Independent Director – Abolish the Institution

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Introduction

Globally, publicly-traded limited-liability companies (hereafter, companies) dominate the corporate sector. Their corporate governance structure is similar across the globe – centralized management. The board of directors (board) is responsible for the company's management and governance. Shareholders, the residual claimants, have no right to participate in the day-to-day decision-making. This structure results in the separation of ownership from control. The board appoints a CEO and delegates to her the power for the company's day-to-day management.[1] She leads the management team. Her decisions affect shareholders' wealth but do not affect her wealth materially, as she receives the compensation committed by the company with a small variable component. The CEO operates under the guidance and oversight of the board. Shareholders use the voting right to elect the directors, appoint the auditor, and approve proposals placed before the assembly of shareholders. The companies act, and capital market regulations protect the shareholders' interests. [2]

In Anglo-Saxon countries, a unitary board is responsible for all the board functions. In Germany and some European countries, a two-tier board structure is the norm. The oversight responsibility rests with the supervisory board. The supervisory board appoints the management board responsible for managing the company. I focus is on the unitary board in this article.

Historical perspective

The concept of the monitoring board and independent directors emerged and evolved in the U.S.A. Later, those were adopted by other countries. Cheffins (2018) chronicled the transformation of publicly-traded American companies. Cheffins (2018, p.105) observes that immediately after World War II, internal constraints on managerial discretion were theoretical, as the relationship between the CEO and the board was congenial and dispersed shareholders had no motivation to scrutinize the company (typical rational apathy). External constraints on managerial discretion were significant. Government interventions in a command economy and the strong bargaining power of employee unions are examples of external constraints on managerial discretion. Furthermore, Cheffins (2018, p.41) observes that business leaders behaved more like

[1] The CEO may be a professional or a nominee of the controlling shareholder.
[2] The law mandates the board to seek the shareholders' approval for certain critical decisions before implementing the same.

stewards from 1950 to 1970. They focused on fostering the growth of the business without ignoring the interests of important constituencies like employees and consumers and the public at large. Until 1970, the American board of directors model was the 'advisory model'.

In the 1970s, regulators and investors were shaken by three events/trends: the sudden demise of Penn Central Rail Road (PC), illicit payments and frauds, and bribes to foreign governments. Before the collapse, PC was considered a blue-chip company. Experts and regulators held the PC's board responsible for the company's collapse. Townsend (1971) observes that the directors of PC and other companies were in bed with the management. The boards gave the illusion that they knew what was going on and acted to keep the management honest. He further observes that a typical director was a well-meaning person of average intelligence, but she could not do her job because of the boardroom decorum of not to challenge the CEO and ask penetrating questions that would embarrass her. Gordon (2006) observes that the advisory boards were a fraud, as they did not enforce the CEO's accountability but gave the impression that they were enforcing accountability.

External constraints in the U.S.A. was weakening and the advisory boards failed. This led to the reconceptualization of the board structure. The monitoring board model replaced the advisory board model. The monitoring board requires independent directors. Cheffins (2018, p.133) reported that during the mid-1970s while resolving a substantial number of cases, usually about illicit payments, the Securities and Exchange Commission (SEC) made the companies agree to the appointment of additional outside directors and the creation of an audit committee. In 1977, on the advice of the SEC, the New York Stock Exchange amended the listing rules making the establishment of an audit committee comprised of outside independent directors a listing condition. All stakeholders agreed that the monitoring board was the solution to the problem.

The logic underlying the appointment of independent directors was straightforward. Independent directors would objectively monitor the company's performance and that of the CEO. The committees constituted of independent directors would focus on issues that required forming independent judgment after in-depth analyses of the issues. The monitoring board would strengthen internal constraints on managerial discretions.

The Cadbury Committee, set up in the U.K., submitted its report in 1992. Its recommendations were in the form of a Code. This led to the issuance of the corporate governance code by various countries. Almost every country adopted the monitoring board model. In 2004, India adopted the same.

Incentives to independent directors

It was expected that independent directors would perform their job effectively because of: (a) the fear of liability prescribed by law, (b) adequate reward (in the form of compensation) for doing the job well, and (c) fear of losing reputation as hypothesized by Fama and Jensen (1983). Fama and Jensen (1983) hypothesize that opportunities for directorship in other companies open up to those directors who build their reputation as capable directors and demonstrate the same. Therefore, directors care about their reputation and perform efficiently and effectively to protect the same. Unfortunately, none of the three instruments – liability, reward, and reputation – effectively induce independent directors to perform.

Liability

Gordon (2006) observes that except in a few cases (for example, Enron and WorldCom), courts have not imposed monetary liability on independent directors. Courts apply the 'business judgment' and 'good faith' principles and do not impose monetary or criminal liability on outside directors unless it is established that the decision-making process was tainted by conflict of interest or that bad faith is established. Gordon's observation gets credence from the fact that no liability was imposed on independent directors of banks that failed in the 2008 financial crisis, although it was established that the boards of those banks failed to manage risks adequately. In the case of Satyam Computer Services, which collapsed due to accounting and management fraud, the court imposed a fine of INR 26.6 million (USD 0.68 million) on Krishna Palepu, a professor at the Harvard Business School, because he provided consultancy services while occupying a seat on the board as an independent director, and a fine of only INR 20,000 (USD 509) was imposed on other independent directors. [3]

In Ravindranatha Bajpe v. Mangalore Special Economic Zone Ltd. & Ors, the Supreme Court of India recently, on 27 September 2021, held that merely because an individual is a Chairman, Managing Director/Executive Director, and/or Planner/Supervisor of a company, they cannot be held vicariously liable unless specific allegations are levied against them concerning their role in a criminal case. It took cognizance of its previously passed judgments on the vicarious liabilities of the key personnel of a company in criminal matters.

Gutiérrez and Maribel (2013) observe that imposition of liability might make directors risk-averse, inducing them to make conservative decisions and over-monitor the CEO, and might result in the flight of talent. However, the Directors & Officers' insurance policy would lowers the likelihood of out-of-pocket payments.

Compensation

Deciding the right amount and form of directors' compensation is a vexing issue. Low compensation results in a lack of motivation, and high compensation impairs independence. The debate on whether ESOP should be granted to independent directors is yet to be settled. Many consider ESOP a perverse incentive. Tirole (2016, p.183) observes that the variable pay (like performance bonus and ESOP) may not reward good

[3] Converted at the exchange rate (USD1 = INR 39.28) prevailing on January 10, 2008, when the court imposed the fine.

management as it may induce the manager (and the board) to short-termism and unscrupulous practices, like selling shares immediately before bankruptcy. Currently, in India, the law does not permit giving ESOP to non-executive directors. A proposal by SEBI to grant ESOP is pending for decision. Regulators are yet to find out the right solution to the issue.

Reputation

Empirical research supports the hypothesis developed by Fama and Jensen (1983) that outside directors' reputation impacts the value of their human capital. Gilson (1990) observes that directors who resign from companies that file bankruptcy or privately restructure their debt hold significantly fewer seats on other boards following their departure. Coles and Hoi (2003) provide evidence that those directors who protect shareholders' interests are likely to gain additional external directorships. Fich and Shivdasani (2007) provide evidence that outside directors experience a significant decline in directorship on the boards of other companies following a financial fraud lawsuit. Yermack (2004) concludes that if the firm does well, the likelihood of obtaining additional directorships increases. Ferris, Jagannathan, and Pritchard (2003) observe that firm performance positively affects the number of appointments a director holds.

However, Gordon (2006) observes that the noise in the reputation market limits the reputation-based incentive's effectiveness. A director's reputation is affected only when the company is involved in a financial catastrophe, management fraud, or a major legal problem. The company's underperformance or minor legal issues do not affect directors' reputations because of noise in the reputation market. Fahlenbrach, Rüdiger, Low, and Stulz (2010) analyzed the sudden departure of directors and concluded that to protect their reputation, outside directors resign when they anticipate the firm on whose board they sit will perform poorly or disclose bad news. They observe that outside directors resign when they are required most. In a nutshell, the incentive for performing effectively to protect reputation is weak, although Fama and Jensen's (1983) hypothesis is correct.

Effectiveness of independent directors

Over the past five decades, regulators, across the world, have tightened the definition of independence, defined their roles, and enhanced their liability and accountability. This demonstrates that the independent directors fail to meet the expectations of the regulators, investors, and other stakeholders.

SEBI's consultation paper issued in 2021 reported that in India, the promoter/promoter group holds more than 50% of the voting right in around 60% of the listed companies (publicly-traded companies), which comprise around 67 percent of the market capitalization.[4] Therefore, the promoter can easily appoint and remove

[4] SEBI. Review of Regulatory provisions related to Independent Directors. Available at: https://www.sebi.gov.in/sebi_data/meetingfiles/jul-2021/1626155485805_1.pdf. Extracted on July 6, 2022.

independent directors of their choice, if the law requires the appointment and removal by a simple majority. Varottil (2010) observes that empirical studies and anecdotal evidence suggest that independent directors do not function effectively in India. Bebchuk and Hamdani (2017) observe that those directors, whose election and retention depend on the controlling shareholder, have little incentive to go against the wishes of the controlling shareholder and protect non-controlling shareholders. In the 2021 consultation paper (referred to earlier), SEBI proposed the appointment and removal of independent directors through a dual process – first, approval by shareholders, and then, approval by the *majority of the minority*. In the UK, the dual process is required for companies that have a controlling shareholder. Companies opposed the SEBI's move. Finally, SEBI amended the law requiring the appointment and removal of independent directors by a special resolution. The new law is applicable from January 1, 2022. The *majority of the minority rule* makes the independent directors accountable to non-controlling shareholders. Opposition by companies demonstrates that the controlling shareholder and the CEOs appoint management-sympathetic independent directors, rather than shareholder-sympathetic independent directors. As a result, in India, a market is created for the management-sympathetic independent directors.

Gutiérrez and Maribel (2013) observe that the empirical literature on board effectiveness is far from conclusive. Adams, Hermalin, and Weisbach (2010) observe that it is difficult to empirically identify any causal relationship between board composition and firm performance or firm value, as the board of directors is an endogenously determined institution. This problem might have resulted in confusing and contradictory conclusions on the contribution of independent directors to firm performance. However, some recent research establishes the fact that the majority of independent directors are not effective.

To alleviate the endogeneity concerns, Nguyen, Dang, and Nielsen (2010) studied the effect of an event (sudden death of an independent director) on the share price. They observe that on the sudden death of an independent director, the stock price drops by 0.85% on average. They further observe that the marginal value of independence is lower when the deceased independent director had a long tenure or was appointed during the tenure of the current CEO. The marginal value of independence is higher when fewer outside directors or the deceased independent director holds an important position like the chairperson or an audit committee member. They conclude that independent directors make valuable contributions to the firm performance. The observation of Nguyen et al. (2010) that the marginal value of independence of directors who hold important positions is higher may be interpreted as those who do not hold important positions do not contribute significantly to the company's performance.

Fogel, Liping, and Randall (2021) observe that more powerful independent directors with better access to information and greater credibility better detect and counter CEO missteps. Thus, they contribute positively to perform performance. They gauged the independent director's power by a composite of social network power centrality measures. However, based on a high incidence of powerless independent directors in the data, they conclude that CEOs select independent directors for diffidence. Ma and Khanna (2016) studied the independent director's dissents in the board meetings of Chinese publicly-traded companies, which are mandated to disclose dissents. They conclude that independent directors feel indebted for being offered a director position and, in exchange, support the management. Schwartz-Ziv and Michael (2013) analyzed Israeli-government-controlled eleven business companies' minutes of board meetings and board committee meetings. They observed that independent directors disagreed with the CEO only 3.3% of the time. In sum, independent directors have failed to play the expected role because they could not protect their independence and the incentive mechanisms are ineffective.

Proposal to revert to the advisory model

Tirole (2006, p15) observes that corporate governance is about creating internal constraints on managerial discretion. The monitory board model has been in existence for around 50 years, and it is taken for granted that the mechanism of independent directors will solve the corporate governance issues, even though the empirical evidence suggests that the institution is ineffective. Moreover, the situation has changed drastically from what prevailed when the monitoring board model replaced the advisory board model.

Companies are now operating in a VUCA world.[5] Disruption has become a norm. Institutional investment in companies is increasing giving impetus to shareholder activism – within the closed-door meeting with the board and in general meetings. Whistle blowers have access to regulators. Sustainability reporting empowered the stakeholders and social activists. Social media spreads the company's irresponsible behavior fast.

It is well accepted that the CEO is better informed than the outside directors. Zhou, Stephen, and Anastasia (2018) analyzing data from sample firms traded on the Athens Stock Exchange conclude that outside directors lack firm-specific knowledge of the operational activities of the firms on whose boards they serve. Cavaco, Patricia, Antoine, and Gwenael (2017) provide evidence that independent directors experience information deficits. Outside directors cannot monitor the CEO effectively due to the information asymmetry. My conjecture is that in a VUCA world, the information gap between the CEO and outside directors is much wider than that in a less uncertain environment. Demsetz and Kenneth (1985) support this conjecture. These authors observe that in less predictable environments, it is more difficult to monitor the CEO. Therefore, even if we assume that the tightening of the norms by regulators protects the independence of the independent directors, the institution of independent directors will remain an inefficient and ineffective device for monitoring the CEO.

[5] VUCA stands for volatility, uncertainty, complexity, and ambiguity.

The monitoring board model assumes that the CEO is an economic person. The economic person is a theoretical construct. However, an individual is not necessarily an economic person as defined in the literature. Jensen and Meckling (1994) posit that every individual cares for respect, honor, power, love, and the welfare of others, not only money. According to Davis, Schoorman, and Lex (2018), organizational relationships are more complex than the underlying assumptions of the agency theory. They posit that CEOs are not predisposed as an agent or a steward. Managers choose to behave like an agent or a steward based on their psychological motivation and perception of the situation. The Principals also choose the agency or stewardship relationship based on their perception of the manager's psychological motivation and the situation.

An organization realizes the maximum reward when both parties choose the steward relationship. The steward perceives that her interests and those of the company are convergent. She takes pride in the company's success and takes the company's failure as her own failure. She is motivated by intrinsic motivational factors. She performs best when she perceives that she enjoys autonomy. In the present volatile environment where innovation is the mantra for survival and growth, the board should create an environment of trust to induce the CEO to choose the stewardship relationships. The monitoring board model induces them to act like an agent. Therefore, in the VUCA world, the monitoring board is dysfunctional, particularly in companies with a controlling shareholder.

An advisory board can effectively perform all the other board functions – providing checks and balances, guiding the CEO, and boundary spanning.[6] Board diversity is essential and therefore, outside directors must be inducted into the board. Shareholders should be empowered rather than made to focus on strengthening the institution of independent directors. Corporate regulators and GAAP require timely disclosure of price-sensitive and other relevant information. Sustainability reporting communicates hitherto undisclosed information. Social media circulates information widely and speedily. The proxy advisory firms are providing analyses to the institutional investors. Therefore, institutional investors and block holders can make well-informed decisions. Stakeholders can put pressure on the management to act responsibly. Thus, the need for the institution of independent directors may be over in today's world.

Conclusions

Literature reveals that the monitoring board is ineffective due to a variety of reasons – lack of independence, lack of motivation and information asymmetry. In the VUCA world, the information gap is increasing. Innovation is the key to the survival and growth of the company. Innovation prospers in an open environment and an environment of trust. Therefore, control and monitoring should be replaced by the stewardship

[6] Boundary spanning refers to arranging resources from the external environment and managing the relationships with stakeholders. For example, boundary-spanning includes persuading the government officials to speed up a decision on a request filed by the company pending with the government. Managing relationships includes explaining the company's position to stakeholders when the company is passing through a reputational crisis.

relationships between the CEO and the board. ESG movement will also make the institutional investors and stakeholders, particularly customers and vendors, watchful. It is time that the regulators explore other alternatives and abolish the institution of independent directors.

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