THEME ARTICLE

The Fundamentals and Strategic Contribution of Independent Directors

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> Independent Nomination Committee, supported by a trusted External Advisor, is the 'gold standard' in ensuring and promoting director independence.

Introduction

In many jurisdictions around the world, "independent" directors, free from unjust ties from the organizations on whose boards they are serving on, have become a well-established pillar of corporate governance systems and frameworks. Their benefits seem to be plenty: Independence from management enables directors to exercise autonomous judgment; in listed companies, they can perform a sensible check on excessive CEO power, which directors who are employees, close relatives of the CEO or contractors of the company might be reluctant to provide; and in family businesses, independent directors can support the controlling family with solving the dilemma of balancing the growth of their businesses with a long-term perspective and yet ensure family harmony and prosperity. Generally, they can provide objectivity and professional skepticism. "Independence is a quality that can be possessed by individuals and is an essential component of professionalism and professional behaviour", states ACCA, the Association of Chartered Certified Accountants.

A Brief History of Independent Directors

For the first half of the twentieth century, a "managerialist" model of corporate governance was based on inside directors, chosen and controlled by the CEO, who dominated the corporate boards. The concept of independent directors originated in countries with highly dispersed ownership systems – such as the U.S. – with the intention to strengthen the monitoring role of the board. Between 1950 and 2005, the composition of large public company boards in the U.S.

increasingly shifted towards independent directors, from approximately 20% to 75% of independent directors on a board. The standards for independence also became increasingly rigorous over the second half of the twentieth century. In the early 2000s, financial scandal around large companies such as Enron and WorldCom led to the Sarbanes-Oxley Act, a law which extensively reformed accounting and financial disclosure regulation and mandated the establishment of an audit committee made up entirely of independent directors.

The Various Ways of Independence - Practices across Europe and Asia

"The concept of independence is difficult and controversial", say Klaus Hopt and Paul Davies from the European Corporate Governance Institute (ECGI). Generally spoken, there are several sources of standards governing director independence: stock exchange listing requirements, security regulations, proxy advisories and the various laws of the country or state of incorporation.

In France, the Afep-Medef Code makes clear statements about the requirement for directors' independence for listed companies: "Here, directors are seen as independent when there is no relationship with the company, its group or management that might compromise their judgement", says Sophie Wignolle, a member of Eric Salmon & Partner's board practice based in Paris. "Especially links such as material shareholding, employment or service contracts are critical". Furthermore, in boards of French listed companies, two-thirds of the audit committee and a majority of the nomination and remuneration committees have to be independent.

In Italy, only listed companies are obliged to have independent directors, whereas it is optional for privately-held firms. "Boards can even opt for "self-regulation", using their by-laws to require that a director comply with specific requirements of integrity, experience and independence", explains Simone Maggioni, member of Eric Salmon & Partner's board practice based in Milan.

Family relations to the CEO, other directors or controlling shareholders are often taken as a litmus test: The German Corporate Governance Code is stating that being a "close family member of a Management Board member" could compromise a director's independence. In Belgium, family members up to the second degree will be taken into account, whereas in Italy, this goes up to the fourth degree of kinship.

Tenure on a board is another factor – under the German Corporate Governance Code, a director is not seen as independent after serving more than 12 years on a company's board, and the same applies in Belgium and France. James Isaacs, member of Eric Salmon & Partner's board practice based in London, states that "in the UK Corporate Governance Code (formerly known as the Combined Code) details seven specific circumstances that are likely to impair, or could appear to impair, a non-executive director's independence. A tenure of more than nine years from the date of their first appointment is one and any extension to this should therefore be clearly explained in its annual report.

The German code also stipulates that no more than two former members of the Management Board shall be members of the Supervisory Board. A lack of previous collegial relationships will usually mean that a director will not have any previous alliances or prejudices that will affect his or her independence in interacting with the management board.

The concept of independence is taken into extreme in the Netherlands. Its Corporate Governance Code recommends that all but one of the members of the supervisory board have to be independent - which applies also to the employee representatives who cannot be employees of the company or employees of the union with representation rights within the company. The thinking behind this relates to a core belief of the Dutch system – that members of the supervisory board and non-executive directors should act in the interests of the company as a whole and not as representatives of partial interests, whether they are shareholders or employees.

Directors' independence is also reinformed by their compensation systems: "In Belgium, variable remunerations must not be awarded to independent directors", remarks Alain de Borchgrave, a member of Eric Salmon & Partner's board practice based in Brussels.

Over in the east, Singapore used to have a "comply or explain" policy. Beginning in 2022, independent directors are no longer independent after nine years unless approved in a two-tier vote by all shareholders excluding directors, CEO and associates. In September 2022, the authorities announced intentions that independent directors no longer be considered independent after nine years – without exceptions. "Given that half of listed companies in a recent survey have independent directors serving beyond nine years, this is a good and necessary development to better achieve renewal and diversity objectives", explains Wai-Leong Chan, member of Eric Salmon & Partner's board practice in Singapore.

Benefits

Independent directors can also be instrumental in the protection of minority shareholder groups. "In Italy, a board of directors must include at least one director appointed from a list submitted by the minority shareholders. He or she has to be independent from the company, but also from the majority shareholder and from other directors and comply with the same requirements of integrity, experience and independence required for statutory auditors", states Umberto Bussolati

Dell'Orto, member of Eric Salmon & Partner's board practice based in Milan. His colleague Jean-Michel Riou, based in Paris, confirms: "The Afep-Medef Code recommends that in the case of listed companies without controlling shareholders, at least half of the directors are independent, whereas listed companies that are controlled by a major shareholder need to have a third of their directors to qualify as "independent". The benefit of having independent directors on a Board is also that of defending the interests of minority shareholders against a majority shareholder, as can be the case in family-owned or public groups, remarks Riou.

When is independence put to a test?

In real-life situations, professional and personal friendships and networks build up over many years. Multidimensional relationships between directors and "interested parties" — "typically management or large shareholders might look like personal interactions that seem innocent and routine to successful businesspeople", explain Shana Elberg, Lisa Laukitis, and Maxim Mayer-Cesiano from Skadden Arps, the law firm. Shared charitable interests and personal favours; directors who serve on the board of a college alongside an interested party, who was a major donor to the school; directors who are partners in a venture capital firm that invested in sectors where the company makes acquisitions, and – most prominently - a director who owned a small private plane with the company's controlling shareholder and former CEO.

Independence and Power

Corporate governance researchers Kathy Fogela, Liping Ma and Randall Morck from the European Corporate Governance Institute (ECGI) analyzed independent directors' "power" – namely their strength of their social networks, defined by the number of their contacts, the degrees of separation and, most importantly, their relative importance to their network contacts (the "Eigenvector"). "Powerful" independent board directors and "powerful" independent nominating committee chairs, respectively, are much more at ease to enforce CEO turnover after poor performance. "Powerful" independent board directors and powerful independent compensation committees increase firm valuations by better linking CEO pay to past performance. They elevate shareholder valuations by deterring value-destroying decisions such as unsound merger bids, excessive free cash flow retention, aggressive earnings manipulation, and CEO pay unrelated to performance. "Powerful" chairmen provide a "credible rival authority figure" vis a vis the CEO.

Outlook

Generally, the circumstances of independence change situationally for both individual directors and the companies on whose boards they serve. It must be reassessed regularly, particularly where a company is facing special, one-of-a-kind situations (change of CEO, going public, major turnaround).

In order to increase director independence, some shareholders prefer to bring new individuals in from outside the actual industry in which the company competes. Often overlooked, independence-threatening informal networks can develop within an industry sector over the years as executives move jobs between competitor companies and as they collaborate and congregate in industry association bodies.

Recruiting and appointing director through personal contacts or friendships entails the danger of overlooking interpersonal dependence which impairs a director's judgement and ability to fulfil his or her duty towards shareholders. A transparent, objective and well-documented selection and nomination process, led by a strong, competent and independent nomination committee, supported by a trusted external advisor, is the "gold standard" in ensuring and promoting director independence. ■

*This article was written by **Mr. Hagen Schweinitz**, Practice Leader Global Board and Governance Advisory Practice, Eric Salmon & Partners. All senior members of the practice have contributed to this article with their expertise.

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