• Company receives praise on the way it handled the issues</li> <li>• Relationships with regulators are re-established</li> <li>• Customer relationships re-framed under a new set of values and principles</li> <li>• BAE Systems ultimately seen as leading the industry in terms of ethical and business conduct</li> <li>• Company adopts “Inspired Work” as part of its brand, re-invigorating employee pride in the Company and its work</li> </ul>
<b>February 2010-present:</b> DoJ/SFO settlement...	<b>Company Leadership:</b> Embedded in the company's culture – total performance	



## APPENDIX B: BAE'S TIMELINE OF EVENTS





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