UNIVERSITY OF CAPE TOWN

FACULTY OF LAW

SCHOOL FOR ADVANCED LEGAL STUDIES

THE INDEPENDENT DIRECTOR AND EFFECTIVE CORPORATE GOVERNANCE

BY

CHIZOBA DAVID IWE
IWXCHI001

SUPERVISOR: Professor Mike Larkin

A Dissertation submitted to the School for Advanced Legal Studies of the University of Cape Town in Partial Fulfilment of the Requirements for the Degree of Master of Laws (LLM) in Approved Courses and a Minor Dissertation.

2007

NAME: Chizoba David Iwe

STUDENT NUMBER: IWXCHI001

PHONE: +27730455971

EMAIL: chizobz@yahoo.com

ADDRESS

10 Cambridge Court,

Main Road

Rosebank, Cape Town.

I hereby declare that I have read and understood the regulations governing the submission of Master of Laws (LLM) dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to the regulations.

Cape Town, this 20th day of November 2007.

Chizoba David Iwe.

DEDICATION

This thesis is dedicated to the glory of God Almighty;

And to my loving mother, Dr Josephine I. Iwe, as a token of my appreciation for her unconditional love and support.

ACKNOWLEDGEMENTS

I would like to express my heartfelt appreciation for the guidance and immense support I received from my supervisor, Late Prof Mike Larkin during the course of this thesis. I am particularly grateful for the illuminating discussions we had, and his never ending show of understanding and concern throughout this study. May his gentle soul rest in peace.

I must also appreciate my wonderful parents, Professor and Dr (Mrs) N. S. S. Iwe, who were entirely responsible for my sustenance throughout this degree. In the same vein I thank my brothers, Iwuchukwu Iwe and Chidi Iwe, for their continued love and encouragement through the course of my studies.

My heartfelt appreciation also goes out to my colleagues and friends in Cape Town whose care and companionship contributed greatly in making my studies a worthwhile experience. Of particular mention are; Nta Onor, Karen Parson, Esther Atoyebi, Nneka Asomuju, Omowunmi Sadiku and Justine Tumuheki.

Finally, I must appreciate the very committed academic and non-academic staff of the Faculty of Law whose hardwork and dedication to excellence continually contributes to making University of Cape Town a centre of reference.

I am grateful for this opportunity.

TABLE OF CONTENTS

PAGE

THE INDEPENDENT DIRECTOR AND EFFECTIVE CORPORATE GOVERNANCE

ABSTRACT

As a response to the rash of scandals in particularly USA and Europe in recent times, corporate governance has elicited a lot of interest worldwide. Today there is growing dialogue among the different stakeholders about corporate governance and how it should evolve to cope with the increasingly dynamic and global nature of our capital markets. Worldwide, corporate reforms and other initiatives are being taken as remedies to rebuild trust in corporate governance. Corporate reforms have led to the introduction in many countries of various codes or guidelines for best practices in corporate governance.

Until now, probably the most important basic ingredient of these reform initiatives has been the emergence of the 'independent director'. The introduction of this concept of independent director is at the heart and soul of corporate governance.[1] Although the relevance or otherwise of this class of director to corporate success has been the subject of robust discourse, it is generally accepted that a 'lack of monitoring by independent, disinterested non-executive directors has been a major cause for the various corporate scandals that we have witnessed'.[2]

The first section of this study attempts a comparative analysis of various definitions (taken from corporate governance codes of various countries) of the independent director, taking a look at his role within the corporate structure. The second part examines the rationale for including the

[1] OECD, Corporate Governance of Non-Listed Companies in Emerging Markets,(2006),p.172
[2]. L.A.A. Van den Berghe …

independent director on the board, his effectiveness, and his relevance in relation to corporate performance.

PART 1

CHAPTER ONE
THE INDEPENDENT DIRECTOR

INTRODUCTION

Corporate governance is a term that has been in circulation for the last twenty or so years. It has elicited a lot of attention in recent times and like many fashionable concepts, it is somewhat ambiguous and, to some, has become a bit of a cliché, an abstraction that commands near-universal respect but suffers from diverse interpretation.[3]It is believed in certain circles that the term 'entered into prominent usage in the mid to late 1970s in the United States in the wake of the Watergate scandal and the discovery that major American corporations had engaged in secret political contributions and corrupt payments abroad. Eventually, it also gained currency in Europe as a concept separate from corporate management, company law or corporate organisation".[4]

The fundamental problem of corporate governance however, can be traced back to what is now known as the 'separation theory' as proposed by Adolf Berle and Gardener Means, in their classically famous work 'The Modern Corporation and Private Property'.[5]This is the theory that, in the modern corporation, there has arisen a 'separation of ownership by passive shareholders from control by a small self-perpetuating management group'.[6] The small group of managers are relatively free to manage the publicly held corporation as they deem fit (for their own benefit), not that of the powerless and passive shareholders.[7] Berle and Means proffer that, there is a significant divergence of interest between ownership and control of the modern corporation. The authors examined the nature of control exercised over the 200 largest American corporations at the beginning of the 1930s. They concluded that 65 percent of

[3]. Kevin Keasey et al, *Corporate Governance: Accountability, Enterprise and International Comparisons* .(2005) Pg.1.
[4]. Jeswald W Salacuse, '*Corporate Governance in the New Century'* (2004) The Company Lawyer, Vol. 25, N0. 3, Pg. 70.
[5] Adolf Berle and Gardener Means, *The Modern Corporation and Private Property* Revised ed (1991).
[6]. Nicholas Wolfson *The Modern Corporation* (1984) Pg.13.
[7]. Wolfson op cit note 4 at pg 4.

the companies and 80 percent of their combined wealth were controlled by the management or by a legal device (e.g., voting trusts or non-voting stock) involving a small proportion of ownership.[8]

CORPORATE GOVERNANCE: AN OVERVIEW

Various definitions of corporate governance have been advanced by corporate governance practitioners, scholars and commentators alike. In a narrow sense, it has been defined as 'the system of rules and institutions that determine the control and direction of the corporation and that define relations among the corporation's primary participants'.[9]In other words, corporate governance is the system by which companies are directed and controlled,[10] the primary concern being with those who supply finance to companies, the shareholders. This view sees the corporate objective as being primarily that of preservation and maximisation of shareholder investment. This theory is sometimes referred to as the 'shareholder theory' of corporate governance.

This 'shareholder-centric' approach to corporate governance is prominent in countries like the United States and the United Kingdom where the view is that the problem of corporate governance is that of ensuring that the corporation is managed in the best interest of the shareowners. The purpose of the corporation is to make profits and the beneficiaries of those profits are the shareholders. In such countries that are characterised by a widely dispersed share ownership structure the principal focus of corporate governance is to define the relationship between the three primary participants in the corporation: shareholders, the board of directors and company management.[11]This is again sometimes referred to as the Anglo-American model of corporate governance.

In a more broad sense, corporate governance has been defined as, the rules and 'the institutions that influence how business corporations allocate resources and returns' and

---

[8]. Wolfson op cit at pg.13.
[9] Salacuse note 2 at pg.70.
[10]. Report of the Committee on the Financial Aspects of Corporate Governance (Cadbury Report), Para. 2.5, available at www.ecgn.org.
[11]. Salacuse note 2 at pg.74

'the organisations and rules that affect expectations about the exercise of control of resources in firms'.[12] It includes the entire network of formal and informal relations involving the corporate sector and their consequences for society in general. In other words, corporate governance is concerned with holding the balance between economic and social goals and running the company as a community, for the benefit of all stakeholders, including shareholders, employees, creditors, suppliers, and the society at large.[13] By this approach, corporate governance seeks to align the interests of the corporation with those of society. This is sometimes referred to as the 'stakeholder theory' of corporate governance.

This 'stakeholder' approach to corporate governance is quite prominent in Continental Europe especially in countries like France and Germany, and in Japan, which have corporate systems that are characterised by a more concentrated share ownership structure. For them, corporate governance is about society controlling corporations for purposes of social welfare (corporate social responsibility).[14] Companies are considered to be social institutions with responsibilities and accountability, and corporate objectives also involve advancing the interests of other groups - like employees and the wider community in general - beyond the traditional category of shareholders.

The heightened attention to corporate governance was caused in part by the rash of high profile frauds and scandals that have plagued corporations, especially in recent times. Ever since the failures in Polly Peck, Guinness, Maxwell and BCCI in Europe, corporate governance had been an increasing concern for those that control and direct companies, and indeed society at large, but the corporate failures and wrongdoing that have come to light since late 2001 have raised the temperature of the international corporate governance debate considerably. The abuses at Enron, Arthur Anderson, Tyco, Global Crossing, Adelphia and WorldCom in the United States, and at Ahold, Parmalat, One.Tel, HIH, Equitable and now Shell in Europe and other parts of the world, have severely

[12]Salacuse note 2 at pg. 70
[13]. Department of Trade and Investment Policy Report, pg.23, available at www.dti.co.za.
[14]. Salacuse, note 2 at pg 72.

impacted investor confidence in the integrity of those charged with the supervision and management of our larger companies.[15]

At the root of these corporate failures are factors like executive greed, dishonesty, accounting defaults, insolvent trading, incompetence, excessive executive pay, lack of accountability and executive arrogance. Other factors underlying these collapses include passive boards of directors, poor management and auditing practices, breach of duty by directors, ostentation and waste. These factors, with their resulting consequences, were the major triggers for the global responses to, and attempts at, corporate governance reforms, particularly since late 2001.

In the United States for instance, in the aftermath of the Enron scandal, the American Congress rapidly responded by passing the Public Company Accounting Reform and Investor Protection Act, popularly referred to as the Sarbanes-Oxley Act, in 2002, which 'tightened regulations on a public company accounting oversight board, auditor independence, corporate responsibility, white collar crime penalties, and fraud and accountability'[16]. In other words it was designed to facilitate the tightening of accounting standards and enhance external auditor independence from management. It was the first new piece of business regulatory legislation for more than half a century and is considered by many to be the biggest overhaul of U.S. securities regulations.[17] The New York Stock Exchange (NYSE) and the NASDAQ also adopted new rules giving a greater role to independent directors of listed companies.[18]

In the United Kingdom which has had its own share of corporate failures, various committees were commissioned to make recommendations on best practices in different aspects of business practice. The corporate governance structures and practices within UK companies have undergone significant changes in response to the recommendations

[15]. J.Farrar, *Corporate Governance in Australia and New Zealand* (2001)
[16]. Gerald Acquaah-Gaisie,*'Toward more Effective Corporate Governance Mechanisms'*, Australian Journal of Corporate Law, (2005), Vol.18, pg.19.
[17]. Fred Robins, *'Corporate Governance after Sarbanes Oxley: An Australian Perspective'* Corporate Governance, Vol.6 No.1, (2006).
[18]. George W. Dent,*'Coporate Governance: Still Broke, No Fix in Sight,'* The Journal of Corporation Law, (2005), Vol.31, pg.42.

of these committees. Concerns over poor corporate governance standards led to the setting up of the first corporate governance committee, the Cadbury Committee on the Financial Aspects of Corporate Governance, in 1991. The committee's terms of reference were 'to review those aspects of corporate governance specifically related to financial reporting and accountability.'[19]Its report incorporating a code of best practice for all listed companies (the Cadbury Code of Best Practice) was published in 1992.

As a response to public concerns over high levels of directors' remuneration, the Study Group on Directors' Remuneration (The Greenbury Committee) was formed to identify good practices in determining directors' remuneration. Its report and code of best practice on the determinants of directors' remuneration was published in July 1995.[20]Further, in November 1995, the Committee on Corporate Governance (The Hampel Committee) was established. This committee published a set of principles and a code which incorporated its recommendations and those of the Cadbury and Greenbury committees. The 'Combined Code' as it is known, has been adopted by the London Stock Exchange, which listing rules require companies to report on their compliance with the code.

In South Africa, corporate governance was institutionalised with the publication of the 'King Report on Corporate Governance' in November 1994.[21] The King Committee on Corporate Governance was formed under the auspices of the Institute of Directors of Southern Africa, to consider corporate governance in the context of South Africa.[22] The purpose of the report was to promote the highest standards of corporate governance in South Africa, and it contained a Code of Corporate Practices and Conduct intended to apply to all companies listed on the JSE Securities Exchange and to all large public companies in South Africa.[23] A revised edition of the King report was issued in 2002, which is hereinafter referred to as King II.

---

[19]. Keasey et al, op cit note 2 at pg.21
[20]. Austin & Ramsey *Ford's Principles of Corporations Law* (2005), 12thEd. pg.322.
[21]. Mervyn King *'Report on Corporate Governance for South Africa'* (2002) P. 5.
[22]. King, ibid..
[23]. Blackman et al *Commentary on The Companies Act* (2002) p.10.

EMERGENCE OF THE INDEPENDENT DIRECTOR

The notion of the independent director has become something of a theme song among corporate governance scholars and commentators worldwide. The concept has also received wide acceptance in the business and corporate community. Indeed, there have been proposals to the effect that all of the board, except the chief executive officer, of a company, be made up of independent directors. While some would go that far, there are many who believe that at least a significant number of independent directors should be on the board. In his book on corporate governance best practices, Frederick Lipman recommends that governing bodies of all organisations, whether designated as boards of directors or not, should include completely independent directors and these directors should preferably constitute a majority of all directors.[24]

A study of legislation and other instruments of corporate governance globally reveals the significant support that this notion of independent director enjoys. The Australian corporate governance code and the Combined Code of the U.K. for instance, both require that the board be constituted of a good proportion of independent directors. The two codes also contemplate a major role for such directors by providing that certain board committees like audit, nomination and remuneration committees, be constituted by a majority of independent directors. Indeed, in Australia, nine of 12 major institutional investors considered it important that a listed company have some independent directors on its board. They expressed a preference for the board to have a majority of independent directors.[25]

In the US, the corporate governance rules of the New York Stock Exchange (NYSE) require that the boards of listed companies must have a majority of independent directors. Requiring a majority of independent directors, the rules state, will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest. The rules also require that all listed companies must have audit, compensation and nomination

---

[24]. Frederick D. Lipman, *Coporate Governance Best Practices* (2006) P.9.
[25]. Ramsey et al, *Institutional Investors' views on Corporate Governance* (1998) Pg.9.

committees composed entirely of independent directors. [26] Similarly, the corporate governance code of South Africa (King 11) recommends that corporate boards be comprised of a majority of independent non-executive directors.[27] The corporate governance code for Nigerian banks released in April, 2006, also requires that the number of non-executive directors on the board must be more than executive directors and of these, at least two must be independent directors.[28]

The International Corporate Governance Network (ICGN) in its statement on global corporate governance principles suggests that each board should include a 'strong presence of independent non-executive directors with appropriate competencies'.[29] In a similar tone, the Organization for Economic Co-operation and Development (OECD) in its corporate governance principles states that in order to exercise its duties of monitoring managerial performance, preventing conflicts of interest, and balancing competing demands on the corporation, the board must be able to exercise objective judgement on corporate affairs. This will mean that a sufficient number of board members will need to be independent of management.[30] The French Principles of Corporate Governance state that even though the quality of the board of directors cannot be defined simply by reference to a percentage of independent directors, it is important to have on the board a significant proportion of independent directors not only to satisfy an expectation of the market but also to improve the quality of proceedings.[31]

As earlier stated, there is a trend toward greater independence on corporate boards, whatever the benefits may be, and most commentators applaud this trend. Major institutional investors such as the California Public Employees' Retirement System

---

[26]. New York Stock Exchange (NYSC) 'Corporate Governance Rules'. Available at www.nyse.com/finalcorpgovrules.

[27]. King op cit note 19 at P.24.

[28]. Code of Best Practices on Corporate Governance for Banks in Nigeria Post Consolidation, (2006) – available at www.cenbank.org/ng.

[29]. International Corporate Governance Network Statement on Global Corporate Governance Principles available at www.icgn.org.

[30]. Organisation for Economic Cooperation and Development (OECD) 'Principles of Corporate Governance' (2004), P.63. Available at www.oecd.org.

[31]. European Corporate Governance Institute (ECGI) 'The Corporate Governance of Listed Corporations' (2003), Principle 8.2, P.9. Available at www.ecgi.org/codes.

(CalPERS), which is the largest public pension fund in the US, and institutional investor representative bodies like the Alternative Investment Management Association (AIMA) and the Investment and Financial Services Association (IFSA) both in Australia, do believe that independent directors are value-adding, and have been high profile proponents of them.[32] The corporate governance principles and guidelines of CalPERS states:

> Independence is the cornerstone of accountability…it is now widely recognised throughout the US that independent boards are essential to a sound governance structure. At a minimum, a majority of the board should consist of directors who are independent. Boards should strive to obtain board composition made up of a substantial majority of independent directors.[33]

However, whether increasing the number of independent directors on boards would translate automatically to better corporate performance is a whole different issue, which will be tackled later in this study. It is however necessary to take a look at the rationale for the introduction of independent directors on corporate boards.

RATIONALE FOR INDEPENDENT DIRECTORS

The separation of ownership (a company is believed to be owned by its shareholders) from control (but a company is controlled by managers who do not own it) in the modern public corporation has created agency costs that interfere with efficient corporate decision making.[34]These agency costs comprise (i) the costs incurred by shareholders in monitoring management in order to minimise the divergence between their interests;(ii) bonding costs incurred by managers;(iii) the residual loss resulting from the remaining divergence in shareholders' and managers' interests.[35]Indeed, the structure of the modern corporation holds obvious advantages for shareholders (as suppliers of capital) and managers. Shareholders can participate in the gains from entrepreneurial ventures even though they lack managerial skills. On the other hand, managers can pursue profitable

---

[32]. Lawrence and Stapledon, *'Do Independent Directors Add Value?'* (1999), Pg.6.
[33]. Available at www.calpers-governance.org/principles
[34]. Thomas W. Joo, *Corporate Governance; Law, Theory and Policy* (2004), P.330.
[35]. Lawrence and Stapledon, note 30 P.4.

business opportunities even though they lack large personal wealth. Both parties benefit from this division of labour.[36]

However, as residual claimants on the firm's income stream, shareholders want their agents - the firm's managers - to maximise wealth. Because managers cannot capture all of the gains if they are successful, and will not suffer all of the losses should the venture flop, they have less incentive to maximise wealth than if they themselves were the principals. Rather, managers have an incentive to consume excess leisure, perquisites and in general be less dedicated to the goal of wealth maximisation than they would be if they were not simply agents.[37] According to one commentator:

> Management develops the tendency to act in a self-serving manner because they only receive a tiny fraction of profits generated by their activities since they rarely own a substantial number of shares in such companies. They thus act in their own interest rather than endeavour to maximise shareholder value. And to the extent that top executives pursue their own agenda rather than seeking to improve the profitability of the company, they impose what can be referred to as 'agency costs' on investors.[38]

In an effort to reduce these agency costs a number of mechanisms were formulated to align the interests of non-owner management with that of shareholders. The introduction of the independent director was one of such mechanisms. The basis for this agency-cost rationale for the introduction of the independent director is that, in order for the board to properly exercise its oversight and monitoring role over management decisions and activities, there is need for outside directors to be independent of executive management and free from any business or other relationship with the company that could compromise their autonomy. It is believed that independent directors are in a better position to effectively monitor the executive management.[39]

This agency-cost rationale for placing independent directors on corporate boards has been adopted by various promoters of board independence. The Cadbury Committee of the

---

[36]. Lawrence and Stapledon ibid.
[37]. Lawrence and Stapledon, ibid.
[38]. Tshepo Mongalo, *'The Emergence of Corporate Governance as a Fundamental Research Topic in South Africa'* (2003) Vol. 120 Issue 1 SALJ.
[39]. Lawrence and Stapledon note 30 at P.5.

U.K. for instance, views independent directors as particularly useful in reducing agency costs arising in areas such as takeovers, boardroom succession and executive remuneration;

> Non-executive directors have two particularly important contributions to make to the governance process as a consequence of their independence from executive responsibility. …The first is in reviewing the performance of the board and of the executive. …The second is in taking the lead where potential conflicts of interest arise. An important aspect of effective corporate governance is the recognition that specific interests of the executive management and the wider interests of the company may at times diverge, for example over takeovers, boardroom succession, or directors' pay. Independent non-executive directors, whose interests are less directly affected, are well-placed to help to resolve such situations.[40]

Similarly, the corporate governance guidelines of the Organisation for Economic Co-operation and Development (OECD) state:

> Independent board members can contribute significantly to the decision-making of the board. They can bring an objective view to the evaluation of the performance of the board and management. In addition, they can play an important role in areas where the interests of management, the company and shareholders may diverge such as executive remuneration, succession planning, changes of corporate control, takeover defences, large acquisitions and the audit function.[41]

In Australia, the corporate governance guidelines published by the Alternative Investment Management Association (AIMA) in 1997 states that 'if the majority of the board are genuinely independent they have the power to implement board decisions even contrary to the wishes of management or a major shareholder, if the need arises.'[42]The Corporate Governance code of South Africa also echoes the same theme when it states that non-executive directors bring an external judgement on issues of strategy, performance, resources, and standards of conduct and evaluation of performance.[43]

Another rationale for the independent director that emerged from the OECD is that their inclusion on the board, as a mechanism of good corporate governance, is necessary for accessing international capital markets. According to the OECD, 'investors increasingly

---

[40]. Lawrence and Stapledon, ibid.
[41]. OECD 'Guidelines on Corporate Governance for State-Owned Enterprises'. Available at www.oecd.org/documents.
[42]. Lawrence and Stapledon, note 30 at P.5.
[43]. King op cit note 19 at P.24.

rely on the corporate governance of the corporations they invest in, or lend to, to provide accountability and responsibility to the investors and, a failure to adapt to efficient governance practices may well lead to restricted access to capital markets.'[44] Echoing the same theme, and indeed rightly underscoring the importance of good corporate governance practices, the OECD guidelines state:

> The degree to which corporations observe basic principles of good corporate governance is an increasingly important factor for investment decisions. Of particular relevance is the relation between corporate governance practices and the increasingly international character of investment. International flows of capital enable companies to access financing from a much larger pool of investors. If countries are to reap the full benefits of the global capital market, and if they are to attract long-term "patient" capital, corporate governance arrangements must be credible and well understood across borders.[45]

[44]. Lawrence and Stapledon, ibid. Pg.6.
[45]. OECD op cit note 39. Available at www.oecd.org/documents.

CHAPTER TWO

COMPARATIVE ANALYSIS OF THE CONCEPT OF INDEPENDENT DIRECTOR

Corporate governance, as noted earlier, has in recent times elicited a lot of global attention. This has been mainly due to the many recent corporate failures which have in turn led to corporate governance reforms. A consequence of these reforms is the emergence of the independent director. The introduction of this concept of independent director is said to be at the heart and soul of corporate governance.[46] There is no doubt that independence is critical to the attainment of effective corporate governance. In order for the board of directors to successfully perform its duty of effectively monitoring the decisions and activities of management, a high degree of independence and objectivity is required. The role of the independent director in corporate governance cannot therefore be over-emphasised.

Before undertaking a comparative analysis of the definition of independent director in selected corporate governance Acts and guidelines, it is useful to canvass other definitions given to the concept. Indeed, 'independent director' is a somewhat ambiguous concept that defies a 'one size fits all' definition. It means different things to different commentators. It has been used interchangeably with terms like outside director, non-executive director, non-interested director, non-management director, non-employee director, disinterested director etc. Each of these terms is defined differently and implies a different role for the director it describes, yet they are frequently discussed together as if they were all describing the same thing.[47]

The Council of Institutional Investors describes the independent director as a person 'whose directorship constitutes his or her only connection to the corporation'. It defines him simply as one whose 'only nontrivial professional, familial or financial connection to the corporation, its chairman, CEO or any other executive officer is his or her

---

[46]. OECD, 'Corporate Governance of Non-listed Companies in Emerging Markets' (2006) P.172. Available at www.oecd.org.

[47]. Donald C. Clarke, *'The Independent Director in Chinese Corporate Governance'*, Delaware Journal of Corporate Law (2006) Vol.31 P.151.

directorship'. The members of the Council recognise that the independence of the director depends on all relationships the director has, including relationships between directors that may compromise the director's objectivity and loyalty to shareholders.[48] The Organisation for Economic Co-operation and Development (OECD) on its part defines the independent director as one who is not the employee of the company and who is not closely related to the company or its management through significant economic, family or other ties.[49] He or she is a non-executive director who 'apart from receiving director's remuneration, does not have any material relationship or transaction, of such amount as may be prescribed, with the company…apart from possessing such abilities for being treated as an independent director.'[50]

Independent directors have further been described as a sub-group of non-executive directors (not all non-executive directors are independent) who are independent of management, influential shareholders and other conflicting interests such as staff, and suppliers of goods and services to the company and its group.[51] In a similar tone, the French code of Corporate Governance for Listed Companies defines the independent director as one 'who has no relationship of any kind whatsoever with the corporation, its group or the management of either that is such as to colour his or her judgment'.[52] He or she is not only to be understood as a non-executive director, but also 'one devoid of any particular bonds of interest (significant shareholder, employee, other) with them'.[53] One interesting definition of the independent director is that given by Donald C. Clarke in his article, 'The Independent Director in Chinese Corporate Governance'.[54] He states that an independent director is one who has no need or inclination to stay in the good graces of management and who will be able to speak out, inside and outside the boardroom, in the face of management misdeeds in order to protect the interests of shareholders.

---

48. Council of Institutional Investors (CII) 'Corporate Governance Policy'. Available at www.cii.org.
49. OECD op cit note 28. Available at www.oecd.org.
50. OECD op cit note 44 at P.172. Available at www.oecd.org.
51. EASD 'Corporate Governance Principles and Recommendations' Recommendation VI.I.b. Available at www.ecgi.org/codes.
52. ECGI op cit note 29 Principle 8.1, Pg 9. Available at www.ecgi.org/codes.
53. ECGI Ibid.
54. Donald C. Clarke op cit note 45 at P.154.

KING II, AUSTRALIAN CODE, COMBINED CODE UK

The corporate governance codes analysed for this study emanate from nations with diverse cultures, ownership structures, financing traditions and legal origins. Some of the codes represent the unitary (or one-tier) board system while others, like the German and French codes, represent the two-tier board system. Despite this diversity in origins, the codes are remarkable in their similarities, especially as regards their attitude towards key roles and responsibilities of the board and their recommendations concerning its structure, composition and practices. For instance, all the codes recognise both the supervisory and managerial functions of the board, even though the functions are made more distinct in the unitary codes. To reinforce the difference in both functions, the codes recommend the appointment of non-executive (or outside) directors who are independent from company management, to the board. They also propose the separation of the positions of chairman of the board and the CEO (or managing director). They recommend that the two positions be held by different individuals.[55]

The codes also recommend the appointment of a senior (or lead) independent director on the board to serve as contact person or mediator when serious disagreements arise between executive and non-executive directors: and also during the performance evaluation of the chairman and board. Some, like the Australian code recommend that the chairman should be an independent director. They recommend a regular assessment of the independence of each director, and in this regard each director is to provide information concerning his interests to the board. Directors considered by the board to be independent must be identified and this information, along with reasons for such consideration are to be disclosed in the company annual report. By this approach, it is believed that investors will be better informed and equipped to assess the quality of the board's independence and its independence standards.

---

[55]. Some bodies like the Business Round Table in the U.S. believe that corporations are generally well served by a structure in which the CEO also serves as chairman. They believe that such a structure provides for a single leader with a single vision for the company, which results in a more effective organisation. – The Business Round Table 'Statement on Corporate Governance' 1997. Available at www.brt.org.

The codes also recognise that the supervisory role of the board is more effectively exercised through a committee structure. This is particularly in the areas where the interests of the company and that of management may tend to conflict, such as audit, nomination and remuneration. Not only do they recommend the setting up of audit, nomination and remuneration committees, but the codes also propose that independent directors play a significant role on these committees. For instance, the NYSE corporate governance rules require that each listed company must have audit, nomination/corporate governance and compensation committees, and that these committees must be composed entirely of independent directors.

This part of the study attempts a comparative analysis of the 'independent director' as defined in selected corporate governance instruments. We start off by comparing the definitions of the concept in the South African code (King II), the Australian code and the UK combined code, which are all representative of the 'unitary board' structure that is predominant in the Anglo-American corporate system. Then we compare these with the definition as provided in the French code, which is representative of the 'two-tier board' structure predominant in Continental European corporate system.[56] Finally, we take a look at the New York Stock Exchange (NYSE) definition of the independent director as contained in the NYSE corporate governance rules.

With respect to strengthening board independence, most of these codes adopt a two-fold approach. On the one hand, they advocate an increase in the proportion of independent directors sitting on the board and its committees. On the other hand, they adopt a more extensive and restrictive definition of independence. This seems to express a strong belief, present throughout the business community, in the potential of the independent director as a solution to the problem of corporate governance. As a result, expectations with regard to independent directors are soaring, although it is still a question mark whether greater board independence translates to better corporate performance.[57]

---

[56]. In France, both the unitary and two-tier board systems are practiced.

[57]. L.A.A. Van den Berghe and Tom Baelden, *'The Complex Relation between Director Independence and Board Effectiveness',* Corporate Governance, (2005) Vol.5, N0.5, P.59.

One observation that can be gleaned from an examination of these definitions is that they are formulated in a negative way and list elements that disqualify a director from being considered as independent. They list those elements that prevent a director from being independent. Instead of giving a positive definition of what constitutes independence, they mostly give a list of circumstances or relationships that imply non-independence.[58] The Combined Code and French code definitions are exceptions in this regard. What they do is list a number of criteria which could be relevant in determining whether a director qualifies as independent. They list a number of circumstances, the existence of which may be relevant in determining a director's independence. They therefore give corporate boards certain latitude to determine director independence by considering the peculiar circumstances and relationships of director's individually. This means that the existence of any of the circumstances listed, would not automatically render a director independent, or disqualify him from being considered independent. The specific circumstances and relationships surrounding each director would have to be considered individually by the board in making a determination.

Another observation from the definitions is that they approach the concept of independence from a structural point of view, 'in a sense that independence seems to equal being constantly in a position free of any possible conflict of interest'.[59] They seem to follow a more formal approach. Other factors relevant to independence like character, attitude and judgment, have not been considered. Instead the focus is on those requirements, and the circumstances that are capable of raising conflicts between the personal interests of the independent director and those of the management.[60] The combined code however seems to acknowledge the importance of these other 'soft' elements of independence when it states that 'the board should determine whether the director is independent in character and judgment and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's

[58]. Van den Berghe Ibid.
[59]. Van den Berghe Ibid.
[60]. Van den Berghe Ibid.

judgment'.[61] Some of the other codes also acknowledge the fact that independence cannot be based solely on compliance with these formal requirements. Indeed, some of the recent corporate scandals have shown that the mere presence of formally independent directors without these 'soft' elements, like independent attitude and strong character, will not prevent future breaches of corporate governance.[62] According to the NYSE rules;

> No code of business conduct and ethics can replace the thoughtful behaviour of an ethical director, officer or employee. However such a code can focus the board and management on areas of ethical risk, provide guidance to personnel to help them recognise and deal with ethical issues, provide mechanisms to report unethical conduct, and help to foster a culture of honesty and accountability.[63]

A close examination of the South African, U.K and Australian definitions of the independent director will reveal that they are quite similar in structure. They each contain seven different circumstances or elements, the existence of which could qualify a director as independent. As a starting point, the three definitions agree that an independent director is a non-executive director. In other words, an independent director is not a full-time salaried employee of the company or the group, and therefore is not involved in its day to day management.[64] This is of course the basis upon which independence can be assessed in the first place, for the concept of independence connotes separation (independence) from executive management. It must be also borne in mind that not all non-executive directors can be considered to be independent.

While the King II and Australian definitions agree that an independent director must not have been employed in an executive capacity by the company or group in the three years preceding his appointment as director, the combined code provides that whether he has been an employee of the company or group within the last five years is an element which is relevant to determining if a director is to be considered independent, by the board. The requirement under the combined code is obviously wider in scope. The definition gives the board certain latitude in determining independence of a director. In other words, such

---

[61]. The Combined Code of Corporate Governance UK (2006) p.6. Available at www.ecgi.org/codes/documents.
[62]. Ibid. P.68
[63]. New York Stock Exchange 'Final Corporate Governance Rules' P.15.
[64]. King, op cit note 19 P.57.

director may have been an executive employee of the company but could still be considered to be independent. This may sound ironic for it is quite logical to assume that a director who has held an executive employment within the last three or five years would be non-independent. Indeed, there would most likely arise conflict of interest situations in such circumstances and it is difficult to see how such a director would still be able to act independently, having been an executive 'insider'. The board is however, expected to examine the particular circumstance of such prior employment in order to decide on such director's independence, for indeed where the employment was in a non-executive capacity, it could be assumed that the director would be independent, the important factor being the holding of prior employment in an executive capacity.

It should be noted that while King II and the Australian definitions provide for a three (financial) year look back period, the combined code provides for a five year period, which is consistent with the five year look back period of the Council of Institutional Investors 2006 director independence standards.[65] The Australian definition adds that an independent director must not have been a director after ceasing to hold any such employment with the company. This could mean that an independent director will not be considered as such where he had been a director of the same company in a non-executive capacity in the preceding three years.

King II and the Australian code also define an independent director as one who has no significant contractual relationship with the company or group, and who is not a major supplier to, or customer of the company or group. The Australian definition extends this by adding that such director must also not be an officer of, or associated with a material supplier or customer of the company or group. This could mean that under King II, an independent director, though not a major supplier or customer could still be an officer of or associated with, a major supplier or customer of the company. The Australian definition is more practical in this regard, for the goal is to minimise as much as possible, situations that could impair a director's independent judgment. Other indirect

[65]. Council of Institutional Investors, op cit note 46.

associations with suppliers or customers are still capable of causing a conflict between the personal interests of the director and those of the company.

Both King II and the Australian definitions provide for what could be termed an 'omnibus criteria', where it states that an independent director must be free from any business interests or relationship that could reasonably be seen or perceived to interfere with his ability to act in an independent manner or in the interest of the company. The critical element in this provision is not necessarily the existence of such relationship or interest; rather it is the materiality of such relationship or interest that counts. Is it such that could interfere with the director's capacity to act independently? This provision, it would seem, covers every other kind of indirect relationship which is not covered by any of the other elements. For instance, a situation where such director has an interest in, or a relationship with a political or charitable organisation that receives support from the company would fit in here. In such instance, it would have to be determined how material the director's links are as to affect his ability to act independently and in the company's interest. The combined code does not seem to contain any such provision in its definition.

The combined code provides to the effect that an independent director may not be a representative of a significant shareholder. King II defines such director as one who is not a representative of a controlling shareowner, while in the Australian code, he is not a substantial shareholder of the company or an officer, or otherwise associated directly with, a substantial shareholder of the company. This could be interpreted to mean that under the combined code and King II definitions, an independent director could be a significant shareholder himself or an officer of a significant shareholder.[66] If this was the intention of the drafters of these codes then the aim would be defeated for the whole idea behind this element of the definition is to ensure that the independent director in performing his duties would not act to protect the interests of only a constituency of shareholders, to wit, controlling shareholders. He is expected to be independent of

[66]. 'In the U.K. where shareholding is relatively widely dispersed, shareholding is not generally viewed as impeding director independence; some would argue that shareholding aligns directors' interests with those of the entire shareholding body' – Weil, Gotshal and Manges, 'Comparative Study of Corporate Governance Codes Relevant to the European Union and Its Member States' Final Report, 2002.

management in order to be able to protect the interests of all shareholders, and not a section of them. It would be difficult to achieve this where the director himself is a significant shareholder or an officer of a significant shareholder.[67] Indeed, there would be a conflict of interest in such a situation. This is not to say by any means that the independent director should be more disposed to act in the interest of shareholders. Indeed independent directors, by their personal qualities should not be different from other directors. The interests of the shareholders as a whole should ideally be represented by all directors.

Another element of the King II definition is that an independent director must not be a professional advisor to the company or group. The Australian code more elaborately provides that he must not have, within the preceding three years, been a principal or employee of a material professional adviser or consultant to the company or group. The use of the word 'material' presupposes that there are professional advisers and consultants that are considered to be non-material. In other words, maintaining links with such may not be detrimental to the company or the director's sense of independence. Therefore, such director may still be considered to be independent even where he is a principal or employee of a non-material professional adviser or consultant to the company. Again, the objective of this element it would seem is to avert the conflict of interest problem, and therefore lack of independence that would almost certainly arise where a director is also an adviser or consultant to the company. The Combined Code is silent on this issue.

However, the Combined Code states that an independent director must not have, or have had, within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company. The problem here is that it is difficult, if not impossible, to determine what could constitute a 'material business relationship' for it could include legal, commercial, consulting or even a familial relationship. All relevant circumstances

---

[67]. Such directors are often referred to as affiliated directors. According to the U.S. Securities and Exchange Commission, when stock ownership is enough to lead to control, affiliation exists and independence disappears.

of a particular director's business relationships would have to be taken into consideration in order to determine whether they are material enough as to interfere with his sense of independence or lead to a conflict of interests.

One element of the Australian definition which does not appear in King II is that an independent director must not have served on the board for a period which could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company. The question that arises is what constitutes a reasonable period that could materially affect a director's sense of independence? What is reasonable in one particular circumstance may not be reasonable in another. The Combined Code is more specific when it provides to the effect that serving more than nine years from the date of first election would be relevant to the determination of a director's independence. This is consistent with the definition of the NAPF[68] which states that an independent director must not have served as non-executive director for more than three 3 year terms (nine years).

King II provides that an independent director must not be a member of the immediate family of an individual who is, or has been in any of the past three financial years, employed by the company or the group in an executive capacity. The combined code similarly provides that having close family ties with any of the company's advisers, director's or senior employees would be relevant in determining a director's independence. The Australian definition has no such provision. However, it is stated elsewhere that family ties and cross-directorships may be considered as interests and relationships which may compromise independence.

It is difficult to explain exactly what constitutes 'family ties'. It is quite an ambiguous and generic term. Does it mean immediate family members only or does it include other extended family relatives? King II is more explicit when it states '…is not a member of immediate family'. There's also the question of what constitutes 'immediate family'. Some define it to include spouse, parents, children, siblings, mothers and fathers-in-law,

[68]. National Association of Pension Funds, U.K.

sons and daughters-in-law, brothers and sisters-in-law, and anyone who shares such person's home.[69] However, whether extended or immediate family ties, it may be safe to assume that, for this purpose what is to be considered are such family links that are capable of interfering with a director's independent judgment. The board would have to consider individual circumstances of each director in this regard.

The combined code definition also provides that an independent director must not receive additional remuneration apart from his director's fees nor must he participate in the share option or a performance-related pay scheme of the company. He must also not be a member of the company's pension scheme. Receiving additional remuneration or other compensatory benefits apart from his fees as director could certainly affect the director's sense of judgement. It is however difficult to see how participating in the company's share options would interfere with his independence. If anything, share options should operate as an incentive for aligning the interests of directors with those of the shareholders, and therefore leading to greater independence from management. This could also be seen as a solution to the agency problem in corporate governance brought about by the separation of control from management.[70]

One other element in the Combined Code definition is that the independent director must not hold cross-directorships or have significant links with other directors through involvement in other companies or bodies. The element of cross-directorships also features in the Australian definition. It is logical to argue that the holding of cross-directorships is capable of compromising a director's sense of independence. For instance, where the director also sits on the board of a competing company, there's no doubt that this is a signal for potential conflict of interest. It is difficult, if not impossible to see how such director would be able to honour his fiduciary duty of acting in the best interest of the company 'at all times' without there arising conflict situations and ultimately lack of independence. There lies the potential danger in holding cross-directorships.

---

[69]. This is the definition of CalPERS and the NYSE.

[70]. Some commentators however oppose the holding of share options by directors because of the risk of undesirable focus on share price rather than underlying corporate performance.

It is however difficult to anticipate or provide for all circumstances or relationships that could amount to 'significant links' with other directors. In today's business circles, most directors are known to have multiple business relationships among themselves and involvements in different companies. This is particularly in countries where the pool of corporate directors is limited to a small group of individuals. In such countries it is common to find one individual holding as many as four or five directorship positions at the same time.[71] Board memberships tend to be rotated among the same crop of individuals and as a result, collegial bonds, both business and casual are formed between them. Some of these relationships are significant and indeed end up having a negative impact on the exercise of objective and independent judgment by these directors, especially where vested interests must be protected. Indeed, the independence of a director should depend on all relationships the director has, including relationships with other directors, which may compromise the director's objectivity and loyalty to the company.[72]

FRENCH CODE VS. NYSE RULES

This part of the study is an analysis of the definition of independent director as contained in the French Code of Corporate Governance for Listed Corporations, on the one hand, and the definition as contained in the NYSE Corporate Governance Rules, on the other hand. One important point to note is that the NYSE rules are of a mandatory character, and therefore companies listed on the exchange are required to comply with its provisions.[73] This is different from the French code which is of a voluntary character. While the NYSE can sanction companies that do not comply with the provisions of its corporate governance rules,[74] the provisions of the French code, and most other codes,

[71]. This is particularly true in countries like South Africa where some individuals hold as many as eight board memberships.

[72]. Council of Institutional Investors op cit note 46.

[73]. The final rules are codified in Section 303A of the NYSE's Listed Company Manual available at www.nyse.com.

[74]. The NYSE may issue a public reprimand letter to any listed company that violates its listing standards. In this regard, each listed company CEO must promptly notify the NYSE in writing after any executive

are recommendations that are, at the most, of a persuasive character. Companies may elect to observe their recommendations or not. This trend is however fast changing as in many jurisdictions now, stock exchange rules require companies to disclose their level of compliance with standards as proposed in these codes.[75] In such jurisdictions, non-compliant companies could be sanctioned for not adopting universally accepted corporate governance standards. This is apart from the fact that owners of capital would prefer to invest in companies with good corporate governance practices.

Another observation is that the NYSE definition tends to equate the independence of a director to the amount of monetary compensation he receives from the company. In determining the independence of a director, emphasis is placed on the amount of compensation he or his family member receives from the company, or on his relationship with another company that receives or makes payments to his company. This attitude of the NYSE definition may not be unconnected with the recent upsurge in executive remuneration in the US and other parts of the world. Indeed, factors such as excessive executive remuneration, executive greed and ostentation have been identified as some of the underlying causes of recent corporate failures. This attitude can also be seen in the Sarbanes Oxley Act[76] and the Securities Exchange Act[77] which define an independent director (for audit committee purposes only) as one who accepts no compensation from the company other than a director's fees and is not an 'affiliated person' of the company or any of its subsidiaries. This attitude of the NYSE is quite different from the French and other definitions which tend to focus more on the director's relationships with other stakeholders or bodies linked to the company in one way or another, and which may or may not necessarily involve any monetary compensation.

---

officer of the listed company becomes aware of any material non-compliance with any applicable provisions of the rules.

[75]. In U.K., South Africa and Australia for instance, the respective stock exchange rules require that listed companies comply with the corporate governance standards in their various codes, and that they disclose the level of compliance in their annual reports.

[76].Sarbanes Oxley Act s 301.

[77]. Securities Exchange Act Rule 10A-3.

Another observation worth mentioning about the NYSE independent director definition is that each of the criteria contains a three-year 'look-back' period.[78] In other words, when determining whether a director is independent with regard to a particular criterion of the definition, the board must consider the director's relationships or interests in the three years immediately preceding the determination. The French definition on the other hand, contains a five-year 'look-back' period.[79] Whether five years or three years, what is critical is the materiality of the particular relationship or interest under consideration, and whether it is such that could hinder the director from acting in an independent manner. The board must examine the peculiar circumstances of each director in this regard. This is necessary because merely satisfying the 'look-back' requirement will not automatically guarantee a director's independence. Despite having met the formal criteria, such director may still be unable to display an independent attitude or objective judgement when dealing with corporate decisions. As earlier stated, there is more to independence than a mere satisfaction of a set of formal criteria.

Another interesting feature of the NYSE definition is that it also covers the immediate family members of the director. In other words, in determining the independence of a particular director, the circumstances and relationships of his immediate family members are to be taken into consideration by the board. This feature runs through almost all the criteria contained in the definition. In the commentary to the first criterion, it is stated that 'immediate family member' includes a person's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers, and sisters-in-law, and anyone who shares such person's home, other than domestic employees.[80] This definition of immediate family member is indeed quite encompassing and should be adopted by other codes when defining 'family ties'. Other definitions do not place as much emphasis on immediate family members and their relationships.

The French and NYSE definitions are similar with respect to only one criterion; that an independent director must not be an employee of the company. The French definition

---

[78]. This is consistent with the Australian and South African independent director standards.
[79]. This is consistent with the CalPERS and CII independent director standards.
[80]. NYSE 'Final Corporate Governance Rules' General commentary to s 303A.02 (b).

adds that he must also not be a corporate officer of the company or an employee or director of its parent or a company that it consolidates, and must not have been such in the previous five years. The NYSE definition on the other hand adds that such director's immediate family member must also not be an executive officer of the company, and must not have been such in the previous three years. In the commentary on this criterion, the NYSE definition states that references to the company also include its parent or a subsidiary of the same group. It states further that employment as an interim chairman or CEO shall not disqualify a director from being considered independent following that employment.

First of all, it is difficult to understand the seeming distinction between an employee, on one hand, and a corporate officer, on the other hand. Indeed one might ask if it is possible to be a corporate or executive officer without first being an employee. Granted, not all employees are corporate or executive officers of the company; but is it possible to hold the position of corporate or executive officer as a non-employee? Holding such position would connote that one is an employee of the company, for even executive directors are generally regarded as employees of the company. Therefore the use of both terms in the French definition is repetitive and may lead to confusion. All other codes under consideration seem to appreciate this view by avoiding such a repetitive use of the terms.[81]

Secondly, it is difficult to understand why a director previously employed as an interim chairman or CEO would still be considered to be independent. This is particularly in the US where it is common practice to find both positions being occupied by the same individual. It is unarguable that the CEO is the 'chief executive director' of the company, and that executive directors are employed in terms of a contract with the company as employer, hence their being referred to as inside directors. Many board chairmen are involved in executive and day to day management of the company and would not satisfy even the least standards of independence in this regard. Some may argue that the rationale for considering such directors as independent lies in the temporariness of the

[81]. The King II, Australian, NYSE and Combined Code definitions all use only the word employee.

position (as interim chairman or CEO). The fact still remains however, that such director would have been so involved in executive management of the company that it would be almost impossible for him to act independently in the future. In such situation, the least that could be done would be to apply the three-year look-back requirement, barring all other considerations, to ensure the absence of any potential conflict of interests.

In another criterion, the French definition provides that an independent director must not be ' a corporate officer of a company in which the corporation holds a directorship, directly or indirectly, or in which an employee appointed as such or a corporate officer of the corporation (currently in office or having held such office going back five years) is a director'. The rationale for this provision it would seem, lies in the fact that it would be impossible for such director to apply his independent judgment when taking decisions that affect the other company, because of his links with the company. As corporate officer of that other company, he would definitely be an insider and therefore be privy to inside information regarding the company. Such a situation would certainly result in a conflict between his interest as a director on one hand, and as corporate officer of the other company, on the other hand. The second limb of this criterion seems to be referring to cross-directorships. Holding of cross-directorships could be detrimental to an independent director's objective judgment.[82] It could lead to relationships or interests which could end up compromising the independence of such director. This is why it is considered very relevant in determining a director's independence.[83]

The French definition further provides that an independent director must not be (or be bound directly or indirectly to) a customer, supplier, investment banker or commercial banker that is material for the corporation or its group; or for a significant part of whose business the corporation or its group accounts. King II and the Australian definition both contain similar provisions. The difference here is the addition of the investment or commercial banker element. The assumption is that these elements were included as an

---

[82]. King II code encourages executive directors to take other non-executive directorships, provided these are not detrimental to their responsibilities as executive directors.

[83]. The Australian and Combined codes state that cross-directorships may be relevant when considering relationships and circumstances which may compromise independence.

additional safeguard for protecting and promoting independence. In doing this however, care must be taken to ensure that the requirements do not become too stringent or cumbersome so as to make it practically impossible for directors to meet the requirements. The important factor to be considered is the materiality of the relationship or interest under consideration; whether it is potentially detrimental to, or capable of compromising the director's independent judgment.

The first criterion of the NYSE definition disqualifies a director from being considered independent unless he has no material relationship, directly or indirectly, with the company. Such relationship could be as a partner, shareholder or officer of an organisation that has a relationship with the company. Again the issue of materiality of the relationship to the company surfaces. Indeed, in the commentary to this criterion, it states:

> It is not possible to anticipate, or explicitly to provide for, all circumstances that might signal potential conflicts of interest, or that might bear on the materiality of a director's relationship to a listed company…Accordingly, it is best that boards making "independence" determinations broadly consider all relevant facts and circumstances. In particular, when assessing the materiality of a director's relationship with the company, the board should consider the issue not merely from the standpoint of the director, but also from that of persons or organisations with which the director has an affiliation. Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships among others.[84]

In addition, materiality should be considered in relation to the independence of the director. In other words, the question should not only be whether the relationship is one that is material, but also whether such material relationship is one that might signal potential conflicts of interest. For indeed, not all material relationships that are capable of compromising director independence. The approach should therefore be two-fold; is the director's relationship one that is material to the company? Secondly, is it one that is potentially detrimental to the director's sense of independent judgment? Like the commentary stated, it is not possible to anticipate all circumstances that might result in conflict of interest. This is probably why certain codes like the French and Combined codes give the board the latitude to determine that a director is independent, or vice versa despite the existence of relationships or circumstances which appear relevant to such

[84]. NYSE 'Final Corporate Governance Rules' Pg 4.

determination. In this regard, a board is expected to adopt its own independence standards and must explain when a particular director is declared to be independent despite having not met the prescribed standards of the company.

The NYSE definition further provides that a director is not independent if he, or his immediate family member receives more than $100,000 per year in direct compensation from the company other than his director's fees and pension. The focus here, as stated earlier, seems to be on the amount of direct compensation the director or his family member receives from the company. Going by this criterion, it means that a director could be considered to be independent where he receives more than $100,000 per year as long as it is indirect compensation. Likewise, he could be considered to be independent even where he receives $99,999 per year in direct compensation. Therefore, so long as the amount is not more than $100,000 per year, and the compensation is not direct, such director could be considered to be independent of the company. This certainly seems absurd.

Another criterion of the definition provides that a director is not independent if he or his immediate family member is affiliated with or employed by, a present or former internal or external auditor of the company. The French definition has a similar provision. It provides that an independent director must not have been an auditor of the corporation within the previous five years. The difference is between the two definitions is in the inclusion of the terms 'affiliated with' and consideration of the director's immediate family member, in the NYSE definition. Indeed, generally speaking, the inclusion of such a standard seems quite logical, as it would be difficult, if not impossible, for a director who sits on the audit committee for instance, to act in an independent manner where he had himself been an auditor of the company. The same applies to where he or his immediate family member is affiliated with, or employed by a present or former auditor of the company.

The difficulty here is however in determining what kind of relationship would constitute an affiliation. Also, considering the fact that there are varying degrees of affiliation, and it may be difficult to anticipate all the relationships or circumstances that could amount to such. However, with the goal being to eliminate, or minimise as much as possible, all potential causes of a conflict of interest between the director and the company, the board must consider the circumstances of the director thoroughly to determine whether he could be described as 'affiliated' , for it has been stated that where affiliation exists, independence disappears.

In another criterion the NYSE definition provides that a director 'who is employed, or whose immediate family member is employed, as an executive officer of another company where any of the listed company's present executives serve on that company's compensation committee is not independent'. This element of the definition is quite interesting because of the reference to the 'compensation committee'. The question that comes to mind is why the specific reference to 'compensation committee' and not 'nomination committee' or 'audit committee?' Indeed, it is arguable that these three are the most significant committees of the board to which the role of the independent director is very critical.[85] Even though the audit committee is sometimes considered more important and therefore given more prominence by many commentators (probably because of the many accounting and auditing scandals), there's no doubt that the three committees are key, not only to the effective functioning of the board, but also have become critical mechanisms for ensuring compliance with independence and other corporate governance standards.[86]

An affiliation with any of these three key committees could certainly impair a director's sense of independence. Whether it is the compensation, audit or nomination committee, a director, in the circumstances described in the definition, should not qualify as an independent director. Granted that the responsibility of the compensation committee is to make recommendations to the board with respect to the compensation and other benefits

[85]. Some commentators would include a corporate governance committee to the list of critical board committees.

[86]. It makes sense to place independent directors on audit committees (in case management is cooking the books), compensation committees (so management does not set its own salary), and nominating committees (so management does not select the board that is tasked with overseeing it). – Usha Rodrigues, *'The Fetishization of Independence'* (2007) University of Georgia School of Law, Research Paper Series, P.7.

of the CEO and other executives of the company, the specific reference to this committee (and exclusion of the other committees) in the definition seems unclear. As mentioned earlier, the NYSE's attitude to independence is significantly compensatory. It associates the standard of independence with the amount of compensation or pecuniary benefits that a director receives. The more compensation a director receives, the more unlikely he is to be independent. This may be the reason behind the specific reference to the compensation committee. This should however not be interpreted as portraying it as the pre-eminent committee of the board.

The last limb of the NYSE definition provides that 'a director who is an executive officer or an employee, or whose immediate family member is an executive officer, of a company that makes payments to, or receives payments from, the listed company for property or services in an amount which, in any single fiscal year, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues, is not independent ….'. This again reflects the attitude of the NYSE definition of measuring independence by the amount of monetary benefits paid to, or received by a director or company. One wonders why charitable organisations are not considered as 'companies' for the purposes of this criterion. As the first limb of the definition recognises, relationships with charitable organisations are to be considered when determining circumstances that could lead to conflicts of interest, for indeed such relationships could be material. The commentary on this criterion states however that 'a listed company shall disclose in its annual proxy statement,…any charitable contributions made by the listed company to any charitable organization in which a director serves as an executive officer…'.[87]

[87]. NYSE 'Final Corporate Governance Rules' P.6 Commentary on s 303A.02(b)(v)

PART 2

CHAPTER THREE

INDEPENDENT DIRECTOR AND FIRM PERFORMANCE

The clamour for increased independence on corporate boards by independence proponents may have largely triumphed. As earlier stated, most commentators applaud the trend toward greater board independence.[88] Today, commentators speak of the 'norm' of a supermajority independent board while corporate governance activists clamour for boards on which independent directors make up a 'substantial majority'.[89] In proclaiming the need for an 'independent watchdog', scholars argue that 'an active and independent board of directors working for shareholders clearly would seem to benefit the corporation by reducing the losses from misdirected 'agency' inherent in the separation of ownership from control that is fundamental to the modern corporation'.[90] Today many large American public companies have "supermajority" independent boards, with only one or two inside directors. For example, a 1997 survey of 484 of the S & P 500 firms found that over half (56%) of the surveyed firms had only one or two inside directors.[91] 'Only nine firms (2%) had a majority of inside directors and the median firm had over 80% outside directors.'[92] As of 2001, approximately 75% of NYSE-listed companies had independent board majorities and 65% of directors of S & P 1500 companies were independent. 'By the time of the enactment of the Sarbanes-Oxley Act in 2002, most public corporations had a supermajority independent board, with only one or two inside directors'.[93]

---

[88]. Sanjat Bhagat and Bernard.Black, *'The Uncertain Relationship Between Board Composition and Firm Performance'* (1999) 54 Business Lawyer, P.2.
[89]. Usha Rodrigues, *'The Fetishization of Independence*' (2007) University of Georgia School of Law, 07 Research Paper Series, P.15. Available at www.ssrn.com/abstract.
[90]. Usha Rodrigues op cit Pg. 14.
[91]. Defined broadly as all current and former company officers, even though some researchers consider former officers to be outside directors if several years have passed since they last served as officers – Bhagat & Black op cit note 86.
[92]. Bhagat and Black, ibid.
[93]. Usha Rodrigues op cit note 88 P.14.

Despite this recent trend towards increased representation by independent directors, some proponents of independent directors acknowledge that inside directors serve an important, if not vital function on a company's board.[94] The argument is that, because of their direct involvement with day-to-day corporate activities, inside directors are better positioned to make decisions at the board level that will affect both the short-term and the long-term direction of the company.[95] Indeed, there is some evidence that having a moderate number of inside directors (say three to five on a typical eleven-member board) correlates with greater profitability.[96] On the other hand, studies of overall firm performance have found no convincing evidence that firms with majority-independent boards perform better than firms without such boards.[97] One could argue that the inclusion of the outside independent directors may actually hamper the efficient operation of a board of directors.[98] 'Because of their limited involvement with corporate activities, outside independent directors do not have exposure to the day-to-day activities of the firm, and thus could prove to be an impediment to management in their attempts to manage and monitor the operations of the firm'.[99]

According to some commentators, independent directors 'often turn out to be lapdogs rather than watchdogs'. Reference is made to companies like Enron, Hewlett-Packard, GM, IBM, Kodak, Chrysler, Sears, and Westinghouse etc, which performed abysmally for years despite their majority independent boards. Others like WorldCom, Apple, Converse, United Health, to name only a few, have been tainted by scandal. Also, 'chief executive compensation exploded over the same period during which independent directors became dominant on large firm boards - a trend that has continued despite the recent trend toward supermajority-independent boards and independent compensation committees'.[100] These and related events have therefore brought into question the role of the independent director in relation to monitoring management, rendering independent

---

[94]. Steven Petra, *'Do Outside Independent Directors Strengthen Corporate Boards?'* (2005) Corporate Governance, Vol. 5, N0.1. available at www.emeraldinsight.com/insight
[95]. Steven Petra, ibid.
[96]. Bhagat & Black op cit note 86 P.3.
[97]. Bhagat & Black, ibid.
[98]. Steven Petra op cit note 92.
[99]. Steven Petra ibid.
[100]. Bhagat & Black op cit note 86 P.4.

judgement on managerial performance and ultimately in relation to the performance of the firm. The question has therefore been frequently asked, does increased board independence translate to improved corporate performance?

This chapter reviews evidence discovered from various empirical studies undertaken by selected scholars and commentators. These will show that the overall evidence on the impact of independent director on firm performance is inconclusive, and sometimes conflicting. While some studies produce evidence that independent directors do not enhance corporate performance, on the one hand, on the other hand other studies produce some evidence that independent directors add value in certain areas like the performance of specific board tasks. (This evidence tends to point out that majority independent boards perform some specific functions better, but other functions worse).[101] The first part of this chapter therefore reviews evidence produced from studies on the impact, if any, of independent directors (or majority-independent boards) in the performance of specific board tasks, like making or defending a takeover bid, CEO replacement, executive remuneration, and financial reporting. It also briefly examines evidence produced from studies on the possible benefits on firm performance, of certain mechanisms like separation of the positions of CEO and Chairperson of the board, and the use of audit, compensation and nomination committees composed entirely of independent directors. In the second part of this chapter, we examine direct evidence on the correlation between independent directors (board composition) and overall firm performance.

DO INDEPENDENT DIRECTORS ADD VALUE?

TAKEOVERS

One important role of the board of directors of a company is approving (or not) major investment decisions like the acquisition or takeover of another company.[102] If independent directors genuinely represent the interests of shareholders, and if they strive

---

[101]. Jeffrey Lawrence and Geof Stapledon, *Do Independent Directors Add Value* (1999) Centre For Corporate Law and Securities Regulation, University of Melbourne, P. vii.

[102]. Bhagat & Black op cit note 86 P.10.

to maximise shareholder wealth, then their influence should be reflected in the takeover process.[103] (The stock price reaction to the announcement of a takeover bid provides a measure of whether shareholders think the acquirer has gotten a bargain or has overpaid)[104]Indeed, some empirical evidence does suggest that independent directors do play an important role of shareholder advocate.[105]A research study by Byrd and Hickman reports that shareholders benefit more when independent directors constitute the majority of the board in tender offers for bidders.[106]They found that, 'for a sample of 128 takeover bids over the period 1980 to 1987, takeover bidders with a majority of independent directors earned, on average, an announcement-date abnormal return of 0% on their acquisitions while bidders with a majority of executive and affiliated non-executive directors lost, on average, a statistically significant amount'.[107]This appears to be because bidders with majority-independent boards offer lower takeover premia.[108]It also appears to show that independent directors, while permitting their companies to pay too much when acquiring another company, were not prepared to over-pay as much as non-independent directors.[109]

With regard to responses to a takeover offer, some studies have shown that tender offer target companies with majority-independent boards realize higher stock price returns than target companies without majority-independent boards.[110]This appears to show that target companies with majority-independent boards are better at extracting higher takeover premia from an acquirer, thereby providing increased economic benefits to shareholders. However, Bhagat and Black argue that there cannot be greater efficiency gains if the target company has a majority-independent board of directors. They argue that a higher takeover price is simply a transfer of wealth from the bidder's shareholders to the target's

[103]. Lawrence & Stapledon op cit note 99 P.10.
[104]. Bhagat & Black op cit note 86 P.10.
[105]. Steven Petra op cit note 92
[106]. Steven Petra, ibid.
[107]. Lawrence & Stapledon op cit note 99 P.10.
[108]. Bhagat & Black op cit note 86 P.10.
[109]. Lawrence & Stapedon ibid.
[110]. J Cotter, A Shivdasani & M Zenner, *'Do Independent Directors Enhance Target Shareholder Wealth During Tender Offers?'* (1997) 43 Journal of Financial Economics P.195.

shareholders,[111]and that there is no evidence of higher returns to both bidder and target companies, if the target company has a majority-independent board. They conclude that higher returns to shareholders of actual target companies may not benefit shareholders of potential target companies, because there's some evidence that this could lead to fewer takeover bids for companies with majority-independent boards.[112]

The perception that independent directors are better at maximising shareholder wealth may be misplaced after all especially with regard to the adoption of takeover defences. Some studies report that the stock market reaction to the adoption of poison pill defences was significantly positive when the firm had a majority-independent board, and significantly negative when it did not.[113]On the other hand, some other studies find a negative stock market reaction to adoption of poison pills and other takeover defences when there's a higher proportion of independent directors. Still others have found no significant correlation between the proportion of independent directors and the likelihood that the company will adopt a poison pill defence.[114] Also with regard to the adoption of greenmail as a takeover defence, companies with a high proportion of outside directors are more likely to pay greenmail to a potential bidder to persuade the bidder to go away.[115]Overall there isn't much evidence that independent boards behave in a significantly more (or less) shareholder-friendlier fashion than other boards when they adopt and employ takeover defences.[116]

CEO REPLACEMENT

There is widespread acceptance that a central role of the board is disciplining or replacing an under-performing CEO. There is little evidence pointing to a difference in attitude of independent directors and inside directors towards the replacement of a CEO. In an in-

---

[111]. Bhagat & Black are of the view that if shareholders are diversified, over a number of transactions, the bidder's shareholders and the target's shareholders are the same people.
[112]. Bhagat & Black op cit note 86 P. 8 – 9.
[113]. Bhagat & Black op cit note 86 P.11.
[114]. Bhagat & Black op cit Pg.12.
[115]. Bhagat & Black, ibid.
[116]. Bhagat & Black, ibid.

depth study on how board composition correlates with CEO replacement, Weisbach[117] found that a board composed of at least 60% independent directors was more likely than a board comprising less than 60% independent directors to fire an under-performing company's CEO.[118]Other studies show that firms with a high proportion of outside directors replace CEOs at a higher rate than other firms.[119]There is also some evidence that firm performance improves modestly, on average, after a CEO is replaced.[120]However, other commentators argue that the economic significance of the additional firings by 60% independent boards is small. They argue that the evidence reflects that independent directors who are likely to know less about a firm than inside directors may be quicker to replace a CEO if the firm's performance is poor, but may be too slow to replace a bad CEO as long as the firm's stock price performance remains respectable.[121]

EXECUTIVE COMPENSATION

It is widely accepted that another critical role of the board of directors is determining and evaluating the remuneration of the CEO and other senior executive officers of the company. To strengthen the board in performing this task, it is popularly recommended that the compensation (or remuneration) committee of the board be composed mainly, if not entirely, of independent directors. The compensation committee can implement compensation arrangements that will help in achieving the company's long-term performance objectives and ensure that shareholder interests are not subordinated to management's short-term interests.[122]However some studies have reported that executive compensation is higher on average in firms with majority-independent boards.[123]Other studies reveal no evidence of a correlation between the proportion of independent

---

[117]. Michael S. Weisbach, *'Outside Directors and CEO Turnover'* (1988) 20 Journal of Financial Economics P.431.
[118]. Lawrence & Stapledon op cit note 99 P.9.
[119]. Bhagat & Black op cit note 86 P.7.
[120]. David Denis & Diane Denis, *'Performance Changes Following Top Management Dismissals'* (1995) 50 J. FIN. 1029, 1055.
[121]. Bhagat & Black op cit note 86 P.6.
[122]. Steven Petra op cit note 92.
[123]. Bhagat & Black op cit note 86 P.13.

directors on the compensation committee and CEO remuneration.[124] Conversely, several other studies have found that CEO remuneration is on average higher the greater the proportion of independent directors on the board. In other words, the higher the proportion of independent directors on the board, the more the CEO is paid.[125]

In a study of 161 of the 250 largest U.S. listed companies, it was reported that CEO compensation was greater in companies that had compensation committees that included affiliated non-executive directors (insider-influenced compensation committees) than in companies that had compensation committees comprised solely of independent directors (independent compensation committees).[126] The study found that 'on average, the CEO of a company with an insider-influenced remuneration committee received approximately 20% more remuneration than a CEO of a company with an independent remuneration committee, everything else equal'.[127] A study by Fich and Shivdasani found that 'the probability of a firm adopting a stock-option plan for outside directors is higher when the board is dominated by independent outside directors and when institutional equity ownership is high'.[128] In a different study involving 167 U.S firms, it was reported that the greater the CEO influence over the board of directors, the higher the levels of CEO salary and bonuses.[129] Also, a study of the banking industry reported that the proportion of outside directors correlated negatively with salary expenditures, suggesting that outside directors helped to control excessive salary expenditure.[130]

In their study of the value of the independent director in Australia, Lawrence and Stapledon reported that the remuneration practices of Australian companies do not appear to vary in accordance with the composition of the remuneration committee. Similarly, they found no evidence that combining the roles of CEO and chairperson, or having less

---

124. C.M.Daily et al *'Compensation Committee Composition As a Determinant of CEO Compensation'* (1996) 41 Academy of Management Journal, 209,P. 214.
125. Bhagat & Black op cit note 86 P.13.
126. Lawrence & Stapledon op cit note 99 P.11.
127. Lawrence & Stapledon, ibid.
128. Fich & Shivdasani, *'The Impact of Stock-Option Compensation For Outside Directors On Firm Value'* (2005) University of Chicago Journal of Business, Vol.78, No. 6, P. 2230.
129. Lawrence & Stapledon op cit note 99 P.11.
130. Bhagat & Black op cit note 86 P.14.

independent directors on the board, leads to higher CEO pay.[131] These studies, on the whole, indicate that the evidence on the relationship between independent directors (or board composition) and executive compensation is inconclusive. Similarly, even though the evidence has failed to clearly erase doubts as to the ability of independent directors to curb excessive executive compensation, there is no doubt that an independent compensation committee can strengthen corporate boards by effectively controlling and evaluating the level of executive compensation. Reference is sometimes made to the compensation committees of companies like Enron, Global Crossing Ltd. etc which were comprised entirely of independent directors who were unable to monitor and control excessive executive compensation.[132]

FINANCIAL FRAUD AND FINANCIAL REPORTING

With the passage of the Sarbanes Oxley Act in the U.S., all listed companies are required to establish audit committees comprised entirely of independent outside directors. The audit committee plays a critical role in maintaining the reliability of the company's financial statements. Indeed, it is widely believed that an independent audit committee has the potential to strengthen the board of directors through controlling management's reporting of financial results.[133]Empirical evidence on the relationship between an independent audit committee and the reliability of financial statements is conflicting. While some studies have found that companies with reliable financial information are more likely to have independent audit committees, others indicate that the presence of an independent audit committee does not increase the reliability of financial information.[134]One study found that companies with a majority of inside (executive) directors and without an audit committee were more likely to commit financial fraud.[135]A similar study found that firms that commit fraud have fewer independent directors than matched control firms that did not commit fraud.[136]Conversely, a different study found no

[131]. Lawrence and Stapledon op cit note 99 P.vii.
[132]. Steven Petra op cit note 92.
[133]. Steven Petra ibid.
[134]. Steven Petra, ibid.
[135]. Bhagat & Black op cit note 86 P.15.
[136]. Bhagat & Black, ibid.

evidence that board composition affects the overall quality of financial reporting by U.S. companies.[137]

INDEPENDENT DIRECTOR AND FIRM PERFORMANCE

We now examine existing empirical evidence (mostly US based) on the relationship between independent directors (or board composition) and corporate performance. The results again are mixed and inconclusive. 'The controversy revolves around whether or not board composition has any impact on the performance of the firm.'[138] While some studies report that having more independent directors on the board improves corporate performance, other studies have not found any correlation between independent directors and corporate performance.[139]Those studies that indicate some link between independent directors and firm performance include a study by Baysinger and Butler which reports that the proportion of independent directors in 1970 was positively correlated with return on equity in 1980.[140]'Firms with a higher percentage of independent directors in the early part of the decade ended up with superior performance records, on average, later in the period'.[141]Also a study of 100 small listed U.S. companies found that 'financial performance was better in companies having a relatively large number of independent directors than in those having a relatively small number of independent directors'.[142] Other studies like Gautchi and Jones (1987), Cochrane et al. (1985), Zahra and Stanton (1988), Rosenstein and whyatt (1990), and Donaldson and Davis (1991) found that board composition had a strong influence on the accountability of managers to shareholders and the performance of the firm.[143]

---

137. Bhagat & Black op cit note 86 P.16.
138. Henry Udueni, *'Power Dimensions in the Board and Outside Director Independence: Evidence from Large Industrial UK Firms'* (1999) Corporate Governance: An International Review, Vol.7, No.1. P.63. Available at www.blackwell-synergy.com.
139. Steven Petra op cit note 92.
140. Lawrence & Stapledon op cit note 99 P.7.
141. Barry Baysinger & Henry Butler, *'Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition'* (1985) 1 Journal of Law, Economics and Organization, Vol. 1, NO.1, P.116.
142. Lawrence & Stapledon op cit note 99 P.8.
143. Henry Udueni op cit note 136 P.63.

Among those studies that found a negative correlation between a high proportion of independent directors and future firm performance is the study by April Klein, which assessed the composition of the boards' committee structures of firms listed on the S & P 500. She found that the proportion of independent directors had no consistent effect on firm performance.[144]She also found that 'inside directors are more likely to be found on the boards of firms that need the inside director's expertise, which suggests that these directors can be valuable if properly used'.[145]In another study by Agrawal and Knoeber, it was found that a greater proportion of independent directors reduce the firms performance.[146]In other words, greater board independence is negatively related company performance. In one of the most comprehensive and large-scale studies ever done in this area, Bhagat and Black found no evidence that firms with a majority-independent board perform better than firms with more inside than independent directors.[147]Instead, a high proportion of independent directors was found to correlate with slower growth. They also found that it may be valuable for firms to have a significant number of inside directors. They studied the financial and stock price performance, between 1985 and 1995, of 957 large U.S. public corporations. They also studied share ownership by management, the board of directors, and 5% shareholders of these companies, and they found that independent directors with significant stock positions may add value, whereas others do not.[148]

In a study of the independent director in Chinese corporate governance, Donald Clarke reports that there is no strong empirical evidence to support the view that independent directors in China enhance corporate performance.[149]In another study of the top 100 listed companies on the Australian Stock Exchange, it was found that there was no conclusive evidence that the proportion of independent directors influences corporate

---

[144]. April Klein, *'Firm Performance and Board Committee Structure'* (1998) Journal of Law and Economics, Vol. 41, P.300.
[145]. April Klein, op cit Pg. 300.
[146]. A. Agrawal and C. Knoeber, *'Firm Performance and Mechanisms to Control Agency Problems Between Managers and Shareholders'* Journal of Financial & Quantitative Analysis, Vol. 31, P.393.
[147]. Bhagat & Black, op cit note 86.
[148]. Bhagat & Black, op cit note 86.
[149]. Donald C. Clarke, op cit note 45 P. 205.

performance, whether measured as share price returns or accounting performance.[150] The studies failed to produce solid evidence supporting the proposition that independent directors add or destroy value.[151]A similar study, of the relationship between board demographics and corporate performance in 348 of Australia's largest publicly listed companies, reported a positive relationship between the proportion of inside directors and the market-based measure of firm performance.[152] On the other hand however, no such relationship was found with respect to the accounting-based performance measure.[153]

In a different study, Millstein and McAvoy adopted a different approach by focusing on board behaviour rather than board composition. They found a substantial and statistically significant correlation between the presence of an active board of directors and superior corporate performance (measured by operating profit excess of costs of capital over the industry average).[154] In their words:

> Our experience is that boardroom behaviour is what is critical, and that the professional board is an active monitoring (but not meddling) organisation that participates with management in formulating corporate strategy in the interests of the shareholders, develops appropriate incentives for management and other employees to harness their interests to achieve the agreed-upon strategic plan, and then judges the performance of management against the strategic plan. Given this position, one cannot identify through generic structural characteristics – such as the number of outside directors, the number of board meetings, and the like – whether a board is performing. The only certain way to know whether a board is performing is to be present in the boardroom, and we cannot be present. But certain elements of board process indicate that there is an environment in which active monitoring is present. And to identify well-governing boards, we believe certain process representatives can be used to indicate monitoring performance.

The process representatives referred to by Millstein and McAvoy were; independent board leadership – whether through a non-executive chairperson or a lead independent director; periodic meetings of the boards independent directors without the presence of management; and formal guidelines to regulate the relationship between the board and management.[155] Millstein and McAvoy considered that these representatives indicated

---

[150]. Lawrence & Stapledon op cit note 99 P.vii.
[151]. Lawrence & Stapledon, ibid.
[152] Geoffrey C. Kiel & Gavin Nicholson, *'Board Composition and Corporate Performance: How The Australian Experience Informs Contrasting Theories of Corporate Governance'* (2003) Corporate Governance: An International Review, Vol.11, No.3, P.201.
[153]. Kiel & Nicholson, ibid.
[154]. Lawrence & Stapledon, op cit note 99 P.8.
[155]. Lawrence & Stapledon, ibid.

board behaviour from which it could be inferred that a board is independent, is likely to have adopted a professional culture, and is therefore a well-governed board.

From these various studies reviewed here, it can be observed that there is no apparent consensus among scholars and researchers about the relationship between board composition and firm performance. There is no conclusive evidence that the appointment of independent directors has an impact on firm performance. There is also inconclusive evidence that a greater proportion of independent directors results in improved levels of performance. Similarly the evidence that a preponderance of inside directors on the board results in better firm performance is also inconclusive. However, in sum, there's no doubt that a greater number of corporate governance advocates seem to favour an increased role for the outside independent director in control and management of the firm. This is consistent with the agency cost rationale that independent directors, by monitoring and overseeing the management of the company's business, serve to reduce the cost occasioned by the divergence between the interests of corporate managers and that of shareholders.

CHAPTER FOUR

TOWARDS MORE EFFECTIVE CORPORATE GOVERNANCE

The heightened global attention to corporate governance in recent years is evidence to the fact that all is not well with leadership of our corporations. One lesson that Enron, Parmalat, Worldcom and others taught the corporate world was that no company can be too big (financially or otherwise) to fail. A common thread that ran through these monumental corporate failures was their poor corporate governance culture, to wit, poor management, fraud, insider abuse by the board members and management, poor asset and liability management, poor regulation and supervision.[156]These events, along with other instances of failed corporate governance, have been identified as the principal causes of the loss of confidence by the investing public in the stock markets, and the general lack of trust that has plagued the business community.[157]Indeed, shareholders, employees, creditors and the general public place broad trust and authority in the corporate directors to ensure the success of our business institutions.[158]'Unfortunately, it took the recent wave of corporate corruption and abuses to focus our attention on the board of directors and on corporate governance more broadly'.[159]These corporate abuses have severely affected investor and public confidence and trust in the integrity of business institutions and leadership.

Most surveys on global trust levels show that public trust in business institutions and leadership is at a low level.[160]Corporate governors have continually failed to live up to

---

156. Inam Wilson, *'Regulatory and Institutional Challenges of Corporate Governance in Nigeria Post Banking Consolidation'*, Nigerian Economic Summit Group (NESG) Economic Indicators (April – June 2006) Vol. 12, No.2, P.1.

157. Oliver Williams, *'Restoring Public Trust In Business: The Crucial Role of Good Corporate Governance'* (2005) Corporate Governance Conference, Eastern Academy of Management, P.3. In the US, corporate governance reform has become a highly charged political issue because half of all adults own stock either directly or indirectly – Jeswald W. Salacuse, op cit note 2 P.69.

158. Troy Paredes, *'ENRON: The Board, Corporate Governance and Some Thoughts on the Role of Congress'* (2003) Faculty Working Paper Series, Washington University School of Law, P.2. Available at www.law.wustl.edu/faculty/workingpapers

159. Troy Paredes, ibid.

160. Oliver Williams, op cit note 155 P.3. – A 2003 World Economic Forum report indicated that in a survey of some 15 countries, the percentage of persons saying that they had "A Lot" or "Some Trust" in the

our expectations, and ineffectual boards have continued to cast doubt on the entire corporate governance system.[161]Despite the proliferation of various codes, guidelines and other instruments of corporate governance best practices, and the continuous call for increased director independence, most studies have shown little or no correlation between the presence of independent directors (or board composition) and firm performance. Some studies have actually reported a negative correlation between the two elements. In the light of the growing scepticism as to the relevance and impact of the independent director, the tough question that must be answered therefore is, how do we ensure that independent (outside) directors are empowered to effectively perform their role of independent and active monitors of management, for the benefit of the shareholders? Put differently, 'how do we ensure that directors are accountable and act in the best interest of the corporation and its shareholders especially given that shareholders' legal and practical influence over the corporation is limited?'.[162]

Clearly, the challenge is therefore how to make independent directors more effective and responsive to their responsibilities. The conflicting evidence from the studies outlined above and the corporate abuses in Enron and other companies around the world teach us one thing; that independence is not enough. It is interesting to note that Enron Corporation had its board of directors composed of a majority of outside independent directors.[163]Of the 14 directors, only two were insiders. They reflected a wide range of business, finance, accounting and governmental experience. 'The board had all the committees one would hope to see, including an executive committee, finance committee, audit and compliance committee, and nominating and corporate governance committee. Perhaps most important to the board's monitoring role, the Enron audit committee had a model charter and was chaired by a former accounting professor who had served as the dean of the Stanford Graduate School of Business. Finally, the board regularly met five

executives of multinational companies averaged 33%. (www.weforum.org). Another survey conducted in 2004 concluded that majority of people (74%) continue to characterise corporate America's reputation as either "not good" or "terrible". (www.harrisinteractive.com).

[161]. Troy Paredes, op cit note 156.

[162]. Troy Paredes, op cit note 156 P.7.

[163]. Steven Petra, op cit note 92.

times a year, with special meetings called as needed'.[164]Clearly, the existence of such a 'great' board did nothing to prevent the auditing and accounting frauds that led to the failure of the firm. It looks like the board was only 'going through the motions and checking the boxes'.[165]

One fundamental concern that has been raised as a result of these turn of events relates to the utility of the independent director. It is often argued that independent directors lack the time, information, and motivation to manage the company effectively.[166]They are usually ignorant of what is happening inside the company.[167]Independent directors are by definition individuals from outside the corporation, who generally have demanding day jobs and other commitments that keep them from devoting much time to board affairs.[168]For example, directors often sit on multiple boards or are executives of other companies.[169]Some may be university professors, public office holders or individuals involved in private professional practice. For this reason, they rely on insiders and other employees who are more knowledgeable about the company's operations, for information and guidance in performing their duties.[170]This is in addition to the fact that these directors who must monitor management are, in most companies, appointed by the very managers they must monitor. This situation certainly leads to a loss of objectivity on the part of the director. It is also an incentive for passivity and acquiescence to management's initiatives and little incentive to actively monitor management where directors owe their positions to executive largesse.[171]'At its worst, such a board of directors becomes nothing but an executive's rubber stamp'.[172]

---

[164]. Troy Paredes, op cit note 156 P.13.
[165]. Troy Paredes ibid.
[166]. Usha Rodrigues, op cit note 87 P.18.
[167]. Bhagat & Black, op cit note 86 P.33.
[168]. Usha Rodrigues, op cit note 87 P.18.
A member of Enron's audit committee, Ronnie Chan, a billionaire real estate magnate from Hong Kong lived overseas during his tenure on the committee and was known to have the worst attendance record of any Enron director, missing more than 25% of board and committee meetings during 1996, 1997, and 2000 – Charles Elson & Christopher Gyves, *'Enron Failure And Corporate Governance Reform*' Wake Forest Law Review, Vol.38, Pg.873.
[169]. Troy Paredes, op cit note 156 P.18.
[170]. Troy Paredes, ibid.
[171]. Charles Elson & Christopher Gyves, *'The Enron Failure and Corporate Governance Reform'* Wake Forest Law Review, Vol.38, P.857.
[172]. Elson & Gyves, ibid.

Another concern that has been raised with regard to the effectiveness of independent directors is that most of them are not given adequate incentives. Directors cannot actively monitor management when there are no tangible incentives to do so. The argument is that there is need for incentives like equity based compensation, in order to align the interests of directors with the interests of the shareholders. The idea is that ownership and control of the company would be united through meaningful director equity ownership, and hence better management monitoring.[173]Some have argued that equity ownership by directors does create more active monitoring.[174]There is some evidence that greater share ownership may improve independent director performance. Bhagat and Black in their study of board composition and firm performance, find some evidence of a correlation between outside director ownership and firm performance.[175]They conclude that their evidence shows that independent directors may perform better if they have stronger stock-based incentives to do so.[176]

Indeed, there seems to be some credibility to the argument that option-based compensation helps align director's interests with those of the shareholders. Directors have been variously described as the shareholders' advocate. Independent directors particularly can become key elements in helping to reduce managerial agency costs, and this can be achieved through increased stock-option based compensation for independent directors. Stock-options might seem to be appropriate because it not only directly aligns directors' interests to those of the shareholders, but it also indirectly aligns directors' share returns in accordance with the performance of the firm. Independent directors should not only be completely independent of management but must also be adequately motivated and incentivized to vigorously champion the cause of the shareholders and to provide objective oversight of management. 'While independence promotes objectivity, the board also must have an incentive to exercise that objectivity effectively. Granting

[173]. Sanjat Bhagat et al *'Director Ownership, Corporate Performance and Management Turnover'* (1999) 54 Business Lawyer 885 P.10.
[174]. Bhagat et al ibid.
[175]. Bhagat & Black, op cit note 86 P.35.
[176]. Bhagat & Black, ibid.

independent directors equity ownership in the firm may help achieve this goal'.[177]When directors have no stake in the enterprise other than their board seats, there is simply no personal pecuniary incentive to engage in the active monitoring of management.[178]

Another concern that has been raised regarding the effectiveness of independent directors is whether the independent director is 'truly' independent. Some argue that the independent director as created by corporate governance advocates is not independent enough. There are concerns about 'soft' conflicts of interest and 'structural biases' that still exist and that might compromise director independence.[179]According to one commentator 'some directors who are classified as independent are beholden to the company or its current CEO in too subtle a way to be captured in customary definitions of independence'.[180]The case of Enron is quite instructive in this regard. There existed indirect relationships between its management and board as a result of charitable donations and political contributions. These relationships obviously compromised the independence and objectivity of the directors.[181]For instance, Enron and its CEO and Chairman, made donations totalling nearly $600,000 to an organization where two of Enron's directors had served as president. Also, an organization which employed an Enron director received more than $50,000 in donations from Enron.[182]'In 2000 Enron paid one of its outside directors over $490,000 for his consulting work; and the National Tank Company, on whose board an Enron director sat, recorded over $2.5million in revenue from sales of equipment and services to Enron subsidiaries'.[183]Could the Enron outside directors be said to have been 'truly' independent?

Another concern that has been raised in recent times has to do with the personal liabilities of directors. Today, there are overwhelmingly high expectations for directors, especially independent directors, to perform their oversight role effectively. The call for greater independence from outside directors has resulted in a demand for increased

177. Elson & Gyves, op cit note 169 P.869.
178. Elson & Gyves, ibid.
179. Troy Paredes, op cit note 156 P.20.
180. Bhagat & Black, op cit note 86 P.35.
181. Elson & Gyves, op cit note 169 P.872.
182. Elson & Gyves op cit note 169 P.873.
183. Troy Paredes, op cit note 156 P.21.

responsibility, accountability and liabilities on the part of directors. Thanks to widespread pressure the legal and regulatory framework within which directors must function have been made more stringent. A director can be held personally liable for any damages resulting from breach of their duties to the company. The American corporate system for example, 'permits shareholders to sue directors and officers for injuries that they have sustained either directly by corporate action or derivatively, on behalf of the corporation, for injuries done to the corporation because of wrongful actions by its officers or directors'.[184]Increasingly directors are being called upon to be accountable. The legal environment in which they operate is becoming more and more risky and this may have led to a tight non-executive director labour market.[185]

Due to the heavy work-load demands on their time and the related risk to their reputations, many who are qualified are becoming increasingly reluctant to take on available directorships. Consequently, the market for outside independent directors becomes smaller as it becomes more difficult to identify individuals who will be willing to accept the personal liability risks involved with board membership. According to one writer, directors and officers feel that they are 'under a microscope, and that serious consequences will follow if they make a mistake'.[186]The increasing complexity and risk attached to board responsibilities have other consequences for corporate performance and strategy. For instance, companies might introduce narrower rather than broader specifications of the skills and experiences required for outside director appointments.[187]On the other hand, directors may become less scrupulous in their monitoring and evaluating of management decisions and activities, for fear of falling foul of the liability requirements. In addition management may become risk-averse and refrain from taking prudent business risk, a trend which will certainly be inimical to business growth as no company ever succeeded without taking some risks.[188]'Directors and

---

[184]. Jeswald Salacuse, op cit note 2 P.82.
[185]. Ruth Aguilera *'Corporate Governance and Director Accountability: An Institutional Comparative Perspective'* (2005) British Journal of Management, Vol.16 P.S49.
[186]. Troy Paredes, op cit note 156 P.43.
[187]. Laura Tyson et al *'Report on the Recruitment and Development of Non-Executive Directors, UK'* (2003). Available at www.dti.gov.uk.
[188]. Troy Paredes, op cit note 156 P.43.

managers should not have to fear legal liability every time they are wrong, assuming that they acted in good faith'.[189]

IS INDEPENDENCE OVERRATED?

Commentators have approached the question of what 'true' independence really is from different perspectives. While some define independence by those formal characteristics and criteria that may qualify a director to be considered as independent (structural approach), others approach independence from the point of view of the way and manner in which a particular director carries out his role as director (behavioural approach). Whatever approach one takes, most independence advocates are agreed as to the fact that 'mere' independence is not enough. In order to achieve maximum board effectiveness, and to strengthen director independence, attention must not only be placed on those formal attributes required of directors, but also emphasis should be on other non-formal factors that may be relevant in this regard. In order to build trust in the ability of independent directors, and indeed the board as a whole, there's a need to move beyond the current 'box-ticking' approach to director independence. As stated earlier in this study, there's the need to move beyond the formal or 'hard' approach taken by many recent reform initiatives, to a more extensive but 'soft' approach.[190]If the lessons learnt from Enron and other corporate failures are anything to go by, then the concept of director independence must be approached from a different perspective, especially when the goal is to improve board effectiveness.

Van Den Berghe and Baelden proposed the concept of 'independence of mind'. According to them, the concept captures the idea that independence is about the character and the spirit of the person under consideration, rather than being a structural formal concept.[191]It is about the ability and willingness to make an independent judgement which is not guaranteed by the definitions of the corporate governance codes and recommendations. According to them, 'an independent director should not only find

---

[189]. Troy Paredes, ibid.
[190]. Van Den Berghe, op cit note 55 P.60.
[191]. Van Den Berghe, ibid.

himself formally in the right position but needs also "something more" than the characteristics determined in the corporate governance codes and recommendations'.[192]They draw a distinction between formal independence and independence of mind. He states that formal independence and independence of the mind, are not ends in themselves, rather they are a means to achieving an end, the end being board effectiveness. They identify vigilant monitoring and objective decision making as the keys to board performance, and that these should be the focus of the board.[193]The board, in order to achieve vigilant monitoring and objective decision-making, would need both elements of formal independence and independence of the mind.

Richard Leblanc submits that because independence is a state of mind, it is difficult to regulate. According to him, much of what comprises independence may only be identified within the boardroom, in the context of specific decision-making situations and the individuals involved.[194]He states that 'a director may be conflicted and yet independent and not conflicted and not independent within the boardroom'. He adds that there's the tendency to appoint directors who are distant and uninformed about the business of the corporation, and unable to provide concrete and meaningful strategic input to management, or to hold management accountable for achieving corporate goals, all in a bid to appease regulators in the over-zealous search for 'independence'.[195]He concludes that for an effective board to be created, the company, or nominating committee must focus attention on (i) what competencies are needed on the board, and which ones, if any, are missing, (ii) mix of behavioural types of the prospective candidates (They must determine if the person they are recommending to the board for membership is a behavioural type who will contribute to making board process more effective). These are the factors that should drive the selection process of prospective directors. [196]

---

[192]. Van Den Berghe, ibid.
[193]. Van Den Berghe, op cit note 55 P.62.
[194]. Richard Leblanc, *'what's Wrong with Corporate Governance: A Note'* (2004) Corporate Governance: An International Review, Vol.12, Issue 4, P.439.
[195]. Richard Leblanc op cit note 192 P.440.
[196]. Richard Leblanc ibid.

Another writer argues that 'effective corporate governance does not depend on the independence of some particular subset of directors, but on the independent behaviour of the board as a unit'.[197]He states that there are three primary functions of board independence: clear accountability to shareholders, informational transparency and increased shareholder voice in corporate decision-making.[198]According to him, 'not only do these functions more meaningfully capture the monitoring and oversight norms envisioned by current independence regimes, they also yield practicable guidelines for refining the processes by which a board goes about its business'.[199]He relies on the tripartite board structure proposed by Professor Donald Langevoort, that a board be composed of conventional independent monitors, quasi-independent or "grey" mediators, and managers.[200]In their own work, Roberts, McNulty and Stiles argue that 'while board structure, composition and independence condition board effectiveness, it is the actual conduct of the non-executive vis-à-vis the executive that determines board effectiveness'.[201]According to them, 'independence' should not just be imagined as requiring that non-executives remain aloof and suspicious of the executives, but should be seen as a valuable resource for executives,[202]for 'enacted in the form of suspicion, "independence" emphasises the division between executive and non-executive directors. Enacted as a resource for the success of the company, "independence" merely strengthens the capabilities of the unitary board in dealing with the challenges and risks that are always associated with decision-making'.[203]

The debate on director independence has been on for quite a while, and is bound to continue as long as the quest for improved board effectiveness and corporate governance exists. Commentators will continue to propose different conceptions of what they think constitute 'real' independence. What is an accepted fact is that an effective board remains

[197]. Harvard Law Review *'Beyond Independent Directors: A Functional Approach to Board Independence'* (2006), Vol.119:1553, P.1560.
[198]. Harvard Law Review op cit P.1561
[199]. Harvard Law Review op cit P.1570.
[200]. Donald C. Langevoort, *'The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability'* (2001) 89 GEO.L.J. 797 at 798.
[201]. John Roberts et al, *'Beyond Agency Conceptions of the work of the Non-Executive Director: Creating Accountability in the Boardroom'* British Journal of Management, (2005), Vol.16, P.S5.
[202]. John Roberts op cit P.S16.
[203]. John Roberts op cit P.S17.

a critical element for the attainment of good corporate governance. Governance reforms therefore, must be able to embrace the various conceptions of independence, whether from the point of view of formally structured criteria or from the point of view of individual director characteristics. In doing this however, the focus should be on how best to improve individual independent director effectiveness. Such reforms would require a shift beyond the current formal and structural approach to the concept of director independence, as contained in most corporate governance guidelines.

IMPROVING INDEPENDENT DIRECTOR EFFECTIVENESS

In this final part of the study, an attempt is made at proposing recommendations on how best to improve the effectiveness of independent directors. A preponderance of studies on the impact of the independent director on firm performance, as revealed earlier, report inconclusive evidence. Even the many formal and informal initiatives taken so far with respect to strengthening board effectiveness have not diminished the growing confusion as to what role independent directors must play in the corporation, and how they can best be equipped to perform this role. There is no doubt that independence plays a critical role in effective corporate governance, especially with regard to reducing conflicts of interest, and objective monitoring and decision-making. Enron and many others after it, revealed that in the area of board effectiveness, more needs to be done. The presence of nominally independent directors on the board will not automatically translate to an effective board. In other words, an independent board is not equal to an active board. An active or effective board is a function of proper motivation and incentivization.

It has been suggested that one way to improve the performance of independent outside directors is in the area of incentives. The argument is that if properly incentivized, independent directors will be better motivated to perform their role of objective monitoring and oversight of management for the benefit of the shareholders. This reasoning sounds quite logical, for the independent or outside director is an individual who supposedly has no material relationship with the company, apart from his directorship, and therefore may have no personal interest or incentive to effectively monitor management. One major criticism of boards of directors has been their failure to engage in the kind of active management oversight that results in more effective corporate performance.[204]This has therefore led to calls for the formulation of better incentive mechanisms for directors such as compensation, replacement and the opportunity to obtain other board directorships. However in recent times, more emphasis has been placed on equity-based compensation for directors, in other words, making directors to actively take part in the ownership of the company.

The rationale for the current call for equity or stock option-based compensation for outside directors, is that such compensation will help to align the interests of the directors with those of the shareholders. In other words, 'the idea is to reunite ownership and control through meaningful director stock ownership and hence better management monitoring'.[205]The argument is that substantial equity ownership by the outside directors creates a personally-based incentive to actively monitor.[206]Evidence from Enron and others alike, suggest that independent outside directors are too passive and therefore negligent of their monitoring role. This, it has been suggested is because of the lack of strong incentives for them to get involved and committed to performing their role.[207]Accordingly, it has been stated: "The board of directors is responsible for making sure that the company has a sound strategy so that shareholders' interests will be protected. However, for many non-executive directors, the performance of the companies they oversee has almost no impact on their personal wealth because they have very little stock ownership in these companies…From an agency theory perspective, these non-executive directors are just like the executives they oversee: they are the 'agents' of the 'principals' (the shareholders), not the 'principals' themselves. If there is a strong need to provide incentives for one group of the agents – the executives, there should also be a strong need to provide incentives for another group of the agents – the non-executives".[208]

[204]. Sanjat Bhagat et al op cit note 171. P.10.
[205]. Bhagat op cit note 171 P.9.
[206]. Bhagat op cit P.10.
[207]. Wei Shen, *'Improve Board Effectiveness: The Need for Incentives'* (2005) British Journal of Management, Vol.16, P.S82.
[208]. Wei Shen op cit note 205 P.S83.

The theory here is that increased equity-based compensation for independent directors helps to improve their engagement in good governance and also guarantees their independence from management. Indeed there is some empirical evidence that equity-based compensation for independent directors not only helps to align director interests with those of shareholders, but it also correlates with improved corporate performance. In one study, Fich and Shivdasani found that there was a positive and significant association between the market to book ratio and the presence of a stock option plan for outside directors.[209] Their result suggests that equity-based compensation for outside directors has a positive impact on firm value.[210]In another study, Bhagat, Carey and Elson found a significant correlation between the amount of stock owned by individual outside directors and firm performance (based on a variety of performance measures).[211]Their explanation for this finding is that the equity ownership created better management monitoring on the part of the board and hence, improved results.[212]This is in line with their hypothesis that there is a common connection between substantial director share ownership and better monitoring.[213]

It may be difficult to agree categorically with these results, that equity-based compensation for independent directors does have some positive impact on firm performance. The evidence on this, like others earlier mentioned, is inconclusive. However, it is difficult to refuse that there is some merit in the notion that such compensation helps in aligning the interests of the independent director with the interests of the shareholders. To effectively pursue these shareholder interests, outside independent directors must have the motivation to remain independent from management so as to be effective monitors. Not only will equity ownership align directors to shareholder interests, but it will also make them responsive to the performance of the firm. ‘By becoming equity holders, the outside directors assume a personal stake in the success or failure of the enterprise. When directors are active equity participants, they have an

[209]. Fich & Shivdasani, op cit note 126, 2229 – 2254, P.14.
[210]. Fich & Shivdasani op cit. P.26.
[211]. Bhagat et al op cit note 171,P.26.
[212]. Bhagat ibid.
[213]. Bhagat ibid.

incentive to monitor management's performance more effectively, since poor monitoring may have a direct negative impact upon their personal financial interests'.[214]Independent directors without equity ownership have little or no incentive to actively monitor management. It is therefore submitted that apart from objective monitoring, long-term equity ownership for independent directors is a key mechanism for achieving effective corporate governance. 'While independence may create the objectivity necessary for proper oversight, it is equity ownership, in combination with independence, that creates the incentive for objective directors to act ultimately in shareholders' interest – to create the kind of corporate productivity that merits past and future investments by the public'.[215]

Proper and continuous performance evaluation and assessment of the board of directors has also been identified as one of the mechanisms for achieving effective corporate governance. Many corporate governance codes and guidelines have proposed a framework for regularly evaluating the activities of the board of directors to ensure the effective performance of their functions.[216]They recommend that companies must put in place controls and systems to make effective and meaningful evaluation of directors possible. A major advantage of periodic evaluation process is that it reveals the quality of the board and the directors on it. It also helps in identifying how effective the board has been in trying to perform its functions. Evaluation should be both collectively as a board, and on an individual director basis. The board must have in place some mechanism for assessing the performance of each individual director. Individual evaluation provides the board with an opportunity to probe particular issues in depth, and this can be achieved through either self or peer evaluation.[217]While self-evaluation will help to encourage directors to reflect on their personal contributions to board activities, peer evaluation will help directors to identify each other's individual strengths and weaknesses.[218] By having members of the board evaluate each other, it is possible to gain a more objective view of

---

[214]. Elson & Gyves, op cit note 169, P.870.
[215]. Elson & Gyves op cit note 169 P.884.
[216]. King, op cit note 19 P.68.
[217]. Kiel & Nicholson, op cit note 150, P.618.
[218]. Kiel, ibid.

the strengths and weaknesses of each director and their contributions to the effectiveness of the board.[219]

Regular evaluation of the board is a process that can ensure that directors develop a clear understanding of their role and responsibilities. 'On appointment, non-executive directors will already have relevant skills, knowledge, experience and abilities. Nonetheless, a non-executive director's credibility and effectiveness in the boardroom will depend not just on their existing capability but on their ability to extend and refresh their knowledge and skills'.[220]The King II corporate governance code of South Africa recommends that the board's informal evaluation should be conducted by the chairperson and, that the board, through the nomination committee or similar board committee should regularly review its required mix of skills and experience and other qualities such as its demographics and diversity in order to assess its effectiveness.[221]

Analogous to a regular evaluation and appraisal of directors is the need for continuous training and education for directors, especially independent outside directors. As earlier pointed out, independent directors are usually outsiders who are not involved in the day to day management of the company. As a result, they may not possess the kind of extensive and in depth knowledge about the firm and entrepreneurial skills that may be necessary for them to effectively perform their monitoring role. Unlike the executive directors (insiders), they are not familiar with the inner processes of the firm, and this no doubt could impede their ability to make the kind of objective and well informed decisions expected of them. Indeed, with the recent spotlight on the independent director in the quest for more effective corporate governance mechanisms, there is no doubt that the responsibilities of the independent director will continue to expand. If independent directors are to employ the kind of independent and objective decision-making required for effective oversight and monitoring of management, then companies must have in place adequate training and other educational mechanisms to equip these directors in

---

[219]. Kiel, ibid.

[220]. Derek Higgs, *'The Review of the Role and Effectiveness of Non-Executive Directors'* (2003), cited in *'The Tyson Report on the Recruitment and Development of Non-Executive Directors'* (2003), P.17. Available at www.london.edu.

[221]. King, op cit note 19, P.68.

performing their role. It is not enough to require objectivity, integrity and other high ethical standards from independent directors; indeed without these personal attributes, an independent director cannot be 'truly' independent, and will not be able to apply an objective judgement when required to do so. However, to achieve the level of effectiveness required today of boards, directors must be able to build their knowledge of business and entrepreneurial skills and other corporate techniques.

Another mechanism that could be a potent tool for improving director effectiveness, are the shareholders themselves. Thanks to the widely dispersed ownership structure in many large corporations, shareholders were rendered powerless in the running of these companies. Even with the rise of institutional investors, especially in the US, there has been a sustained call for more direct participation by shareholders in corporate governance. Shareholders, in many cases of corporate abuse, end up at the receiving end, as their long-term interests are always at risk. An example is Enron where directors and other top managers emerged from their bankrupt corporation with substantial financial gains while investors and employee shareholders sustained large losses.[222]One way therefore, to protect the legitimate rights and interests of shareholders is to have in place mechanisms and structures to enhance shareholder participation, particularly in the selection of independent directors.

Independent directors act as a link between the shareholders and management. They are supposed to hold managers accountable and to report to shareholders about managerial conduct.[223]Therefore, not only should they be directly involved in nomination and election of directors, but also mechanisms should be put in place whereby a particular director who fails in his responsibilities can be identified and at the consent of the shareholders, relieved of his position. This should be the objective of the regular evaluation and assessment exercise carried out by the board. A sound accountability structure where each individual director is answerable to the shareholders for his conduct and activities on the board will go a long way in instilling a sense of responsiveness in

[222]. Jeswald Salacuse, op cit note 2 P.71.
[223]. Ruth Aguilera, op cit note 183 P.S45.

each director and will help stave off passivity on the board. The involvement of shareholders acts as a check on board and managerial activities.

After Enron, many came to have serious doubts about the ability of directors of many leading companies.[224]At the same time, the responsibilities, liabilities and expectations from directors began to increase. Just as public trust in director abilities took a downward spin, so also did the expectations of the public from directors begin to rise. The public began to demand more active and effective performance from directors just as shareholders also demanded accountability from their elected agents. Much of the blame for the manifold corporate collapses was laid at the doorstep of the board of directors.[225]Many boards have been identified as passive and ineffective. One of the major factors that contributed to these collapses was lack of independence on the boards.[226]To strengthen board and director independence, various structural best practices have been widely recommended such as separation of the position of CEO from that of Chairperson of the board, appointment of a lead independent director etc. However, it is also recommended that boards put in place a mechanism whereby independent directors can meet regularly without management present. Also there should be a procedure whereby the board can seek independent professional advice where necessary. In addition, the re-election of independent directors should not be made automatic, but subject to favourable performance evaluation, and the decision of the shareholders.[227] These are only some practical steps that can, if adopted, facilitate increased independence and effectiveness on the board.

CONCLUSION

The first part of this study consists of a comparative analysis of varying definitions of independent director contained in corporate governance codes and instruments from particular countries. These definitions differ in structure and in content. Most of the

---

[224]. Oliver Williams, op cit note 155 P.9.
[225]. Gerald Acquoah-Gaisie, op cit note 14 P.1.
[226]. Acquoah-Gaisie op cit note 14 P.6.
[227]. Some of these mechanisms have already been recommended in some corporate governance guidelines.

definitions have adopted a more formalised approach to independence, by focusing on a structured set of criteria by which independence can be measured. Some others have focused more on the individual director and those inherent characteristics and attributes, such as integrity, professionalism etc which help to assure the individual director objectivity and professional judgement required for vigilant corporate monitoring and leadership. The opinion is that an independent director must not only find himself formally in the right position but must also possess some "extra individual quality" beyond the criteria required in the corporate governance codes and recommendations.[228]

The second part of this study took a close look at the relevance and value of this class of directors to corporate performance. As this study has shown, evidence of the impact of independent directors on corporate performance is inconclusive. While some studies report a positive impact, especially with regard to specific board tasks, others report that there is no positive evidence of the impact of the independent director on corporate performance. Despite the conflicting evidence, this study has tried to establish that the value or relevance of the independent director to the modern corporate leadership is critical, and cannot be overemphasised. Indeed the existence of this class of directors has now become conventional wisdom. They are, or ought to be, the custodians or gatekeepers of the corporation, because they are the link between the owners of the corporation (shareholders) and the managers of the corporation. The role of the independent director can therefore be summed up as being to provide objective and disinterested monitoring of management and ensuring that corporate executives and managers account to shareholders about the day to day management of the company. Future research and studies in this area should therefore focus on how best to enhance the effectiveness of the independent director, especially in the increasingly dynamic global corporate environment.

---

[228]. Van den Berghe op cit note 53 p. 60.

APPENDIX:

DEFINITIONS OF INDEPENDENT DIRECTOR

KING'S CODE, SOUTH AFRICA

An Independent Director is a non-executive director who:

- Is not a representative of a shareowner who has the ability to control or significantly influence management;
- Has not been employed by the company, or the group, of which it currently forms part, in any executive capacity for the preceding three financial years;
- Is not a member of the immediate family of an individual who is, or has been in any of the past three financial years, employed by the company or the group in an executive capacity;
- Is not a professional advisor to the company or the group, other than in a director capacity;
- Is not a significant supplier to, or customer of the company or group;
- Has no significant contractual relationship with the company or group; and
- Is free from any business or other relationship that could be seen to materially interfere with the individual's capacity to act in an independent manner.

CORPORATE GOVERNANCE CODE, AUSTRALIA

An independent director is a non-executive director (ie is not a member of management) and:

- Is not a substantial shareholder of the company or an officer of, or otherwise associated directly with, a substantial shareholder of the company;

- Within the last three years has not been employed in an executive capacity by the company or another group member, or been a director after ceasing to hold any such employment;

- Within the last three years has not been a principal of a material professional adviser or a material consultant to the company or another group member, or an employee materially associated with the service provided;

- Is not a material supplier or customer of the company or other group member, or an officer of or otherwise associated directly or indirectly with a material supplier or customer;

- Has no material contractual relationship with the company or another group member other than as a director of the company;

- Has not served on the board of for a period which could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company;

- Is free from any interest and any business or other relationship which could, or could reasonably be perceived to.

THE COMBINED CODE, UK

In determining whether a director is independent, the board must consider whether such director has been;

- Has been an employee of the company or group within the last five years;
- Has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;

- Has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;

- Has close family ties with any of the company's advisers, directors or senior employees;

- Holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;

- Represents a significant shareholder; or

- Has served on the board for more than nine years from the date of their first election.

CORPORATE GOVERNANCE CODE, FRANCE

The criteria to be reviewed to determine whether a director can qualify as independent are the following:

- Not to be an employee or corporate officer of the corporation, or an employee or director of its parent or a company that it consolidates, and not having been in such a position for the previous five years;

- Not to be a corporate officer of a company in which the corporation holds a directorship, directly or indirectly, or in which an employee appointed as such or a corporate officer of the corporation (currently in office or having held such office going back five years) is a director;

- Not to be a customer, supplier, investment banker or commercial banker:
  - that is material for the corporation or its group;
  - or for a significant part of whose business the corporation or its group accounts;

- Not to be related by close family ties to a corporate officer;

- Not to have been an auditor of the corporation within the previous five years;

- Not to have been a director of the corporation for more than twelve years.

NEW YORK STOCK EXCHANGE RULES

- A director who is an employee, or whose immediate family member is an executive officer, of the company is not independent until three years after the end of such employment relationship;

- A director who receives, or whose immediate family member receives, more than $100,000 per year in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service), is not independent until three years after he or she ceases to receive more than $100,000 per year in such compensation.

- A director who is affiliated with or employed by, or whose immediate family member is affiliated with or employed in a professional capacity by, a present or former internal or external auditor of the company is not "independent" until three years after the end of the affiliation or the employment or auditing relationship;

- A director who is employed, or whose immediate family member is employed, as an executive officer of another company where any of the listed company's present executives serve on that company's compensation committee is not "independent" until three years after the end of such service or the employment relationship;

- A director who is an executive officer or an employee, or whose immediate family member is an executive officer, of a company that makes payments to, or receives payments from, the listed company for property or services in an amount which, in any single fiscal year, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues, is not "independent" until three years after falling below such threshold.

BIBLIOGRAPHY

BOOKS

1. Austin and Ramsey *Ford's Principles of Corporations Law* 12ed (2005) Lexis Nexis.
2. Berle, Adolf and Means, Gardener *The Modern Corporation and Private Property* Revised ed (1991) Macmillan Publishing Company.
3. Blackman et al *Commentary On The Companies Act* (2002) Juta & Co.
4. Farrar, John *Corporate Governance in Australia and New Zealand* (2001) Oxford University Press.
5. Joo, Thomas W *Corporate Governance: Law, Theory and Policy* (2004)
6. Keasey, et al *Corporate Governance: Accountability, Enterprise and International Comparisons* (2005) John Wiley & Sons Ltd.
7. King, Mervyn *Report on Corporate Governance for South Africa (*2002) Institute of Directors, South Africa.
8. Lawrence, Jeffrey and Stapledon, Geof *Do Independent Directors Add Value?* (1999) Centre for Corporate Law and Securities Regulation, University of Melbourne.
9. Lipman, Frederick *Corporate Governance Best Practices* (2006) John Wiley & Sons Ltd.
10. Ramsey, et al *Institutional Investors' Views on Corporate Governance* (1998) Centre for Corporate Law and Securities Regulation, University of Melbourne.
11. Wolfson, Nicholas *The Modern Corporation* (1984) Macmillan Inc. Canada.

ARTICLES

1. Acquaah-Gaisie, Gerald *'Towards more effective Corporate Governance Mechanisms'* (2005) Australian Journal of Corporate Law, Vol.18.
2. Robbins, Fred *'Corporate Governance After Sarbanes Oxley: An Australian Perspective'* (2006) Corporate Governance, Vol.6, Issue 1, 34-48.
3. Dent, George W *'Corporate Governance: Still Broke, No Fix in Sight'* (2005) The Journal of Corporation Law, Vol.31.
4. Mongalo, Tsepho *'The Emergence of Corporate Governance as a Fundamental Research topic in South Africa'* (2003) South African Law Journal, Vol.120, Issue 1.
5. Clarke, Donald C *'The Independent Director in Chinese Corporate Governance'* (2006) Delaware Journal of Corporate Law, Vol.31.
6. Van den Berghe, L A A and Baelden, Tom *'The Complex Relation Between Director Independence and Board Effectiveness'* (2005) Corporate Governance, Vol.5, No.5.
7. Rodrigues, Usha *'The Fetishization of Independence'* (2007) University of Georgia School of Law, Research Paper Series, No.07-007.
8. Bhagat, Sanjat and Black, Bernard *'The Uncertain Relationship Between Board Composition and Firm Performance'* (1999) 54 Business Lawyer.
9. Petra, Steven *'Do Outside Independent Directors Strengthen Corporate Boards?'* (2005) Corporate Governance, Vol.5, No.1.
10. Cotter, et al *'Do Independent Directors Enhance Target Shareholder Wealth During Tender Offers?'* (1997) 43 Journal of Financial Economics, 195.
11. Weisbach, Michael S *'Outside Directors and CEO Turnover'* (1988) 20 Journal of Financial Economics, 431.
12. Denis, David and Denis, Diane *'Performance Changes Following Top Management Dismissals'* (1995) Journal of Finance, Vol.50, No.4, 1029.
13. Daily, C M et al *'Compensation Committee Composition as a determinant of CEO Compensation'* (1996) Academy of Management Journal, Vol.41, 209.
14. Fich, Eliezer and Shivdasani, Anil *'The Impact of Stock-Option* Compensation *for Outside Directors on Firm Value'* (2005) University of Chicago Journal of Business, Vol.78, No.6.

15. Udueni, Henry '*Power Dimensions in the Board and Outside Director Independence: Evidence from Large Industrial UK Firms'* (1999) Corporate Governance: An International Review, Vol.7, and No.1.
16. Baysinger, Barry and Butler, Henry *'Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition'* (1985) Journal of Law, Economics and Organisation, Vol.5, No.1.
17. Klein, April *'Firm Performance and Board Committee Structure'* (1998) Journal of Law and Economics, Vol.41, 275.
18. Agrawal, A and Knoeber, C '*Firm Performance and Mechanisms to control Agency Problems between Managers and Shareholders'* (1996) Journal of Financial and Quantitative Analysis, Vol.31, No.3, 377.
19. Kiel, Geoffrey and Nicholson, Gavin *'Board Composition and Corporate Performance: How the Australian Experience Informs Contrasting Theories of Corporate Governance'* (2003) Corporate Governance: An International Review, Vol.11, Issue 3, 189.
20. Wilson, Inam '*Regulatory and Institutional Challenges of Corporate Governance in Nigeria Post Banking Consolidation'* (2006) Nigerian Economic Summit Group Economic Indicators, Vol.12, No.2.
21. Williams, Oliver *'Restoring Public Trust in Business: The Crucial Role of Good Corporate Governance'* (2005) Research Paper, Corporate Governance Conference, Eastern Academy of Management.
22. Paredes, Troy *'ENRON: The Board, Corporate Governance and Some Thoughts on the Role of Congress'* (2003) Faculty Working Paper Series, Washington University School of Law, 03-02-01.
23. Elson, Charles and Gyves, Christopher *'The Enron Failure and Corporate Governance Reform'* (2003) Wake Forest Law Review, Vol.38, 855.
24. Bhagat, Sanjat et al *'Director Ownership, Corporate Performance and Management Turnover'* (1999) 54 Business Lawyer 885.
25. Leblanc, Richard *'What's Wrong with Corporate Governance: A Note'* (2004) Corporate Governance: An International Review, Vol.12, No.4, 436.

26. Harvard Law Review *'Beyond Independent Directors: A Functional Approach to Board Independence'* (2006) Vol.119, No.5, 1553.
27. Langevoort, Donald C *'The Human Nature of Corporate Boards: Law, Norms and the Unintended Consequences of Independence and Accountability'* (2000) 89 Georgetown Law and Economic Research Paper No.241402.
28. Roberts, John et al *'Beyond Agency Conceptions of the Work of the Non-Executive Director: Creating Accountability in the Boardroom'* (2005) British Journal of Management, Vol.16.
29. Shen, Wei *'Improve Board Effectiveness: The Need for Incentives'* (2005) British Journal of Management, Vol.16.
30. Kiel, Geoffrey and Nicholson, Gavin *'Evaluating Boards and Directors' Corporate Governance: An International Review,* Vol.13, No.5.
31. Aguilera, Ruth *'Corporate Governance and Director Accountability: An Institutional Comparative Perspective'* (2005) British Journal of Management, Vol.16.
32. Salacuse, Jeswald *'Corporate Governance in the New Century'* (2004) The Company Lawyer Vol.25, 69-83.

INTERNET SOURCES

1. New York Stock Exchange *'Listed Company Manual - Corporate Governance Standards.'* Available at www.nyse.com/regulation/listed.
2. Central Bank of Nigeria *'Code of Best Practices on Corporate Governance for Banks in Nigeria Post Consolidation.'* Available at www.cenbank.org/ng.
3. International Corporate Governance Network *'Statement on Global Corporate Governance Principles.'* Available at www.icgn.org.
4. Organisation for Economic Co-operation and Development *'Principles of Corporate Governance.'* Available at www.oecd.org/dataoecd.
5. *'The Corporate Governance of Listed Corporations in France.'* Available at www.ecgi.org/codes.

6. CalPERS *'Corporate Governance Principles and Guidelines.'* Available at www.calpers-governance.org/principles.
7. Organisation for Economic Co-operation and Development *'Guidelines on Corporate Governance for State-Owned Enterprises.'* Available at www.oecd.org/documents.
8. Organisation for Economic Co-operation and Development *'Corporate Governance of Non-Listed Companies in Emerging Markets.'* Available at www.oecd.org/documents.
9. Council of Institutional Investors *'Corporate Governance Policy.'* Available at www.cii.org/policies.
10. European Association of Securities Dealers *'Corporate Governance Principles and Recommendations.'* Available at www.ecgi.org/codes.
11. The Business Round Table *'Statement on Corporate Governance.'* Available at www.brt.org.
12. Weil, Gotshal and Manges *'Comparative Study of Corporate Governance Codes Relevant to the European Union and its Member States.'* Available at www.weil.com/wgm/pages/controller.
13. National Association of Pension Funds UK *'Corporate Governance Policy.'* Available at www.napf.co.uk/documentArchive/policy/corporategovernance.
14. Tyson, Laura et al *'The Report on the Recruitment and Development of Non-Executive Directors UK.'* Available at www.dti.gov.uk.
15. European Corporate Governance Network *'Report of the Committee on the Financial Aspects of Corporate Governance.'* (Cadbury Report) Available at www.ecgn.org.

LEGISLATION

1. Sarbanes Oxley Act of 2002.
2. Securities Exchange Act of 1934.