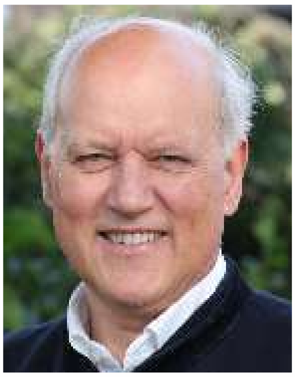
THEME ARTICLE

Today Independence: why it is crucial and remains a challenge

Authored by



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Mistaken beliefs regarding corporate capitalism

In more than 20 years of teaching corporate governance, major surprises regularly surfaced when discussing the foundations of corporate capitalism with our students.

The first surprise arose when we asked executives why their companies have boards of directors. Their most common answer was that it is a legal obligation. This is correct. Even if some companies do not have boards, in which case the corporate responsibility falls on owners, by default, or sometimes on their executives. That effective boards generally lead to better executives being appointed, better strategies, and risks becoming better assessed and mitigated was a rare answer. Governance was simply not on their radar; it was all about execution. Yet, the root cause of most corporate failures (like Bhopal, VW's Dieselgate, or the Boeing 787 grounding) is governance failure. *(The classic here is "Corporate Governance: The Other Side of the Coin," by Kenneth N. Dayton, Harvard Business Review, January-February 1984)*

The second surprise is the regularly heard statement that boards work for the shareholders. This is another wrong answer. Corporate law places responsibility for companies with their boards of directors. Board members collectively exercise a fiduciary duty on behalf of the corporation when governing the corporation through market and competitive meanders. The fact that boards delegate executive powers to managers does not change the responsibility of board members. Given that one can hold only one fiduciary duty at any given time, boards work for the corporation, and its relations with all stakeholders, including shareholders. The latter are privileged, for they are given the countervailing power in being able to elect, evaluate, and remove board members. Boards have a duty of care obligation, which means that they cannot do harm to shareholders, and for that matter to any stakeholder.

A third erroneous belief is that it is always better to have a board. Having personally seen boards make poor decisions with regards to CEO appointments and strategies (HP and its demise is a great example here), the desire must be to have a good, and possibly a great board. But having no board and devolving its responsibility to the owner(s) might in some such cases be superior to keeping a dysfunctional and incompetent board.

A fourth mistaken belief concerns "best corporate practices," which are hard to replicate in another corporation facing a different context. An example is that of GE for a long time regarded as "best practice" amongst US and global corporates. GE was considered the best leadership school for executives worldwide. Yet, many GE alumni when joining other corporations seemed unable to replicate their performance within GE. When leaving GE, they left colleagues behind, and the GE culture, both contributing to their high performance. These factors were sorely missing when they joined another company whose senior managers and culture might in additional be hostile to their arrival. Best practices do not easily

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translate, for context and culture do not translate at all. This certainly holds for boards as well.

We will return to these points in our comments on independence, which is intricately woven into the fabric of good governance. Independence is never an absolute and needs to be qualified: it always is independence in a particular context and for a given role, with the caveat that board members are never independent from their colleagues, since board decisions are collegial.

The last mistaken belief is in one type of board, that of the listed and widely held corporation, with diffuse ownership. This is a US centric view, stimulated by the media. In practice, millions of companies are not listed. Even when they are, they often have a dominant owner – a family, trust, private equity, or government. Owner-led companies require a wider view of boards, where the corporate board is only one of three vital and interacting governance structures. The other two are the owners board, which sets the corporate mission, its values and major governance rules, and the executive board, which implements the goals set by the board through aligned strategies and that take into account risks and financing challenges.

Fundamentals of corporate capitalism: shareholders enjoy dividends but are not responsible for the corporation

Corporate law has its roots in the Roman Empire. Roman law was very effective in ruling conflicts within the empire. It gave a legal status to corporations, which then enjoyed rights and responsibilities, just like citizens. These included the right to do commerce in the empire and the obligation to follow the laws. Corporations which failed to do so could be sanctioned and lose their rights to commerce.

The modern version can be traced to the Joint Stock Companies Act of 1844 and the Limited Liabilities Act 1855, both voted by the British Parliament. These acts limited the responsibilities of shareholders to their invested capital and placed corporate responsibility with the board of directors, collectively. This arrangement leads shareholders to enjoy dividends without assuming responsibility. To avoid a “taxation without representation” reproach, shareholders were given the right to appoint the members of the board of directors. The latter were tasked with a duty of care and duty of loyalty obligations, which include the requirement to keep shareholders informed of business progress, not to harm shareholders, and not to place one's personal interest above that of the corporation and its shareholders.

This arrangement is prima facie surprising. It is at odds with the often-evoked theory of shareholder supremacy, which mandates that all, from employees to board members, act foremost in the best interests of the shareholders. This can only be a theoretical view, as shareholders, even in an unlisted family-owned enterprise, typically do not agree on many matters, often for diverging time and risk preferences. Shareholders are not uniform, they can be classified in segments, like customers. Therefore, the governance responsibility devolves to the board of directors, speaking of a single voice. Board decisions will typically be experienced differently by distinct shareholder segments.

To illustrate the point further, it might be useful to invoke the board of a private family firm, where four brothers were members, all having worked in the firm. They were joined by three independent directors, who were leading business figures. The brothers often did not agree on matters. Their disagreements could turn board meetings into shareholder discussions, where the independent directors had little to contribute. They also trusted the four brothers, collectively and individually. When asked why these non-family directors had not intervened more forcefully (read “more independently”) in the debate on a major expansion project in a foreign country, they replied that after all the money belonged to the family. This is the wrong answer: board members should always think about whether the money invested into the firm, regardless of its origin, is well invested. This is their duty of care obligation. The expansion project went awfully wrong, costing the firm approximately 10 years of profits. This example illustrates the mistaken beliefs regarding the corporate responsibilities of the board members, and the costs that they may have helped to avoid through greater engagement. The board was too dependent on shareholders who also were the leading executives. It lacked independence. Such errors are all too common. It results in corporate governance practices deviating too far from good practice, as intended by corporate law.

Turning to capital markets, the arrangement whereby corporate responsibility is not placed with shareholders, but with their boards is essential for a good functioning of stock markets. If responsibility were traded together with dividend and control rights, few if any trades would occur, for the buyer would be in a fog about the rights and obligations he bought into. Share prices, due to unknown risk, would be excessive. Thanks to this arrangement, corporations can continue their business when shareholders change. Financial markets provide shareholders with liquidity, and an exit when they judge corporate prospects to be too negative.

The firm has a great number of relationships with other parties, referred as stakeholders. Democratic societies require corporations to be responsible in its dealings with all its stakeholders (employees, customers, shareholders, government, partners). The board of directors assuming full corporate responsibility is thus also responsible for the firm's relations with stakeholders. It mediates and governs the firm's interactions and contracts, which Jensen and Meckling refer to in their seminal paper on agency theory as the core of the firm. (Michael C. Jensen and William H. Meckling, "Theory of the firm: Managerial behavior, agency costs and ownership structure," Journal of Financial Economics 3(4): 305-360, 1976) Shareholders are privileged stakeholders, but do not have primacy over the corporation and its board. To be concrete, shareholders do not decide about strategy or who is the next CEO, the board does.

These facts make agency theory hard to apply to the governance of the firm, as that theory talks about shareholders as principals and managers as their agents. Boards are notoriously absent in this model, just as boards were never mentioned in Friedman's famous article on profitability as the sole responsibility of businesses and their CEOs. (Milton Friedman, "The Social Responsibility of a Business is to Increase its Profits," The New York Times Magazine, September 13, 1970. Today most people would view EVA, which is profit minus the cost of equity, as the financial yardstick for companies.)

Why independence is a necessity

Similarly, the theory of shareholder supremacy runs counter the mandate of the board, which cannot privilege the interests of a particular shareholder over the corporate interest. Boards must thus be able to decide "independently" what this interest is. For corporate capitalism to function well, it is necessary for all board members to either commit to act in the interests of the corporation, or to recuse themselves because of conflicts of interests on a particular topic.

Independence is precisely the absence of influences that bias a person's behaviour and decision making. Examples of violations of independence are when a board member has been nominated by a particular shareholder who then tells the director to vote in the interests of that shareholder, against the interests of the company. Such private interests, if they influenced decision making, would represent added costs to the corporation, which will be borne by other stakeholders. This is inherently unfair and weakens the corporation. Ethical directors will not accept this. Hence, corporate law obliges board members "under influence" to abstain from decision making.

Instances of corruption typically involve the exercise of pressure, often through financial means. The mafia exercises more physical means when exerting pressure. Most cases of corruption involve the exercise of influence for the undue gain of some stakeholders. All are associated with corporate governance failures, mostly due to a lack of independence.

The other side of the coin: dependence and power

Some economic sectors are notorious for regularly presenting instances of fraud. These are typically driven by the financial interests of some stakeholders and require the benevolent participation of at least some board members and executives. This is the area of so-called facilitation payments, where individuals are bribed by those whose interests they must serve.

But influence is not limited to finance. Non-financial interests such as career prospects or advantages accruing to individuals and their own "dependents" are other ways to exert pressure on board members. Family businesses too are prone to undue influence from other family shareholders, who as family leaders may aim to dominate not only the nomination of independent directors, but also tell their children and nephews how to vote on proposals they favour. Board "stacking" with members that are dependent on shareholders or important stakeholders (like the government) is a common practice and one of the cancers of corporate governance. An independent nomination or governance committee is typically the tool to mitigate such risk.

The other end on the spectrum of board failure are boards captured not by their shareholders, but by their executives. This is what happened to GE whose board became captured by Jack Welsh, and to Renault and Nissan when Carlos Ghosn was reigning supreme. The practice of CEOs becoming Chairs is a signal of a loss of independence of the board. It is hard to see how the board would not be subjected to pressures from a CEO doubling up as Chair, including through resignation threats Such examples are sometimes mentioned as evidence that corporate governance is not effective. Examples of bad corporate governance cannot be used to claim that governance does not work. Good boards make that argument.

Finally, one should mention that independence is a requirement for board effectiveness, but this should be coupled with a diversity of views and opinions which are essential to a thorough debate. Board members that are too similar might be viewed as independent but would not ensure board effectiveness.

Challenges to good corporate governance

One of the big advancements in science over these last decades concerns the decision sciences, which Kahneman's best-selling book, Thinking Fasts and Slow, summarized well. (Daniel Kahneman, Thinking Fast and Slow, Penguin, 2012. Amos Tversky died in 1996 and could not be named in the Nobel Award to Kahneman in 2002, which the latter shared with Vernon Smith). The text documents how we all dispose of two decision making systems, one intuitive and fast, the other rational and slow. It is the former that often derails governance. If we add to it that humans are prone to choose the first available decision that appears good enough, we easily understand that all of us are prone to biases, consciously and unconsciously. Efficiency in governance often comes at the cost of effectiveness.

Independence of thought is thus not sufficient as a pre-requisite to good corporate governance. Dissent (polite and constructive) along with a diversity of opinions, each possibly biased, is the second requirement. That implies that the board should have good processes that allow the board to focus on the right questions, allow a thorough exploration of options, and steer the debate towards an effective conclusion. The latter deserves a separate article, if not several chapters. Our forthcoming text on governance in owner-led firms makes this point explicitly. (Massimo Massa, Kai Taraporevala, Ludo Van der Heyden, Value Creation for Owners and Directors, Palgrave Macmillan, forthcoming 2023). It underlines the role of owners in ensuring effective governance through boards, something that is largely devolved to regulators or the boards themselves in publicly listed firms with diffuse shareholding.

Independence needs to be qualified as well in owner-led firms. In corporate capitalism, owners have the right to frame the mission of the firms they own, as well as determining the values and governance arrangements that will govern the enterprise, consistent with corporate law. Board members do not have the luxury to deviate from this mission, these values, or these governance arrangements. Independence then takes a dual form, better described as "independence within a frame."

This article's main point is that independence needs to be understood as exercising one's own, unpressured judgement of how best to serve the corporate interest. Such judgement is determined collectively by a deliberative process amongst diverse board members, each driven by a personal and deep commitment to "do the right thing" in securing the best interest of the corporation. When board members conclude that they are no longer able to do that, they should exercise the final option, which is exit. That too requires independence. ■

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