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# Independent Directors: Magic Bullet or Band-Aid?

## **Abstract**

This article examines directors' independence reforms in Australia, the US and Europe. It examines and contrasts how this end is achieved in the three jurisdictions. It then critically examines the assumption that independent directors necessarily improve corporate governance standards or a company's performance. The fluid nature of Australian corporate governance standards make this inquiry relevant. It concludes that Australia should pause – and look very hard – before it leaps into adopting rules similar to those in the US or Europe.

## **Keywords**

corporate governance, Australia, independence of directors, reforms

## **Disciplines**

Business Organizations Law | Comparative and Foreign Law

# INDEPENDENT DIRECTORS: MAGIC BULLET OR BAND-AID?

By Thomas Ritchie<sup>1</sup>

## Introduction

Recent years have witnessed the high profile collapse of a number of large public companies in Australia, the United States and Europe. Various governments and regulators have responded to a perceived crisis by raising the standard of corporate governance. A common theme in these reforms has been creating some requirement for the independence of directors – although the extent of these requirements has differed.

This article examines directors' independence reforms in Australia, the US and Europe. It examines and contrasts how this end is achieved in the three jurisdictions. It then critically examines the assumption that independent directors necessarily improve corporate governance standards or a company's performance.

The fluid nature of Australian corporate governance standards make this inquiry relevant. It concludes that Australia should pause – and look very hard – before it leaps into adopting rules similar to those in the US or Europe.

## Directors' independence in Australia

In Australia, regulation of directors' independence occurs both directly and indirectly. The Australia Stock Exchange (ASX) has developed principles by which all listed companies should abide. The 'Principles of Good Corporate Governance and Best Practice Recommendations'<sup>2</sup> ('Principles') recommends that a majority of directors are independent. The Principles are a guide only, however ASX Listing Rule 4.10.3 provides that, if a company does not comply with the Principles, it must disclose this fact in its annual report. A disclosure of this nature may have an adverse impact on investor confidence, as recent studies have shown that many investors take an active interest in corporate governance standards.<sup>3</sup> In 2006, a large international survey found that the independence of directors was viewed as the most important corporate governance issue.<sup>4</sup> Thus, companies are encouraged to ensure the independence of a majority of directors.

'Independent director' is defined in the Principles, at Box 2.1:

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

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<sup>2</sup> Australian Stock Exchange Corporate Governance Council, *Principles of Good Corporate Governance and Best Practice Recommendations* (2003) Australian Stock Exchange.

<<http://www.shareholder.com/visitors/dynamicdoc/document.cfm?documentid=364>> at 29 March 2005.

<sup>3</sup> Stephen Bartholomeusz, 'Institutions muscle up over governance' *Sydney Morning Herald* (Australia), 20 April 2006.

<sup>4</sup> Institutional Shareholder Services, *Global Investor Study* (2006) International Shareholder Services <<http://www.issproxy.com/globalinvestorstudy/index.jsp>> at 15 May 2006.

1. is not a substantial shareholder of the company or an officer of, or otherwise associated directly with, a substantial shareholder of the company;
2. 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;
3. 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;
4. 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;
5. has no material contractual relationship with the company or another group member other than as a director of the company;
6. has not 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;
7. is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company.

On 2 November 2006, the ASX Corporate Governance Council released a public Explanatory Paper setting out a number of proposed changes to the Principles. The Explanatory Paper retains the requirement for independence, however it does alter the criteria for determining independence in several ways. If the proposed changes are accepted by the Corporate Governance Council, the following criteria are added to those already in Box 2.1:<sup>5</sup>

- a. the director is employed by the company (or another group member);
- b. there has not been a period of at least three years between the director ceasing employment in an executive capacity by the company (or another group member) and the director serving on the board.

If the proposed changes are accepted, the current criteria 6 (concerning length of service on the board) will be removed.

Importantly, the Explanatory Paper clarifies that the existence of the relationships in Box 2.1 should only be considered initial indicators of matters that could affect independent decision making. The existence of a relationship is thus not a definitive indicator of a lack of independence, but rather should act as a trigger for further investigation by the board into a director's status.<sup>6</sup>

Directors' independence is also regulated indirectly by statute. The directors' duties in s 180-184 of the *Corporations Act 2001* (Cth) ('Act') provide a basic

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<sup>5</sup> Australian Stock Exchange Corporate Governance Council, *Principles of Good Corporate Governance and Good Practice Recommendations – Exposure Draft of Changes* (2006) Australian Stock Exchange <[http://www.asx.com.au/supervision/governance/principles\\_good\\_corporate\\_governance.htm](http://www.asx.com.au/supervision/governance/principles_good_corporate_governance.htm)> at 12 December 2006.

<sup>6</sup> Australian Stock Exchange Corporate Governance Council, *Review of the Principles of Good Corporate Governance and Best Practice Recommendations – ASX Corporate Governance Council Explanatory Paper and Consultation Paper* (2006) Australian Stock Exchange <[http://www.asx.com.au/supervision/governance/principles\\_good\\_corporate\\_governance.htm](http://www.asx.com.au/supervision/governance/principles_good_corporate_governance.htm)> at 12 December 2006.

code of conduct for directors. They must act in the best interests of their companies, and use their positions for the good of their companies. These sections (in part) reflect a director's duties as fiduciary, however fiduciary duties are not subsumed by the Act. Thus directors who owe conflicting fiduciary obligations (for example, where they are on the boards of two competing companies) may breach their fiduciary duties to both companies.

## **Independence in the US**

While directors' independence is optional in Australia (albeit with a reporting requirement), the listing rules in the US stipulate all listed companies must have a majority of independent directors. This is the case with both the NASDAQ<sup>7</sup> and the New York Stock Exchange ('NYSE'), although only the NYSE will be examined here.

Companies listed on the NYSE must comply with the Listed Company Manual, which requires listed companies to have a majority of independent directors.<sup>8</sup> The tests for independence are as follows:

- (a) No director qualifies as 'independent' unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organisation that has a relationship with the company). Companies must identify which directors are independent and disclose the basis for that determination;
- (i) The director is, or has been within the last three years, an employee of the listed company, or an immediate family member is, or has been within the last three years, an executive officer of the listed company;
- (ii) The director has received, or has an immediate family member who has received, during any twelve-month period within the last three years, more than \$100,000 in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service...
- (iii) (A) The director or an immediate family member is a current partner of a firm that is the company's internal or external auditor; (B) the director is a current employee of such a firm; (C) the director has an immediate family member who is a current employee of such a firm...; (D) the director or an immediate family member was within the last three years (but is no longer) a partner or employee of such a firm and personally worked on the listed company's audit committee within that time;
- (iv) The director or an immediate family member is, or has been within the past three years, employed as an executive officer of another company where any of the listed company's recent executive officers at the same time serves or served on that company's compensation committee.
- (v) The director is a current employee, or an immediate family member is a current executive officer, of a company that has made payments to, or received amounts from, the listed company...

The *Clayton Act 1914* also deals with directors' independence. Section 8 of that Act prohibits a person from serving as a director or officer of any two corporations that are competitors (with some exceptions, such as banks).

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<sup>7</sup> NASDAQ, *NASD Rules*, Rule 4350(c).

<sup>8</sup> New York Stock Exchange, *Listed Company Manual*, s 303A.01.

## **Independence in Europe**

Europe is gradually progressing to a state of legal uniformity in the area of directors' independence. In late 2004, the Commission of the European Communities formally recommended Member States reinforce the presence and role of independent directors.<sup>9</sup>

More recently, in February 2005, the Commission made a formal recommendation to the European Parliament proposing definite rules to eliminate and prevent conflicts of interest.<sup>10</sup> In particular Article 18 of the recommendation suggests member states be more active in determining a practical standard for independent directors. The recommendation also suggests a definition of 'independence':

- a number of criteria...should be adopted at national level. Such criteria...should be based on due consideration of at least the following situations:
- (a) not to be an executive or managing director of the company or an associated company, and not having been in such a position for the previous five years;
  - (b) not to be an employee of the company or associated company, and not having been in such a position for the previous three years...
  - (c) not to receive, or have received, significant additional remuneration from the company or an associated company apart from a fee received as non-executive or supervisory director...
  - (d) not to be or to represent in any way the controlling shareholder(s)...
  - (e) not to have, or have had within the last year, a significant business relationship with the company or an associated company, either directly or as a partner, shareholder, director or senior employee of a body having such a relationship...
  - (f) not to be or have been within the last three years partner or employee of the present or former external auditor of the company or an associated company;
  - (g) not to be executive or managing director in another company in which an executive or managing director of the company is non-executive or supervisory director, and not to have other significant links with executive directors of the company through involvement in other companies or bodies;...

The recommendation also allowed for the possibility of a 'comply or explain' mechanism as is used in Australia.<sup>11</sup>

It is likely that the states of Europe will adopt this recommendation or one close to it, given that it strongly echoes the US model.

Having examined the different understandings of 'independent director' in the three jurisdictions, it is now possible to critically examine their differences in greater depth.

## **The key differences in the definitions of 'independence'**

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<sup>9</sup> European Commission, 'Corporate Governance: Commission urges member states to ensure a strong role for independent directors' (Press Release, 6 October 2004) <[http://www.europa.eu.int/comm/internal\\_market/company/independence/index\\_en.htm](http://www.europa.eu.int/comm/internal_market/company/independence/index_en.htm)> at 29 March 2005

<sup>10</sup> Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board [2005] OJ L 162/52, 63.

<sup>11</sup> Ibid at 51.

While the three definitions are superficially similar, a closer examination reveals some important differences.

There are significant differences in how employment within the company is seen to affect directors' independence. In Australia, an independent director must not have been employed by the company in an executive capacity. However in the US and Europe, an independent director must not have been an employee (including an executive) of the company. This is an important difference: the US and European models prevent non-executive employees of the company from becoming independent directors.

Australia's model is arguably better in this regard. A company's senior non-executive employees could function effectively as directors: they are aware of a company's functioning at an operational level, and understand a company's day-to-day running. This may give them a greater ability to make sound decisions at a board level.

The US and European models define an independent director as one who is not (and has not been within the last three years) a partner or employee of the firm that performs the company's internal and/or external financial audits. The Australian model says that an independent director must not have been (within the last three years) a principal or employee of a material professional advisor or consultant.

Thus the Australian model takes a stricter view than the others of a director's employment with a company consultant. The Australian model encompasses all 'material professional advisors' which would include financial auditors, strategic consultants, media advisors, business advisors, and importantly, lawyers, so long as their advice is 'material' to the company.

The comprehensive nature of the Australian model is preferable to the others. The US and European models refer to financial auditors and not others for two reasons. Financial auditors will have intimate knowledge of the company's financial data, and it is essential that the auditing process remain independent of the company. Also, these models are reactions to recent corporate collapses. As those collapses were largely caused by poor or biased financial auditing, it is not surprising that financial auditors are targeted above others.

However, a company's financial data (and other types of data) would presumably be made available to most material advisors in some degree, in order that they are able to give accurate advice. For any advice to be accurate it is also important that it be impartial. This is especially so in the case of the company lawyers.

The generality of the Australian model is thus advantageous. Naturally, the generality is accompanied by ambiguity: which advisors are 'material' advisors? Probably in all cases, it will be the company's lawyers and accountants. For any other advisor, it will depend on the type of company and the industry in which it operates. A media advisor may be 'material' to an entertainment company but not to a mining company. Whether an advisor is

'material' may also change with time. An IT consultant employed to redesign the processes of a mining company, where it will have a large impact on the company's efficiency and profit, may be 'material'. But where the consultant is employed to do routine work of little significance, he/she will not be.

Misinterpretation on this point could be costly in the form of bad publicity to the market if the ASX interprets the term differently from the company concerned. It is important for the ASX to understand that the provision's ambiguity may result in occasional non-compliance, and enforce it accordingly.

The US/European models provide greater certainty. That certainty limits the operation of the provisions and may compromise the overall model.

Only the Australian model makes provision for the effect a long period of service on a board may have on a director's independence. This is a useful provision. It reflects the natural tendency of a director to acquire a sense of ownership over his or her company after a long period spent as one of its leaders. This tendency to paternalism may hamper a director's ability to make independent judgements. Australia's model is also the only one to contain a catch-all provision relating to factors which may detract from independence. As noted earlier, the ASX Corporate Governance Council has recently highlighted both of these provisions for removal. The Explanatory Paper states that in the view of the Corporate Governance Council the length of service on a board is an issue relating to succession (i.e., not independence).<sup>12</sup>

It is evident that the Australian model is preferable in several ways to the European and US model. While those models contain provisions that the Australian model lacks – the US model has specific provisions about the compensation committee, and directors' remuneration – these matters are all captured by the Australian 'catch-all' provision. More important than any of these differences, however, is the optional nature of the Australian model. In the US the listing rules state a company must have a majority of independent directors. In Australia it is not a requirement but a recommendation that, if not followed, must be reported to the market. The European model is the same as the Australian in this respect.

It is in this crucial difference that the Australian model surpasses the US model. As each company differs in size, structure and industry, they have different needs from their directors. It is not reasonable to provide one standard for every company and expect it to have beneficial effect for all. In fact independent evidence shows that the merits of having a majority of independent directors are debatable.

### **Will independent directors raise company performance – the evidence**

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<sup>12</sup> Above n 5 at 13.

Directors' independence is promoted because it is thought to improve standards of corporate governance and therefore company performance. Yet many studies have been carried out concerning the effect of independent directors on company performance, and they are not so certain in their conclusions.

Some studies show an indirect correlation between the number of independent directors and corporate performance. Core, Holthausen and Larker<sup>13</sup> examined the relationship between corporate structure, CEO compensation and company performance in large US companies in the 1980s. They found a general correlation between poor corporate governance structure and poor performance. But independence of directors is only one element of corporate governance structure.

Other studies have investigated the more specific point of whether independent directors improve company performance. Most of them refute the hypothesis that independent directors improve the value of the company.<sup>14</sup> There is even evidence to suggest that in some situations, independent directors reduce company value.<sup>15</sup> This is more likely when independent directors comprise a large majority of the board.<sup>16</sup> In his survey of the studies done in this area, Wan<sup>17</sup> finds only one study that positively indicates independent directors add to company value. Wan concludes his study finding that 'firm performance is not reduced in firms with so-called 'weak' corporate governance standards.'<sup>18</sup> Rosenstein and Wyatt<sup>19</sup> found that the stock market reacts positively on the announcement of the appointment of an independent director.

Most relevant studies show that independent directors do not add value to a company. Wan's survey indicates that there is no link between today's definition of good corporate governance, in which independent directors play a central role, and corporate performance. Some studies have shown independent directors can actually harm a corporation's value. Although the market responds positively to the appointment of an independent director, and a company's share price may increase momentarily, the independent director does not have any lasting positive effect on share price.

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<sup>13</sup> J Core, R Holthausen and D Larcker, 'Corporate Governance, Chief Executive Officer Compensation, and Firm Performance' (1999) 51 *Journal of Financial Economics* 371 – 406.

<sup>14</sup> B Hermalin and M Weisbach, 'The Effects of Board Composition and Direct Incentives on Firm Performance', (1991) 20 *Financial Management* 101-112; A Klein, 'Firm Performance and Board Committee Structure' (1998) 41(1) *Journal of Law and Economics* 275-303; S Bhagat and B Black, 'The Non-Correlation between Board Independence and Long Term Firm Performance', (2001) 27 *Journal of Corporation Law* 231-274.

<sup>15</sup> A Agrawal and C Knoeber, 'Firm Performance and Mechanisms to Control Agency Problems between Managers and Shareholders' (1996) 31(3) *Journal of Financial and Quantitative Analysis* 377-397.

<sup>16</sup> S Bhagat and B Black, 'The Uncertain Relationship between Board Composition and Firm Performance', (1999) 54 *Business Lawyer* 921-963.

<sup>17</sup> K Wan, 'Independent Directors, Executive Pay, and Firm Performance' (Paper presented at the 2004 Financial Management Association Conference), <<http://207.36.165.114/Zurich/Papers/140216.pdf>> at 3 May 2005.

<sup>18</sup> Wan, above n 16.

<sup>19</sup> S Rosenstein and J Wyatt, 'Outside Directors, Board Independence and Shareholder Wealth' (1990) 26 *Journal of Financial Economics* 175-191.

## **Why independent directors will not always bring lasting value to a company**

The role of the board of directors is to manage and direct the company's business. The directors set business goals and formulate strategy, and monitor the performance of the management and company generally. Independent directors are thought to benefit the process because they bring independent judgement to the board's decision-making.<sup>20</sup> Until they became directors they were third parties to the business of the company; however, once directors their interest is still artificial. Therefore it is not surprising that their contribution to the company's bottom line is debatable.

In particular, it is submitted that directors who are 'independent' will lack relevant experience and will tend to manage the company more conservatively.

### **Experience**

It is a proposition of common sense that the individuals with the most valuable experience of company business are those who have worked for that company for many years, or who have been closely involved with it on a supply or demand level. These people – especially those in senior management – are intimately aware of the company's position in the market, its processes and how to maximise its efficiency, where risks from competitors lie, and so on. Clearly they will make better directors than individuals who begin with no experience of the company. This conclusion is supported by a 1997 study by Rosenstein and Wyatt.<sup>21</sup> They established that non-independent directors are more effective than independents because they have superior knowledge of the firm and industry compared to outside directors.

Because the US/European models exclude these people from becoming 'independent directors' and require a majority of directors be independent, companies are limited in how they can utilise this key skill-base at a board level. The prohibition is less pronounced in Australia, where there is no express prohibition relating to employees. However, the model does state that an independent director cannot have a 'material contractual relationship with the company' which would effectively exclude current employees, but not former ones.

A model that requires a majority of directors be independent greatly narrows the opportunity of the company to select directors from the group of people – senior management – with the best experience for the job.

### **Loyalty and risk-taking**

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<sup>20</sup> Above n 1; above n 7 at s 303A.01.

<sup>21</sup> S Rosenstein and J Wyatt, 'Inside Directors, Board Effectiveness, and Shareholder Wealth' (1997) 44 *Journal of Financial Economics* 229-250.

Independent directors are thought to be unaffected by self interest. Their loyalties to the company are defined and limited by equity and statute. These duties are expressed in negatives and minimum standards. Independent directors must also face shareholders at general meetings. But these are all of the encouragements they have. It is not surprising that viewed in this way, independent directors' interest in their companies' performance is rather disconnected.

It is submitted that the goal of growing a business, which will involve reasonable commercial risk-taking, will be better achieved by a board that has a more immediate sense of loyalty to the company and an incentive to take commercial risks. Directors with these attributes will be those who have significant shareholdings themselves, represent significant shareholders, or who are long-serving employees. These individuals will work harder, and be willing to take more commercial risks than their independent colleagues, who have nothing to gain by taking risks but everything to lose.

The conclusion that non-independent directors make better commercial managers is supported by numerous independent studies which are cited above. There is a real risk in that by requiring companies to have a majority of independent directors, regulators are compromising the quality and changing the nature of company management.

## **Conclusion**

Australian legislators should think cautiously before following the US lead in mandating a majority of independent directors. The problem does not lie in independent directors *per se*: they can fulfil an important role in bringing independent judgement to bear on board decisions. However their benefits are arguably overshadowed when they make up a majority of the board.

Numerous studies show that independent directors do not always add value to a company. Some reasons for this may be that independent directors lack relevant experience, and, apart from complying with their legal obligations of due care and skill, lack a direct interest in the company's performance (and the incentive that interest brings).

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. Just because an individual conforms to the requirements of the definition, he will not necessarily exercise independent judgement. There are more subtle ways in which independence can be compromised. It is not difficult to imagine how, especially given the significant networking among professional directors, which is unsurprising among such a small elite group. Independence can be compromised in any number of ways; it would be a mistake to assume compliance with the model will ensure the board exercises independent judgement and has good corporate governance.

Furthermore, companies will all differ in the qualities, knowledge and experience they require from their directors. Small mining companies have

vastly different needs from their directors than do a Telstra or Woolworths. A large multinational with a solid business and no plans for growth may benefit from a majority of independent directors; a small company in a highly specialised field may receive no benefit. A 'one size fits all' such as in the US does not uniformly add quality to the boards of companies affected by it.

It is better that the requirement that a majority of directors be independents remains optional. For this reason the Australian model is superior to the US model and that suggested for the EU.