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Preface

In recent decades, board independence has become high on the agenda of corporate governance reform, resulting in a dramatic change in the composition and structure of the boards of publicly traded companies. Debate nevertheless continues: the inefficiency of independent directors has been regularly explored by commentators, and the current financial crisis appears to reinforce the doubts about the contribution of board independence. In this thesis, the author stands with the proponents of independence, firmly backing the movement encouraging more independent directors to join the boards of listed companies. However, this thesis intends to bring a more systematic analysis, which many previous academic studies have ignored, to a number of questions; for example, what specific functions are expected of independent directors? How can these functions conform with the unitary board structure? Why are independent directors seen as an inherent demand of corporate governance? Can they be compatible with other governance mechanisms? How can their value be better appreciated? And how is mainstream company law applied to independent directors? On the other hand, the author accepts some critical findings about the difficulties which independent directors face, in practice. In response, the author offers a series of solutions, which critics have rarely mentioned, for the purpose of eliminating those obstacles. In general, this dissertation seeks to fuse two sides of academy, that is, the advocates and critics of independent directors; and chart a course through which independent directors can better serve the goal of improving the system of corporate governance.

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Finally, this book is dedicated to my family. Without their support, the five years of continuous doctoral study would have been a far more arduous process, and I would not have been able to present this book to the world.

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Introduction

Since the 1970s, 'corporate governance' has been a popular term for the academy of company law. In its narrow meaning, as classically defined by the Cadbury Report of 1992, corporate governance refers to 'the system by which companies are directed and controlled'.[1] In other words, it is about how the internal structure of the company should be constructed and how the relationship between the board of directors, management, and shareholders is to be organised. Definitely, a successful company must be run under a well-structured system, with a view to ensuring co-operation and a reasonable division of power and authority between participants with no one party given a monopoly on all the powers. Certainly, such a balanced regime is what a classical model of corporate governance strives for;[2] shareholders invest their money into the company in return for stockholding along with voting power, by which they can select directors to form the board; with the board in charge of the power of business control as a top organisation within the internal hierarchy; the senior officers are hired by the board to serve the purpose of daily management, and if necessary, the board may delegate some of its power to these managers.

Within this system of corporate governance, it is clear that a good firm depends on many smart and honest business professionals at all levels. There is no doubt that intelligence and integrity are the most important characteristics of management. However, in recent decades, some high-profile scandals and failures of large companies, for example, the incredible crash of Barings Bank and the notorious collapses of Enron and WorldCom, which have generally been attributed to a poor regime of internal control and slackness in detecting financial problems at

1. *Cadbury Committee Report on the Financial Aspects of Corporate Governance* (Gee, 1992), para. 2.5.
2. In this thesis, the scenario of corporate governance specifically refers to the governance of public companies whose shares are traded on the stock market – e.g. London Stock Exchange.

an early stage, remind us of certain drawbacks within the traditional system. In some incidents, these collapsed companies were criticised for blindly ignoring 'red flag' signals prior to the occurrence of the scandals, due to a lax monitoring system within their organisations. It may be argued that, if the system could be tightened up and appropriate reviews could be undertaken, similar tragedies, or at least some of them, could be avoided. In this sense, corporate governance lost its purpose in these events, because it failed to work as a 'firewall' to insulate the company from potential risk, or act as a 'brake' when the company was being driven on the wrong track.

1. THE PROPOSAL OF 'BOARD INDEPENDENCE'

In response to the above problems, the academy has long attempted to offer proposals designed to eliminate irresponsible behaviour while retaining the confidence of the industry. Many proposals have thus been put forward for discussion by commentators setting out their visions on the future development of corporate governance. In all those agendas to reform the incumbent system of corporate governance, the board of directors has been thrust firmly in the spotlight. To be sure, it is necessary to mention here that the formation of corporate governance is a complicated mixture of multifarious factors in relation to the running of a business. Within all the parts, the board of directors is only one piece of the picture. However, given the fact that the board has been traditionally recognised by law as the leadership body of the company, it is not strange that a great extent of attention is intensely focused on those holding seats in the boardroom.

It is suggested that an effective board could be very beneficial for both the purposes of promoting business performance; that is, ensuring the prosperity of the company, and also improving internal integrity by rendering the management more accountable and rooting out potential abuse of corporate powers. In the modern age, however, the contributory role of the board may be offset by certain factors. In the unitary board structure prevalent across the Atlantic, as senior offices are appreciated for their contribution to the company, they may sometimes receive an invitation into the board as a reward, and then be enrolled as an executive director. By recognising their professional kill and business talent, the board would usually delegate authority to these executive directors in charge of primary management. As a result, when the executives gradually dominate the boardroom, the board may finally fall to be merely a prolongation of the management, rather than a superior body that should be empowered to objectively keep an eye on the delegated management. Therefore, in a situation where the management power grows quickly at the expense of the shrinking of the board's role, the board would become more powerless to monitor, question and confront management.

In order to regain a balance in power sharing and ensure that any individual does not autocratically control the board, the academy has placed its emphasis upon the group of 'non-executive' or 'outside' directors. In fact, the term 'non-executive director', or, in US terms, 'outside director', is not a brand-new title.

It refers to those directors who are not incumbent members of the management and are not generally detailed to carry out the function of the running of the business. Given that they sit outside the inner group of executives, the presence of non-executive directors can be possibly treated as a counteractive force against the domination of management. Thus, the board can still, at least to a certain extent, resist the assimilation by the management and keep its self-existent position. In accordance with views set out in the Higgs Review,[3] an effective board, which should embrace an idea of power equilibrium, may normally require a balanced composition of executive and non-executive directors.

During the discussion of the contribution of non-executive or outside directors, one particular characteristic has long received greater attention: independence. The proposal is indeed a call for 'board independence', which means that independent non-executive or outside directors should dominate the board instead of executive directors. Put another way, if the theory of corporate governance does want the board to be a leadership organ that is separate from the executive team, then non-executive or outside directors must be less influenced by the management's philosophy and retain their objective judgements. In this sense, in most situations, a group of 'independent directors' is actually what the reform wants to achieve. Such a requirement has been commonly recommended by market rules, for example, the UK Corporate Governance Code (in place of the Combined Code) states that non-executive directors, who meet a defined standard of 'independence', should compose a majority of the board, and moreover, they should be able to actually control a number of core sub-board committees. Consequently, 'the independence of the board' is a central topic in modern theories of corporate governance.

2. A NOTE ON THE CREDIT CRUNCH

In the midst of writing this thesis, an unprecedented financial crisis occurred. This 'plague' quickly spread over the planet and cruelly hit the global economy. Amidst this crisis, the banking industry in the UK is certainly a poor victim. The government found itself with no choice but to rescue them through the injection of billions of pounds of the taxpayers' money. Reluctantly picking up the bill, the public angrily questioned the banks for making overly bold decisions or fanatically financing their business through takeovers, without carefully evaluating potential risks. Later, when it was revealed that one former bank head, who was generally held responsible for the massive losses of his institution, could still be entitled to his pension of nearly Great Britain Pound (GBP) 700,000 a year, the public was

3. Derek Higgs, *Review of the Role and Effectiveness of Non-Executive Directors* (January 2003), 4.2: 'In the unitary board structure, executive and non-executive directors share responsibility for both the direction and control of the company. The benefit of the unitary board, strongly supported in consultation responses, is the value of executive knowledge within the board, alongside non-executive directors who can bring wider experience.'

furious. When it was further disclosed that banks sought to distribute billions of pounds as bonuses to their senior staff, the public viewed it as absolutely unacceptable since it appeared that those banks, which had received significant public funds to keep them afloat, were now using the taxpayers' money as 'reward for failure'.

In all these events, the board was often the target of the irritated public. The angry question among the public was, why did the boards fail to constrain the over-ambitious and risk-taking management? Why did the board design excessive remuneration packages that were criticised as disproportionate and 'short-termist'? If it is suggested that the board should be in a position to oversee the performance of management, where were the independent directors when we expected them to play a key role in this regard? All these emotional questions can be summarised as a criticism against the system of board independence. It may suggest that independent directors failed in their responsibilities, or at least, they did not carry out their functions effectively.

All these allegations provide us with a proper opportunity to carefully review the system of 'board independence' in a practical paradigm. A number of serious questions should be seriously considered: what should independent directors do? How can they effectively fulfil their roles? What are the obstacles that stand in the way of their efficiency? What can be done to remove these barricades? It is certainly a mission of this thesis to answer them.

3. RESEARCH BOUNDARIES

Before discussing detailed components of 'board independence' in the following chapters, here, the author intends to first make it clear that the research for this thesis is exclusively based on the structure and circumstance of corporate governance in the UK and US (as representatives of Anglo-Saxon system), where the 'separation of ownership and control' (a conception which will be analysed in the following chapters) and the single board system are common features. Since this thesis is finished in the land of UK, the research on a local basis can be understandable. And given the fact that the US shares a similar system and symptom and both jurisdictions are relying board independence as a prescription, reference to American development is somewhat necessary.

However, it is necessary to bear in mind that there is not only one corporate governance system around the world. Although a strong performance by financial markets in London and New York has given rise to a popularity of the Anglo-Saxon corporate governance model, it is still merely a group within the universe of corporate governance systems.[4] A distinct model, which takes root in Continental Europe (e.g. Germany) and spreads to many other countries (e.g. Japan), represents an opponent of the Anglo-Saxon system. In this model, ownership structure is

4. See Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership around the World*, 54, no. 2 The Journal of Finance 471–517 (April 1999).

concentrated rather than dispersed, and responsibilities of management and leadership are separately arrangement to two boards rather than combined in a single board.[5] Thus, it is questionable whether board independence, as a solution to the problems of corporate governance in the Anglo-Saxon system, may be smoothly applied to and equally efficient in a system where conditions are significantly different.[6] Answering this question and providing compatible proposals deserves a systematic study,[7] but it is not within the content of this thesis, neither is it the intention of the author to compare two models so as to judge the superiority of each one. All in all, readers should not misunderstand what the author discusses in this thesis as a 'one-fit-for-all' system.

4. THE STRUCTURE OF THE THESIS AND RESEARCH ISSUES

As the title of this thesis suggests, the system of board independence is the core topic of the research. In order to understand it, we must have a clear thought about its development in history. Chapter one thus starts as a review on this issue. It considers a number of critical questions: Is non-executive or outside directors, or as currently called, 'independent directors', an original component of corporate governance since the company was created as a business form? If not, when were these directors introduced into the company, and what was reason for their introduction? For which purposes were they expected to serve, and are these purposes unchanged at all times during the development of the notion of board independence? More importantly, by reviewing historical development across the Atlantic, Chapter one is supposed to find out whether, in chasing the goal of board independence, two countries, the UK and US, were through the same way and under the same impetus. If there was a difference, what are the factors of causing it? These considerations help us better understand the regulatory frameworks as what will be discussed in next chapter.

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5. See, e.g. Petri Mäntysaari, *Comparative Corporate Governance: Shareholder as Rule-Marker* (Berlin: Springer, 2005), Chs 5–6; Eddy Wymeersch, 'A Status Report on Corporate Governance Rules and Practices in Some Continental European States', in Klaus Hopt et al., *Comparative Corporate Governance: The Status of the Art and Emerging Research* (Oxford: Oxford University Press, 1998), at 1078.
6. This question has been seriously raised in some developing countries, for example China, which traditionally implanted German corporate governance model, but currently is under influence of Anglo-Saxon system to introduce independent directors. See, e.g. Yihe Zhang, *Review and Reconstruction: Functional Complement between Systems of Supervisory Board and Independent Directors*, 5 Contemporary Law Review (China) at 22 (2003).
7. Some development in European Union has been made by the High Level Group report during the Communication 'Modernising Company Law and Enhancing Corporate Governance in the European Union: A Plan to Move Forward'. See *Final Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe* (Brussels, 4 Nov. 2002).

In Chapter 2, two different regulatory frameworks are posted in front of us: a statutory model in which board independence should be regulated by the law and the industry only has the option to follow the orders and rules made by authorities, and a self-regulatory system where the industry is allowed to play as a rule-maker and rule-enforcer and the law is averse to interfering with the discipline of the market.The conventional wisdom is that corporate governance should be exclusively placed under either framework: regulated by law or regulated by the industry itself. However, the author intends to explore whether there is a new method by which advantages of two models can be added together and both side effects can be minimised.

After a reasonable regulatory framework is established, a number of new questions arise and much research still remains to be undertaken. Some of the most important topics are outlined below;

First of all, it is essential for us to consider which roles independent directors are supposed to play. It is overwhelmingly supported by commentators that the monitoring function is the primary job of independent directors. However, in the unitary board structure prevalent in Anglo-Saxon countries, where there is only one board to represent the company, there is a worry that an over-emphasis on control may not properly reflect the general role of independent directors. Designating independent directors the sole task of monitoring might confine their participation in board performance, and deprive the company of their potential contribution to the prosperity of business. It is thus analysed in Chapter 3 what multiple roles independent directors should play in serving the board, and how these roles could be compatible with the unitary board structure.

Secondly, it is reasonable to bear in mind that changing the board system is only one of many potential measures of corporate governance reform. It should not be viewed as an exclusive solution to the problems that we face in the modern age, for example, the over-confidence of management and the irresponsibility of the company's leaders. In the face of a number of different proposals designed by intelligent scholars for the purpose of resolving current corporate governance problems, it is questionable whether reforms that focus on improving the board's independence are really indispensable, and cannot be replaced by other means which may possibly be more effective and efficient, for example, by increasing the activism of shareholders or strengthening the self-correction mechanisms of the stock market. By way of a detailed analysis, Chapter 4 is designed to answer this doubt. Moreover, this chapter also reviews a derivative proposal of board independence, that is, an idea to install a pure independent board by removing executive directors (other than Chief Executive Officer (CEO)) out of the board. It is interesting to see whether such a radical change can bring additional benefit to the efficiency of board dynamics.

Thirdly, discussion of the topic of independent directors cannot avoid the following question; are independent directors in practice effective? While the inclusion of independent directors might theoretically be beneficial in creating a sound and responsible system of corporate governance, such a goal might be damaged by obstacles arising in practice that may adversely impact upon the