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INDEPENDENT DIRECTORS AND NEW CORPORATE GOVERNANCE PARADIGM (*PROS & CONS* OF INDEPENDENT DIRECTORS)

In the last few decades there has been a powerful trend in favour of independent directors for public firms. For larger public companies around the world, it is the norm for the board of directors to include "outside" directors who are not involved in the day to day running of the company but are generally expected to take a central role in overseeing company managers. This paper presents the major drivers of the trend towards board independence and the main reasons for greater role of independent directors and stricter standards of independence, their number and diversity. The shift towards independent directors is reflected not just in the numbers or percentages but also in the strengthening of various mechanisms of director independence.

The cummulative effect of the considered reasons led to a significant reconceptualization of the board's role and structure. The effect of the reforms on the board's role is to make the role of the independent directors more important than ever. Despite the fact that evidences that connect the increased presence of independent directors to shareholder benefit are weak, the expectations of independent directors has become too large.

However, there are counter views and reasons which suggest that the role of independent directors is uncertain. Difficulties regarding the regulations of these issues and reserves about expectations of independent directors are the final concerns of this paper. If the rise of independent directors is tied to a new corporate governance paradigm that looks to the stock price as the measure of most things, and "independent directors", namely independent boards, should serve as a "visible hand" to balance the tendency of markets to overshoot, there is the open question is whether the independent board has even independence from stock market and unknown market pressure.

Key words: *Board structure. Corporate Governance. Independent Directors. Monitoring board. Shareholder Value.*

1. THE RISE OF INDEPENDENT DIRECTORS AND DIRECTOR INDEPENDENCE

One of the most important developments in corporate governance over the past half century has been the shift in board composition away from insiders toward independent directors. The history also reveals that the shift towards independent directors is reflected not just in the numbers or percentages but also in the likelihood of independence in fact.[1] Nowadays, the move to independent directors, which began as a "good governance" exhortation, has become in some respects a mandatory element of new company law reform. The presence of independent directors has become commonplace on the boards of larger public companies around the world, and has become a widely accepted practice in most listed companies. Nowadays, it is the norm for the board of directors in these companies to include "outside" directors who are not involved in the day-to-day running of the company but are generally expected to take a central role in overseeing company managers. "Independent directors" – that is the worldwide accepted answer, but what is the question? The question could be phrased: Good governance means the right directors, and why do we need then independent directors? Or in the other words: What are the major factors which promote independent directors?

Some authors believe, with some suspicion, that the global corporate social responsibility movement has played a major role in motivating the changes in corporate governance practice and theory.[2] However, other reasons seem more convincingly. Thus, other authors point out that from the post-World War II era to the present, the board's principal role shifted from the "advising board" to the "monitoring board", and director independence became critical and connected with the monitoring of managerial performance in order to serve shareholder goals.[3] The hostile takeover movement (of 1980s) is also considered as a catalyst for this development – in this environment, managers turned to the monitoring board and to independent directors as the best available protection to preserve managerial autonomy against the pressure of the market in corporate control.[4] As an important

[1] J.N. Gordon, "The Rise of independent directors in the United States, 1950 2005: of shareholder value and stock market prices", European Corporate Governance Institute (ECGI), Law Working Paper No. 74/2006, 1472 1476, *http://papers.ssrn.com/sol3/papers.cfm?abstract id 928100*, last visited 15 March 2011. This article shows on the basis of data assembled from a number of different sources, the fraction of independent directors for large US public companies has shifted from approximately 20% in the 1950s to approximately 75% by the mid 2000s.

[2] C.A. Williams *et al.*, "An Emerging Third Way? The Erosion of the Anglo American Shareholder Value Construct", *Cornell International Law Journal* 2/2005, 493, 550 551.

[3] J.N. Gordon, 1514 1520.

[4] *Ibid.*, 1522 1526. The author also points out that: "a complementary develop ment has been observed: managers who once vigorously resisted board independence as a

and key driver in changing board composition must be admitted is the shift toward shareholder wealth maximization as the dominant corporate purpose.

It is also doubtless that the prominent role in the current reform and the possible convergence of corporate governance was played by the recent financial collapses and scandals.[5] The number and scale of corporate scandals is frightening, and their effects have been dramatic – on confidence, on financial markets and on many people's lives and livelihoods. A series of corporate scandals such as Enron and Parmalat,[6] and the resulting loss of confidence by the investing public in the stock market, have led to dramatic declines in share prices and substantial financial losses to millions of individual investors.

The recent corporate scandals and business failures have prompted a lively debate on how public corporations should be governed. Both the public and the experts have identified failed corporate governance as a principal cause of these scandals.[7] Corporate governance reform has become a highly charged political issue. Countries around the world have responded to these debacles by enacting new laws and regulations aimed at improving corporate disclosure and governance practices, and many firms, in turn, have changed their corporate charters and altered their board structures. The American Congress rapidly responded by passing the Sarbanes-Oxley Act of 2002.[8] Taking the situation in the United States

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limitation to their autonomy came to champion the independent board as a buffer from the hostile takeover and as a substitute for greater government intervention in the wake of scandals." *Ibid.,* 1472.

[5] Credit for this belongs primarily to U.S. corporate scandals, among which highli ghts the collapse of Enron Corp. (2001), WorldCom Inc. (2002), but also Global Crossing Ltd (2002), Kmart Corp (2002), Adelphia Communications (2002), and others. In Europe as examples of corporate scandals are set out: "Royal Ahold" (Netherlands), "Barings Bank" (U. K.), "Parmalat" (Italy), Elan (Ireland), EmTV (Germany), Vivendi (France), Swiss Life (Switzerland), Marconi (U.K.), Bipop (Italy), ABB (Sweden U. K.), MobilCom and Com Road (Germany), Cirio (Italy), and others.

[6] Some observers have gone so far as to state that Enron will stand out as a mark ing point in the chronology of regulation: the time before and after Enron. Lessons of "Enron" has prompted Europe to act promptly and as the key to European company and capital market law reform is stressed the improvement of European corporate governance. See K.J. Hopt, "Modern Company and Capital Market Problems: Improving European Corporate Governance after Enron", ECGI, Law Working Paper No. 5/2002, updated January 2007, 446, 450, *http://papers.ssrn.com/sol3/papers. cfm?abstract id 356102*, last visited 15 May 2011.

[7] However, as some authors point out, there is little agreement as to what went wrong and what changes need to be made, or more fundamentally, "there is no consensus as to whether the existing corporate governance regime is deficient or has simply been poorly implemented." See J. Armour, Wolf Georg Ringe, "European Company Law 1999 2010: Renaissance an Crisis", ECGI, Law Working Paper No. 175/2011, *http://pa pers.ssrn.com/sol3/papers.cfm?abstract id 1691688*, 38, last visited 15 July 2011.

[8] Sarbanes Oxley Act of 2002, H.R. 3763, 107th Cong. (2002).

as alarming one, European countries, mindful of earlier financial scandals of their own, started examining their own systems of corporate governance in an effort to prevent similar abuses. In a direct reaction to Enron, the European Commission mandated the High Level Group of Company Law Experts (hereafter: High Level Group) to come up with a vision on where the priorities of the European company law should be and to include issues related to best practices in corporate governance and auditing, in particular concerning the role of non-executive directors and supervisory boards. The High Level Group came up with its report on 4 November 2002,[9] and the European Commission in its Action Plan of 21 May 2003, accepted many of the recommendations of the High Level Group.

The principle institutional failure that produced Enron and its followers was the failure of the gatekeepers, especially external auditors, not the insufficiency of director independence. Moreover, "what is stunning is not only the failure of the auditing control device, but that *all* control mechanisms failed".[10] The corporate scandals demonstrated weaknesses in the board governance system and pointed the way toward new roles for independent directors and standards of independence. After the Enron debacle the struggle for efficient internal management control has become a major focus of the corporate governance debate, regulatory initiatives and innovations in many countries.[11] As a consequence, board structure has become an issue for corporate governance reform.

9 Report of the High Level Group of Company Law Experts on a Modern Regula tory Framework for Company Law in Europe, 4 November 2002, *http://ec.europa.eu/ inter nal market/ company/docs/modern/report en.pdf* (hereafter: High Level Group), last visited 15 May 2011. The Report covers most of the topics of corporate governance, reflecting the fact that the company law and corporate governance practices widely differ from member state to member state, calls for significant legislative action by the E. C., that would occur in the form of recommandations non binding acts that are *soft law*, and directives binding acts that are *hard law*.

10 K.J. Hopt, P.C. Leyens, "Board Models in Europe Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy", ECGI, Law Working Paper No. 18/2004, January 2004, 3, *http://papers.ssrn.com/ sol3/papers.cfm? abstract id 487944*, last visited 15 March 2011.

11 Prestigious groups and organizations within individual countries produced over 30 recommended codes of best practices in corporate governance over the last decade. For a comprehensive listing of these codes and reports see Weil, Gotshal & Manges LLP, on behalf of the European Commission, Internal Market Directorate General, *Comparative Study of Corporate Governance Codes Relevant to the European Union and its Member States* (January 2002), 14 16, *http://ec.europa/internal market/company/docs/corpgov/ corp gov codes rpt part1 en.pdf*, last visited 15 May 2011. All these initiatives have ai med to establish principles, standards and guidelines for best practice corporate governan ce. They particularly emphasized the importance of transparency, accountability, internal controls, compesation scheme for members of the Board, presence of independent and non executive directors and interdependence of completed compensation and actual performance of the company. These proposals and recommendations also contains the Report of High Level Group.

2. THE NEW ROLES FOR INDEPENDENT DIRECTORS

Corporate scandals have launched a broad debate about the causes that led to the collapse of Enron, Parmalat and other corporations. The post-Enron reforms lay the groundwork for a revised model of corporate governance. The model operates at many different levels. It imposes new duties, new liabilities, and a new regulatory structure on certain gatekeepers, accountants in particular but also lawyers and, in a fashion, securities analysts. But, the prevailing opinion that the inadequacy of the board of directors was a major factor of corporate collapse,[12] has put the board back into the focus of regulatory initiatives. This perception of the board initiated a reform in two directions: to change its role and its structure. Thus, in these globalizing times, as a leading issue of corporate law has again arised the question whether one-tier or two-tier corporate governance system (or component thereof) possesses relative competitive advantage, while the scholars has become enchanted with the notion of "global" convergence in corporate governance.[13] The cumulative effect of the above pressures led to significant reconceptualisation of the board's role and structure. First, the advising board model was replaced by the "monitoring board", and this new model rapidly became conventional wisdom.

The shift towards to new corporate governance paradigm granted a new role for the board: the monitoring of financial controls and disclosure. Stock market prices were not spontaneously created – they could be manipulated and influenced by self-interested managerial action, and the new approach that incorporated stock prices into both compensation and termination of directors created powerful incentives for such behavior.[14] This has placed new and greater demands on the monitoring capacity of boards and the effect of the reforms on the board's role is to make the role of the independent director more important than ever. Both the state law and the stock exchange listing requirements imposed more rigorous stan-

[12] G. Ferrarini *et al.*, *Reforming Company and Takeover Law in Europe*, Oxford University Press 2004, 228, 232.

[13] D.M. Branson, "The Very Uncertain Prospect of "Global" Convergence in Corporate Governance", *Cornell International Law Journal* 2/2001, 321 323. However, this author believes that convergence in corporate governance is far more likely to be regional rather than "global", and may occur in discrete areas, such as financial accounting or disclosure (362). During the last decade, a variety of academic disciplines, including law, finance, and sociology, have paid sustained attention to the potential convergence of these two systems of corporate governance. American law professors who study convergence have primarily examined whether European companies are moving toward the Anglo American pattern either because of cross border mergers and acquisitions resulting from American institutional capital investing abroad, or as a consequence of global competition, each of which favors a focus on shareholder value. Contrary views suggest that corporate governance systems will not converge to any great extent because of politics, path dependence, and history.

[14] J.N. Gordon, 1540.

dards of director independence. Boards, in particularly the audit committee, are given a specific mandate to supervise the company's relationship with the accountants and thus to oversee the company's internal financial controls and financial disclosure. As a consequence, directors then, would have a particularized monitoring role, what might be called "controls monitoring," in addition to "performance monitoring."[15]

Another key issue of the reform concerned the composition of the board. This question is not of pure technical nature, but related essentially to governing relations in each company. In companies with dispersed ownership, shareholders are usually unable to closely monitor management, its strategies and its performance for lack of information and resources. The role of non-executive directors in one-tier board structures and supervisory directors in two-tier board structures should be to fill this gap between the uninformed shareholders as principals and the fully informed executive managers as agents by monitoring the agents more closely.[16] Even in controlled companies, there is a need for monitoring by non-executive directors or supervisory directors on behalf of minority shareholders, given that the position of the controlling shareholder(s) creates potential conflicts of interests with minority of shareholders who lacks sufficient information and resources to monitor management and the controlling shareholder(s).[17] In a public company with a controlling shareholder, outside directors can also plausibly play a productive corporate governance role by acting as a check on the blockholder. The newest analysis also suggests that board composition is a key determinant of corporate value, but not the reverse, and the evidence supports causality running from an increase in allied directors leading to a reduction in corporate value.[18]

Outside directors of public companies play a central role in overseeing the company's management. Non-executive and supervisory directors normally have a role of oversight of the executive managers in areas like the financial performance of the company and major decisions affecting its strategy and future. However, there are three areas where there is a specific need for impartial monitoring by non-executive and supervisory directors: the nomination of directors, the remuneration of directors and the audit of the accounting for the company's performance. In these three areas, executive directors clearly have conflicts of interests. Lack of monitoring by independent, disinterested non-executive directors in these

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[15] *Ibid.*, 1539 1540.

[16] High Level Group III 59.

[17] *Ibid.,* 60.

[18] J. Dahay, O. Dimitrov, J.J. McConnell, "Dominant Shareholders and Allied Di rectors: A Simple Model and Evidence from 22 Countries, ECGI", Working Paper Series in Finance, No. 99/2005, 33 34, *http://papers.ssrn.com/sol3/papers.cfm?abstract id 805544*, last visited 15 March 2011.

three areas has been a major cause for the various corporate scandals that we have witnessed in the last decade, and an important element of the regulatory responses that followed therefore has focused on strengthening the independent monitoring by non-executive directors in these areas.

It is likely that the optimal number and degree of diversity of independent directors will vary from industry to industry, from firm to firm, and from time to time. Any recommendation for a minimum number of independent directors and for a higher degree of diversity among directors is likely to be good for some companies and bad for others. High Level Group does not express views on composition of the full one-tier board or supervisory board, and to what extent independent non-executive or supervisory directors should be members of it. But, promoting the role of non-executive and supervisory directors, the Group expressed the view that, for all listed companies in the EU, should to be ensured that nomination, remuneration and audit committees should consist exclusively of independent non-executive or supervisory directors, but rejected this as a European rule, considered it neither appropriate nor necessary.[19] It is therefore recommended by High Level Group that the European Commission issue a Recommendation to Member States that they have effective rules in their company laws or in their national corporate governance codes ensuring that the nomination and remuneration of directors and the audit of the accounting of the company's performance is decided upon by non-executive or supervisory directors who are at least in the majority independent, and it should be enforced at least on a *comply or explain* basis.[20] In most countries the recommendations on these issues are not binding, since listed companies are free to decide whether to comply with them or to explain why they do not. This approach relies on the free market response, and companies and their CEOs, however, one may find it hard to explain convincingly why they have deviated from recommended behavior, and the cost in terms of lower investor confidence of such a move may be higher than the cost of following commonly-adopted corporate governance recommendations.

Outside directors constitute a key component of most prescriptions for good governance of public companies. The core assumption is that outside directors can make a pivotal contribution by monitoring the performance and conduct of senior executives, thereby enhancing manage-

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[19] High Level Group III 60 61. The Group noted that: "In Europe, we have to take account of particular situations relevant to board structures, like the existence of control ling shareholders and boards which are partly codetermined by employees".

[20] *Ibid.,* 61. Principle *comply or explain* means that the listed companies are obli ged to fully comply with this requirement or to disclose in their annual corporate governan ce statement to what extent and why they deviate from it. The European Commission adop ted the Recommendation on the role of non executive/supervisory directors on 06 October 2004., which urges Member States to ensure a strong role for independent directors.

rial accountability, and also contributing to the strategy development. It is believed that independent directors have a comparative advantage for these different tasks. They are less dependent on the CEO and more sensitive to external assessments of their performance as directors; they are less devoted to inside accounts of the company's prospects and less worried about the disclosure of potentially competitively sensitive information. They also have credibility in the "checking" of market signals and they might create significant value in the allocation of resources. This emphasizes the critical role of independent directors as an efficiency and justified strategy for importing stock market signals into the firm's and the economy's decision-making.[21] Thus, this role of outside directors requires the development of various mechanisms of director independence aimed at producing directors who will be independent in fact.

3. NEW STANDARDS OF DIRECTOR INDEPENDENCE

Independence of directors is viewed as the most important corporate governance issue, and it is one of the cornerstones for efficient control, and the shift towards independent directors is reflected not just in the numbers or percentages but also in the likelihood of independence in fact. In the last decades we have observed the common trend to stricter standards of independence which today serve as a common denominator for good corporate governance. Independent directors are individuals who serve on the board of a company but do not act in any sort of executive capacity. They are obliged to comply with various legal duties, the details of which vary across countries. Although definitions vary in detail, convergence can be noted in the growing tendency towards stricter standards of director independence and the strengthening of various mechanisms that enhanced the independence-in-fact of directors.[22]

A popular view present on both sides of the Atlantic, holds that outside directors should be more independent, as reflected also in their selection and nomination process, more numerous and more diverse, more active and more in control of the board's monitoring activity.[23] But, the unresolved question still is what exactly constitutes "independence". The concepts of what 'independence' is meant by and who or how many of directors should be independent in the sense of the relevant rule differ widely. As it is well known, no definition of independence will ever assure that an independent director will indeed act as such. Regardless of

[21] J.N. Gordon, 1471.

[22] K.J. Hopt, P.C. Leyens, 21.

[23] D. Higgs, *Review of the Role and Effectiveness of Non Executive Directors,* 20 January 2003, 6 7, 42 44, *http://www.berr.gov.uk/files/file23012.pdf*, last visited 15 March 2011.

the debate on the notion of independence there is a practical need to establish what are the criteria and standards of independence (property, status, personal, moral, competence and experience), according which to evaluate whether the non-executive or supervisory directors are eligible to be considered independent or not. That is why the High Level Group recommended to the Commission to establish the minimum list of the principles of independence, that should include a list of relationships which would cause a non-executive or supervisory director to be considered not to be independent. In the view of the High Level Group, "such a list should at least include: [24]

- Those who are employed by the company, or have been employed in a period of five years prior to the appointment as non-executive or supervisory director;
- Those who receive any fee for consulting or advising or otherwise, from the company or its executive managers;
- Those who receive remuneration from the company which is dependent on the performance of the company (e.g. share options or performance related bonuses, etc.);
- Those who, in their capacity as non-executive or supervisory directors of the company, monitor an executive director who is non-executive or supervisory director in another company in which they are an executive director, and other forms of interlocking directorships;
- Those who are controlling shareholders, acting alone or in concert, or their representatives. Controlling shareholder for the purposes of this rule could be defined, as a minimum, as a shareholder who, alone or in concert, holds 30% or more of the share capital of the company.
- In defining relations which disqualify a non-executive or supervisory director from being considered to be independent, related parties and family relationships should be taken into account."

The regulatory approach in the United Kingdom to the determination of independence is more flexible. According to the revised Combined Code independence primarily means that there are no "relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement".[25] In addition to this general definition the revised Combined Code lists the following seven indicators where a director, in

[24] High Level Group III 62 63. Such the Law on Commercial Companies, *Offici al Gazette of the Republic Serbia*, No. 125/04, Article 310 (3), Article 318 (1), Article 325 (1), also provide the criteria to director's independence.

[25] Combined Code section A.3.1, *http://www.fsa.gov.uk/pubs/ukla/lr comcode2003. pdf*, last visited 15 May 2011.

principle, should not be deemed independent: employment contract with the company or group within the last five years, a material business relationship within the last three years, additional remuneration apart from the director's fee, close family ties, cross-directorships, representation of a significant shareholder, or a directorship for more than nine years. The board should explain its reasons in the annual report if it determines that a non-executive director is independent although one of the specific examples indicates that he is not. Similar to the approach of the Combined Code, the general definition of independence in the France code of Corporate Governance is supplemented by specific examples that indicate non-independence.[26]

However, a paradigm of independence is even wider. Central issues in post-Enron debate has focused on conflict of interest rather than competence. But, it has been observed from the beginning of the independent director movement and since the foundation of practical experience in respect of the directors' independence that the specific management knowledge and business relations of the board of directors can be highly useful both the running and the control of the company. The codes stress a director's competence and experience as key qualities that should be regarded separately and in addition to independence. However, it is not so easy to ensure simultaneously competence and independence, and sometimes it could be a case of trade-of between loyalty and competence. While non-executive directors do not face the same conflicts of interest as executive directors, they may be less familiar with the company's affairs and less competent than executive directors. This is already the case for supervisory board members, particularly under labour co-determination. If strict independence requirements for non-executive directors are set up, ensuring competence becomes a real problem.[27]

Specifying what competence involves – for example, being able to read balance sheets or demonstrating 'financial literacy – could help, but it may unduly restrict companies' choice of directors. A way out of this dilemma may be disclosure, that is, a rule requiring the company to disclose why each non-executive director is considered competent or fit and proper for his office.[28] Another solution might be to require competence, but to ask for training, including continuous professional education as in other professions, or forming pools of candidates for directorships. In any case, ensuring of non-executive directors of competence is a real problem, not

[26] Principes de gouvernement d'entreprise résultant de la consolidation des rapports conjoints de l'AFEP et du MEDEF de 1995, 1999 et 2002, Paris Octobre 2003, section 8, *http://www. natixis.com/upload/docs/application/pdf/2009 03/afep medef oct 2003.pdf*, last visited 15 May 2011.

[27] K.J. Hopt, 459 460.

[28] *Ibid.*, 460.

only for countries in transition, but also for developed countries. In view of this requirement the High Level Group considers that the existing rules on the competence which is expected of non-executive and supervisory directors are generally abstract. In the light of the collective responsibility of all board members for the financial statements of the company, the High Level Group considers that basic financial understanding is a fundamental skill all board members should possess or acquire upon their appointment, but other skills may be of high relevance as well and board members may be elected for their expertise in particular areas.[29]

A different mechanism for director independence focuses on incentives – sanctions and rewards – for particular director behavior. Most commonly these are economic, but reputation matters too. An important mechanism for director independence is the creative use of board structure to create a spirit of teamwork and mutual accountability among independent directors that helps foster independence-in-fact. Structural innovations multiplied over the last decades, including board committees tasked with specific functions in areas where the interests of managers and the shareholders may conflict.[30]

Recent proposals have stressed the importance of having a higher number (usually a majority) of independent directors on the board. Besides to a number of independent directors, emphasis has been given also to the importance of putting together a diverse set of board directors, because "the interplay of varied and complementary perspectives amongst different members of the board can significantly benefit board performance".[31] In order to ensure independence, emphasis has been given to the process of selecting and nominating independent directors. A director's independence-in-fact may be seriously affected by the route by which the director arrived on the board.[32] In addition, more time and money should be allocated by companies for this. Some of the initiators emphasize the need to establish special pools and funds for the recruitment and refreshing the knowledge and skills of directors.[33] On the other hand, if we allow the independent director can be removed without cause, we must ask whether he can then really be independent.

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[29] High Level Group III 63.

[30] J.N. Gordon, 1483 1490.

[31] D. Higgs, 42.

[32] J.N. Gordon, 1496. The author points out that: "Until recently, CEOs heavily in fluenced if not controlled outright director selection. Directors picked in this way are likely to feel a strong sense of loyalty, even gratitude, to the CEO".

[33] D. Higgs, 6 7, 42 45. So, Higgs in his report suggests that directors are elected to the senior management, just below board level, that women are more represented, as well as foreigners and persons from the noncommercial sector sitting in the bodies of charities and public sector institutions.

4. THE REALITY OF THE EXPECTATIONS OF INDEPENDENT DIRECTORS

The global trend of corporate governance reforms have emphasized on the importance of board independence. The reform efforts over the last decades enhance substantially the conditions that foster director independence and the cumulative effect of innovations in these various mechanisms significantly increased director independence-in-fact. Legal institutions encourage the appointment of at least some indpendent directors in all of the principal corporate law jurisdictions.[34] But, it is a well-known phenomenon that there are two main sets of legal rules on the supervision on corporate management: one-tier board system and two-tier-board syistem, where issues related to independent directors do not reflect in the same way.

This tendency toward independent non-executive directors is less marked in countries with a two-tier board system such as Germany. In Germany, some argue that the supervisory board members are *per se* outside or non-executive directors.[35] As their task is clearly defined and limited to the control of the company, it is not necessary for them to have the same degree of independence as the non-executive directors on the unitary board. Therefore, typically, the two-tier countries advocate a minimum standard for the inclusion of independent directors on the boards of listed companies.[36] But, there are some structural deficiencies of two-tier system which are unfavorable for the independence-in-fact. Thus, the separation of management and control – the key advantages of the two-tier system – somewhat dilutes the independence of the members of supervisory board. Namely, the members of the supervisory board are not involved in the decision-making process at all. The way in which the supervisory board exercises its control is always reactive and never active. This necessarily leads to a decrease of the quality of control. The need for information is another weak point in the two-tier system of control, which stems from the supervisory board's non-involvement in the decision-making process and the fact that its members are not present at the meetings

[34] R.R. Kraakman *et al.*, *The Anatomy of Corporate Law, A Comparative and Functional Approach*, Oxford University Press 2004, 50.

[35] K.J. Hopt, 459 461. This author points out that: "Yet as a European rule for all Member States, this creates considerable difficulties for countries with labour co determination, in particular for Germany". It is obviously that a common standard of independence proves difficult for labour participation. Representatives from workers' unions could qualify as being free from any direct business relationship but they are bound to the interests of the union's members, i.e. the employees of the company.

[36] C. Jungmann, "The Dualism of One Tier and Two Tier Board Systems in Europe", 2009, 13, *http://www.duslaw.eu/files/TheDualism of One Tier and Two Tier Boards in Europe (Jungmann). pdf*, last visited 15 May 2011.

of the management board. Therefore, there is a strong information asymmetry between two boards, since all information concerning of questions of strategy, future projects, business opportunities, budgetary questions, etc. lies in the hands of management board. In addition to the structural deficiensies of the two-tier system, there are problems originating solely from the German laws of co-determination – it complicates the introduction of mandatory qualification standards for all members of the supervisory board. Such standards would be considered as an obstacle to employees to freely choose their representatives. However, without common standards concerning qualification and professional experience, it is extremely difficult to ensure the quality of work performed by the members of the supervisory board.[37]

In the unitary system, non-executives directors have, contrary to members of the supervisory board, direct right to information. But, the one-tier system has an inherent weakness – the members of unitary board fulfill both managerial and supervisory roles, i.e. they should make decisions and, at the same time, monitor these decisions. The mere fact that there are executive and non-executive directors is not sufficient to guarantee the adequate execution of the monitoring role of the board. Therefore, independence is deemed to be a necessary precondition for the ability to handle the combination of two tasks in practice. This has led to a further class of board members: within the group of the non-executives directors, only some are deemed independent. It thus remains a problem of the one-tier system to find ways to guarantee that a certain number of board members are independent and to name criteria for independence. In addition, the independence non-executive directors face the dilemma of being colleagues with the other board members but also having to monitor them at the same time. It is mainly the responsibility of the chairman to hold meetings in an environment in which there is a clear understanding of the different tasks of the board members and in which problems and questions can be discussed frankly and openly. What remains, however, is the structural weakness of the one-tier system, in which the effectiveness of corporate control depends not only on the personality of the non-executive directors, but foremost on the personality of the chairman. Thus, a minimum formal requirement should be that the chairman is not a also the CEO and that he is independent.[38]

But, regardless of whether one or another corporate governance system is concerned, the difficult problem remains: independence is more a disposition, a state of mind, rather than a concrete fact. However, adoption of these various governance innovations both reflected a cultural

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[37] *Ibid.,* 5 6.

[38] *Ibid.,* 10 11. Thus, both requirements are recommended in Sec. A.2.1 and Sec. A.2.2 of Combined Code.

change in the expectations of director behavior and helped create the cultural change, so that board composition and board attitude have notably shifted toward independence-in-fact.[39]

There is a tendency to think that simply having independent directors improves corporate governance, but the reality sometimes may be the opposite. Evidences that connect the increased presence of independent directors to shareholder benefit are weak. Even in the United States, which are the birthplace of today's reforms, it is unclear how much independent directors actually contribute to the improvement of corporate governance.[40] There are numerous surveys which point out that there was a tremendous gap between the current performance of independent directors and the expectations of the public, and there is only limited evidence that board independence generates differences in board behavior, and the differences are not clear.[41] Nowadays it is certain that the high expectations of independent directors have been only partially fulfilled.[42]

On the other hand, it is obvious that the expectations of independent outside directors are still too high. Independent directors are expected to have an enhanced role in committees, not to sit idle in them. They are expected to get familiar with the company and its organization, to be informed, to control the executive directors, to set them intelligent and unsentimental questions, to review their most important decisions, to monitor the external auditors, to determine appropriate compensation for executive directors, and etc. But as first and foremost, integrity, probity and high ethical standards are a prerequisite for all directors, so that we can ask whether they are expected to more than human. Bearing in mind the qualities required of an independent director and the task given to him by corporate governance best practice codes, it is natural wonder, such as professor Enriques, "whether there are indeed enough human beings around who may qualify to serve as independent directors or whether, instead, such an independent director will have to be a sort of *homo no-*

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[39] J.N. Gordon, 1499 1500.

[40] R.R. Kraakman *et al.*, 51.

[41] J.N. Gordon, 1500 1501. The author points out that "[m]ost studies find little correlation, but a number of recent studies report evidence of a negative correlation be tween the proportion of independent directors and firm performance but the conclusion is the same: that increasing the degree of board independence does not improve firm per formance".

[42] K.J. Hopt, "Comparative Corporate Governance: The State of the Art and Inter national Regulation", ECGI, Law Working Paper No. 170/2011, 38, January 2011, *http:// papers.ssrn.com/sol3/papers.cfm?abstract id 1713750*, last visited 15 May 2011. In ad dition, the author says that: "Independent directors seem to have had an impact on replac ing executive directors, but this was often mainly due to pressures from institutional in vestors. More recently, independent directors have not been able to prevent huge scandals, e.g., Enron, where the board was composed of a majority of qualified independent direc tors."

vus, created by capitalism in order to overcome its current crisis" – because, in fact, "anyone displaying this plethora of personal qualities would qualify for sainthood".[43]

Hyperactivity of independent directors can also produce countereffects, because it is obvious that CEOs of public corporations will have much less freedom to serve their own interests, but also much less freedom (and less time) to make innovative and profit-generating business decisions. Therefore, the warning that "the increased bureaucratization of business decision-making within public corporations may well be the most negative long-term consequence of Enron and its progeny of scandals, fostering going-private transactions and delaying plans to go public by existing private companies", should be taken very seriously.[44]

Given that outside directors are important, one is led to wonder what will motivate the individuals serving in this capacity to carry out their responsibilities in an effective manner. It is also said that independent directors may have fewer incentives to monitor management activity than other directors because their pay is less and has not included stock options. Remunerating independent directors had always been a big question mark for companies. The immediate doubt which arises as soon as the remuneration of an independent director is specified is whether the director's independency still stands good.[45] Companies seeking to recruit top-flight boardroom candidates theoretically could increase directors' fees. Moreover, if director's remuneration becomes genuinely lucrative, some directors might become too dependent on their positions and lose the independence that is felt to be critical to good corporate governance, since outside directors play a central role in overseeing management.[46] On the other hand, if companies increase a risk of personal liability of independence directors it could also result in a counterproductive effort by directors to formalize boardroom procedures and create a paper record

[43] L. Enriques, "Bad Apples, Bad Oranges: A Comment from Old Europe on Post Enron Corporate Governance Reforms", *Wake Forest Law Review* 3/2003, 931 932, *http://papers.ssrn. com/sol3/ papers.cfm?abstract id 464241*, last visited April 2011.

[44] *Ibid.,* 931.

[45] The remuneration of directors and "pay without performance" has become a prominent topic in the US, the UK and more recently in many other European and non European countries as well. The recent corporate scandals and the current financial crisis has led to the detailed rules on remuneration, in order to prevent perverse incentives in financial institutions for corporations. The tendency of these rules is to balance the vari able and non variable components of remuneration, to define performance criteria in view of long term value creation, to defer a major part of the variable component for a certain period of time, to have contractual arrangements permitting the reclamation of variable components under certain circumstances and to limit termination payments.

[46] B.R. Cheffins, B.S. Black, M. Klausner, "Outside Directors, Liability Risk and Corporate Governance: A Comparative Analysis", ECGI, Working Paper No. 48/2005, 31, *http://papers.ssrn.com/sol3/papers.cfm?abstract id 800584*, last visited March 2011.

for everything they do. An additional potential negative consequence of increased out-of-pocket liability risk is that capable people will be less willing to serve as outside directors and those individuals who agree to serve as outside directors despite a significant risk of out-of-pocket liability may well demand higher fees to compensate for that risk. If companies do raise director's pay substantially to recruit and retain quality outside directors, the change could impair the quality of corporate governance.[47]

The rise of independent directors is a very important change in the political economy landscape, and should be evaluated in light of new corporate governance paradigm, that places shareholder value as the primary corporate objective, and looks to the stock price as the measure of most things. Maximizing the stock price serves to promoting the interests of shareholders and making use of the information impounded by the market to allocate capital efficiently. This new paradigm also opens up space for a distinctive role for the independent board: deciding when prevailing prices misvalue the firm and its strategies. In this environment, independent directors are more valuable than insiders, because they are less committed to management and less captured by the internal perspective. In this way, independent directors are an essential part of a new corporate governance paradigm, and have become a complementary institution to an economy of firms directed to maximize shareholder value.[48]

The responses by countries and firms aimed at improving corporate governance practices, primarily through altered board structures, raise the question whether or not such changes in corporate governance are reflected in improvements in corporate valuation. Some authors find that improvements in corporate governance over and above what can be considered the norm and average practice in the country have a positive effect on firm valuation, the market provides incentives for firms to improve corporate governance and enhance shareholder value.[49] The turn to independent directors serves a view that stock market signals are the most reliable measure of firm performance and the best guide to allocation of capital in the economy, but that a "visible hand," namely, the independent board, is needed to balance the tendency of markets (as an "invisible hand") to overshoot. In this time of increased shareholder activism, one important question is whether the enhanced independence of directors will create a

[47] B.R. Cheffins, B.S. Black, "Outside Directors, Liability Across Countries", ECGI, Law Working Paper No. 71/2006, 1479 1480, *http://papers.ssrn.com/sol3/papers.cfm?abstract id 438321*, last visited March 2011.

[48] J.N. Gordon, 1563.

[49] V. Chhaochharia, L. Laeven, "The Invisible Hand in Corporate Governance", ECGI Working Paper Series in Finance, No. 165/2007, 27 28, *http://papers.ssrn.com/sol3/papers.cfm? abstract id 965733*, last visited 15 Jun 2011.

space for a public firm to resist stock market or whether the very pressures that give rise to director independence will in the end defeat this possibility. Another open question is whether the independent board has even this independence from the stock market. If the apogee of a corporate governance paradigm resting on independent directors, in that case the independent board may also mark the moment of its decline.[50]

It is not to easy to observers to be very optimistic about the role of independent directors in corporate governance around the world. Bearing in mind that the independence of directors is only one element of corporate governance structure, it is probably still too early to give a final answer, and it remains to be seen whether the movement for independent directors will provide a better quality of corporate governance. By making independent directors a key aspect of good corporate governance, companies and regulators may be lulled into a false sense of security by compliance with it. Therefore, for the sake of precaution, in the meantime, we should bear in mind that the growing importance of codes of conduct, listing rules, and corporate governance ratings leads to a considerable unknown market pressure,[51] and the powerful "invisible hand" of market could defeat "visible hand" (independent directors – namely, independent board) with role to balance it. In this case, the possible failure of this part of corporate governance reform will once again require government interference and the "helping hand" of government will be needed to improve corporate governance by force through new laws and regulations. We can conclude that "independent directors" is the answer, but it seems that there are still more questions than answers.

[50] J.N. Gordon, 1469 1472, 1564.

[51] K.J. Hopt, P.C. Leyens, 20.