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DECONSTRUCTING INDEPENDENT DIRECTORS

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In this paper we argue that boards of directors lack the mandate, the incentives and the ability to control insiders, especially in jurisdictions where the main agency problem arises between controlling and minority shareholders. We analyse the problems that render independents an inefficient monitoring device for companies with concentrated ownership structures and conclude that the current focus of the regulators and codes of best practice on empowering independents is ineffective, and that companies would be better off choosing their board members freely or by introducing so-called "minority directors". We nevertheless also present two different proposals for reform: independents as gatekeepers for the regulator and independents as surrogates for the minority. Both proposals are based on the idea that if independent directors are expected to monitor controlling shareholders their most important characteristic should be accountability rather than mere independence.

A. Introduction

Independent directors have been seen as the magical solutions to many corporate governance problems. Most jurisdictions around the world have trusted on the introduction of independent directors to boards to solve inefficiencies in corporations.[1] It is remarkable that the notion of independent directors has

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[1] L Enriques, H Hansmann and R Kraakman, in *The Anatomy of Corporate Law. A Comparative and Functional Approach* (Oxford University Press, 2009), 64 ("Among our core Jurisdictions, the principal trusteeship strategy today for protecting the interests of disaggregated shareholders—as well as minority shareholders and non-shareholder corporate constituencies—is the addition of "independent" directors to the board"). Referring to the US, CM Elson, "Enron and the Necessity of the Objective Proximate Monitor" (2004) 89 *Cornell Law Review* 496, argues that the board independence is a critical component of modern governance theory. Regarding practical implementation, by virtue of the Dodd-Franking Act of 2011 (DF), the Sarbanes-Oxley Act of 2002 (SOX) and new exchange listing requirements at the NYSE, a company listed in the NYSE is required to have a majority of independent directors (listing standard), a completely independent nominating/corporate governance committee (listing standard), a completely

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been such a success: it is widely considered to be a key element of corporate governance, and the widespread presence of these directors in corporate boards corroborates it. The philosophy beneath it is very intuitive, and also familiar. Judges Chandler and Strine have stated it very clearly: "Strong and diligent oversight by independent directors who are required to focus on legal and accounting compliance will result in public companies behaving with integrity . . . Thus, the reforms hope to encourage responsible conduct and deter wrong-doing and imprudent risk-taking".[2]

According to this perspective, insiders would want independent directors on the board as a bonding mechanism, signalling to potential investors that they are willing to be monitored effectively (and reducing the firm's cost of capital).

However, the drawback to this optimistic view of boards is that the role and rationale of independent directors remain—surprisingly—largely under-theorised, and the empirical research does not support the high expectations that policy-makers have put on the value of board independence. In this paper we will argue that boards of directors lack the mandate, the incentives and the ability to control insiders, and that this problem is especially acute in jurisdictions where the main agency problem arises between controlling and minority shareholders.

Even though minority expropriation is the most important agency problem in most European countries and in developing economies in Asia and Latin America, the focus of research on boards of directors has been on their role in the agency problem between managers and outside shareholders, which is typical in countries with dispersed ownership structures such as the US and the UK. In this paper we show that the application of conventional wisdom about board independence to companies with concentrated ownership structures may lead to several problems that have been overlooked by legislators and most of the academic literature. Independent boards are the most popular pill that these "doctors" prescribe to companies as the solution to whatever governance problems they might suffer. We will argue that this medicine is unlikely to "cure" patients with minority expropriation problems.

independent compensation committee (DF), an independent audit committee consisting of at least three members (listing standard) and a financial expert or a reason not to have a financial expert (SOX), regularly scheduled meetings of the non-management directors (listing standard) and a yearly meeting of the independent directors (listing standard). In Europe, most countries have enacted corporate governance codes of best practice, with similar requirements regarding board structure and independence, and listed firms are required to comply or disclose the reasons for not complying. M Bianchi, A Ciavarella, V Novembre and R Signoretti, "Comply or Explain? Investor Protection through Corporate Governance Codes" (2011) 23(1) *Journal of Applied Corporate Finance* 107, report compliance levels above 70% for most European countries.

[2] WB Chandler and LE Strine, "Views from the Bench: The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State" (2003) 152 *University of Pennsylvania Law Review* 953.

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Some clear conclusions appear after analysing the problems that render independents an inefficient monitoring device for companies with concentrated ownership structures. First, the function of the independent directors must be restated as the prevention of the expropriation of minority shareholders by the controlling shareholders. Secondly, independents can only complement, and never substitute for, good regulation and enforcement minority expropriation laws, which is lacking in most jurisdictions. Thirdly, there are substantial problems in the nomination of and incentives given to independent directors that should be addressed to make them meaningful. To this end, we present two different proposals for reform: independents as gatekeepers for the regulator and independents as surrogates for the minority. Both proposals are very radical, but we believe that radical choices are necessary if we want to save independents from irrelevance.

To support our point, we will proceed as follows. In Section B we begin with a brief review of the academic literature on independent directors. In Section C we analyse which are the functions that independents perform and which of these functions are useful for the regulator. We then study in Section D which tools the independents can rely on to perform those functions. Section E discusses the practical problems in the nomination process and in the provision of incentives that hinder the efficiency of independent directors. We present our proposals for reform in Section F and conclude in Section G.

B. Brief Overview of the Theory and Evidence on Independent Directors

In this section we argue that, in contrast to the positive public perception of independent directors, the academic literature has failed to show a direct link between independent directors and firm performance.[3]

The small but growing theoretical literature on boards of directors has stressed the conflict generated by directors' dual role as advisors and monitors of the management team, and the problems of asymmetric information between inside and outside directors.

A lot of the information needed to exert a broad monitoring function is soft information, and the independent directors depend on managers to supply them with this information; they, in turn, use that information to control the managers. But this is also the information that they need to perform their advisory and networking roles efficiently. Therefore, the managers will have more incentives to share this information with board members if they can also

[3] The interested reader will find an in-depth review of the literature on boards in R Adams, B Hermalin and MS Weisbach, "The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey" (2010) 48(1) *Journal of Economic Literature* 58.

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benefit from these functions. This implies that a board that is too centred on monitoring and controlling the CEO may have more problems obtaining the right information, so there is a limit to the monitoring that board members can perform.

There is empirical evidence that directors are aware of the tensions between these two functions,[4] and several theoretical models of boards have been developed around this trade-off between the advisory and monitoring functions of boards.[5] These models imply that there is some optimal board composition that balances the gains from monitoring with the gains from advising.[6] The main conclusion that can be drawn from this literature is that a majority of independents is not a valid recipe for all firms.

Meanwhile, the empirical literature on the effectiveness of boards of directors is far from conclusive.[7] A strand of the literature has focused on the link between board independence and performance. Some of these papers find no relationship,[8] other find a positive relationship,[9] and still others find a negative one.[10] This lack of clear results seems consistent with the theoretical literature if we assume different companies choose optimally different levels of board

[4] See R Adams, "Governance and the Financial Crisis", ECGI Finance Working Paper No 248/2009 (2009).

[5] C Raheja, "Determinants of Board Size and Composition: A Theory of Corporate Boards" (2005) 40(2) *Journal of Financial and Quantitative Analysis* 283; R Adams and D Ferreira, "A Theory of Friendly Boards" (2007) 62(1) *Journal of Finance* 217; M Harris and A Raviv, "A Theory of Board Control and Size" (2008) 21(4) *Review of Financial Studies* 1797.

[6] However, they do neither explain why both functions are performed by the same individuals, nor why managers value board advice above that coming from other independent advisors.

[7] For a review of this literature see Adams et al, *supra* n 3; BE Hermalin and MS Weisbach, "Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature" (2003) *Economic Policy Review* 7.

[8] Among them are BD Baysinger and HD Butler, "Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition" (1985) 1 *Journal of Law, Economics and Organization* 101; BE Hermalin and MS Weisbach, "The Effects of Board Composition and Direct Incentives on Firm Performance" (1991) 20(4) *Financial Management* 101; S Bhagat and B Black, "The Non-correlation between Board Independence and Long-term Firm Performance" (2002) 27 *The Journal of Corporation Law* 231.

[9] See J Cotter, A Shivdasani and M Zenner, "Do Outside Directors Enhance Target Shareholder Wealth During Tender Offer Contests?" (1997) 43 *Journal of Financial Economics* 195; KA Borokhovich, RP Parrino and T Trapani, "Outside Directors and CEO Selection" (1996) 31(3) *Journal of Financial and Quantitative Analysis* 337; JA Brickley, JL Coles and RL Terry, "Outside Directors and the Adoption of Poison Pills" (1994) 35 *Journal of Financial Economics* 371; JW Byrd and KA Hickman, "Do Outside Directors Monitor Managers? Evidence from Tender Offer Bids" (1992) 32 *Journal of Financial Economics* 195.

[10] See, eg D Yermack, "Higher Market Valuation of Companies with a Small Board of Directors" (1996) 40(2) *Journal of Financial Economics* 40(2) 185; 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; S Rosenstein and J Wyatt, "Inside Directors, Board Effectiveness, and Shareholder Wealth" (1997) 44 *Journal of Financial Economics* 229; A Klein, "Firm Performance and Board Committee Structure" (1998) 41 *The Journal of Law and Economics* 275.

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independence, and that an independent board may destroy the value for some companies.

Another strand of the literature has studied whether more independent boards remunerate or replace their CEOs in a different way. These papers have found that more independent boards give their CEOs more variable incentives[11] and are more likely to fire their CEOs following low performance.[12] Unfortunately, it is not clear whether they do this with the aim of improving performance or as a way to protect their reputations, ie whether they give too much variable compensation and fire the CEO too often. Interestingly, almost all of the papers have concentrated on the US case.

Among the few researchers that use data from other countries, Dahya and co-authors have studied the relationship between Tobin's *Q* and board composition in companies with a dominant shareholder in a sample of 22 countries.[13] Their results indicate that there is a positive correlation between board independence and Tobin's *Q*. They view this as evidence that independents can substitute for weak legal protection of minority shareholders. However, their results can also be explained by the need for companies with growth opportunities that need to raise funds in the market to "look good" by adding independents to their boards.

In the rest of the paper we will argue that we cannot expect independent directors to be a good solution to the agency problem, especially in countries with a concentrated ownership structure. We will show that they lack a clear monitoring mandate, that they have very limited monitoring tools at their disposal, that there are important difficulties in defining their profile and in their selection process, and that they are given poor incentives. Given all these problems, it is not surprising that the empirical literature has failed to provide clear support for their effectiveness.

C. The Legal Rationale for Independent Directors

From a regulatory perspective, independents can be useful if they perform functions that increase the value of the firm for outside investors and that they will not be able to implement by themselves. However, although the legislators carefully define the conditions of independence and specify clearly the convenience of a relatively high number of independents on the board, they are very vague as to the task they are supposed to carry out.

[11] See RJ Fisman, R Khurana and M Rhodes-Kropf, "Governance and CEO Turnover: Do Something or Do the Right Thing?" (2005), available at http://ssrn.com/abstract=656085.

[12] See M Weisbach, "Outside Directors and CEO Turnover" (1988) 20 *Journal of Financial Economics* 431.

[13] See J Dahya, O Dimitrov and J McConnell, "Dominant Shareholders, Corporate Boards and Corporate Value: A Cross-country Analysis" (2008) 87 *Journal of Financial Economics* 73.

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The main task of executive directors is to manage the affairs of the corporation on behalf of the shareholders. For directors who are not executives, academics have identified three broad functions: monitoring, advising and networking. While the advising and networking role of non-executive directors are likely to be very important and valuable for companies, there is no reason why they should be carried out by independent directors rather than by executive, inside, grey or non-independent directors, or even by external firms (companies routinely hire consulting firms to perform these functions for them).[14] Moreover, corporations should be capable of choosing the structure of the board which best suits their advising or networking needs, ie optimal board composition may vary across firms. There is also no reason for corporate lawmakers to be concerned about the advising or networking roles of boards and whether or not they add add value to the firm, because these functions do not generate a conflict between the insiders and the outside investors. Therefore, independent directors are of interest for the regulator only as monitoring agents and as independent decision-makers when insiders face a conflict of interest.

Interestingly the monitoring function that independent directors should carry out can differ greatly, depending on the ownership structure of the corporation.

1. Monitoring in Companies with a Dispersed Ownership Structure

The main governance problem of jurisdictions where a majority of firms are diffusely held is to reduce the agency costs associated with a separation of ownership and control. In these jurisdictions, the decision-making system of the corporation is controlled by managing directors—director primacy—who act as fiduciaries of the shareholders. This delegation in the directors has important advantages,[15] but it also produces some natural conflicts of interests between directors and investors that the literature has deeply analysed. Corporate governance in this kind of organisation is about finding low-cost mechanisms that reassure incumbent and potential new investors that the directors fulfil their fiduciary duties of care and loyalty and maximise shareholder value.[16]

A general recipe to combat the agency costs that arise between managing directors and dispersed investors is to monitor the directors. To do this we can rely on the law, but also on market forces, and any other institution or device that exercises power over decision making within a corporation.

14 However, there must be some reason why firms prefer to have these people on the board. Arguably, the directors do not only advise or connect firms; they also have voting power, which may make their advice and influence qualitatively different.

15 KJ Arrow, *The Limits of Organization (Fels Lectures on Public Policy Analysis)* (Norton, 1974).

16 JR Macey, *Corporate governance: Promises Kept, Promises Broken* (Princeton University Press, 2008).

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The law has an obvious role to play. Corporate law has traditionally been based on the assumption that the extensive powers of directors can only be justified if there is some sort of counter-power that can make directors accountable to shareholders. The bottom line of this legal programme is the power of shareholders to remove and appoint directors, the so-called "shareholders franchise". However, the feasibility of this programmatic statement is doubtful because of the dispersed ownership structure of listed companies: shareholders face collective action problems, information asymmetries and transactional costs that make them bad monitors of their agents. In addition, shareholders face severe legal impediments to appoint and remove directors.[17] Therefore, to make it work, the current regulatory framework needs to be changed.[18]

Other strategies have also been tested. Market-oriented mechanisms, and especially the market for corporate control, have been very effective in reducing agency costs. The empirical evidence has proved that the likelihood of managers being replaced in a hostile acquisition correlates with higher managerial discipline.[19] Thus, takeovers are considered to be a crucial monitoring mechanism to control managerial discretion.[20] In fact, they are generally perceived as being much more effective than the standard legal tool that allows investors to dismiss incumbent managers: the proxy fight for the election of directors.[21] Both mechanisms can work as substitutes and increase directors' accountability to investors. Nevertheless, this mechanism is not perfect,[22] and has been criticised for being too costly and/or too bloody. Above all, it has been successfully fought against by the powerful lobby of managers.[23] Thus, at

[17] L Bebchuk and S Hirst, "Private Ordering and the Proxy Access Debate" (2010) 65(2) *The Business Lawyer* 329.

[18] L Bebchuk, "The Myth of Shareholder Franchise" (2007) 93(3) *Virginia Law Review* 675.

[19] Several studies have found that there are significant positive abnormal returns on the investments of shareholders in companies that received takeover bids. For the US they are of around 30%, eg G Andrade, M Mitchell and E Stafford, "New Evidence and Perspectives on Mergers" (2001) 15(2) *Journal of Economic Perspectives* 103. In Europe target shareholder returns have been estimated at around 10% , eg JM Campa and I Hernando, "Shareholder Value Creation in European M&As" (2004) 10(1) *European Financial Management* 47.

[20] See A Schleifer and RW Vishny, "A Survey of Corporate Governance" (1997) 52(2) *Journal of Finance* 737.

[21] See T Baums and K Scott, "Taking Shareholder Protection Seriously? Corporate Governance in the US and Germany" (2005) 17(4) *Journal of Applied Corporate Finance* 44.

[22] The interested reader can find an excellent review on the empirical evidence on the efficiency of takeovers in "Takeovers" by M Burkart and F Pununci, published in X Freixas, P Hartmann and C Mayer (eds), *Handbook of European Financial Markets and Institutions* (Oxford University Press, 2008). Even though the aggregate evidence suggests that overall takeovers generate value, there are many cases in which they destroy total wealth, (i) because they are undertaken by the bidders managers to build empires, (ii) because they generate negative externalities not reflected in market prices on the debt-holders and the employees, or (iii) because of the free raiding behaviour of the shareholders, which makes value increasing (decreasing) takeovers less (more) likely to succeed.

[23] The counter-argument against the efficiency-enhancing justification for hostile takeovers (and obviously supported by incumbent managers) argued the inefficiency of the market for

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some point during the last decade of the twentieth century, the market for takeovers declined due to legal interventions that increased managers' negotiation power through the acquisition process (supposedly to seek a higher price for shareholders, but also at the expense of deterring future bids and constraining the market of corporate control).[24]

Interestingly, the decline in the market for corporate control coincided in time with the rise of independent directors as monitors of the managing or inside directors. The focus of the board shifted from the "advising board" to the "monitoring board",[25] where some members (the insiders) make decisions and get advice from other members (the non-independent outsiders) while other members monitor them (the independent outsiders). The logic for this division of roles within the board is clear. The interests of the managers are usually different from those of the shareholders, and even though all members of the board of directors have fiduciary duties towards the shareholders, wrongdoing is difficult to prove in many corporate decisions. Agency costs can have many different and subtle manifestations in the decisions of the corporation that are difficult to control through fiduciary duties: favouring low-risk or short-term projects, sub-optimally reducing or increasing investment levels, wasting corporate resources, etc. Therefore, only a broad mandate for monitoring can be effective in reducing them. If managers feel that they are being closely monitored by the independents, they will make decisions that are better aligned with those of the shareholders, and if they try to deviate, the independent directors will use their voting rights to prevent it.

Therefore the function that independents are expected to perform in companies with dispersed ownership structure is clearly a monitoring one. But what abilities do they have to do this? The board is responsible for hiring, fixing the remuneration and replacing CEOs. In other words, the shareholder franchise is now taken over by independent directors. Moreover, independent directors also have voting power on all board decisions. Therefore, a majority of independents have the power to prevent agency problems *ex ante* by choosing and

corporate control due to its "short-termism", undervalued acquisitions and other quick-buck strategies.

[24] F Easterbrook and DR Fischel, "The Proper Role of a Target's Management in Responding to a Tender Offer" (1981) 94 *Harvard Law Review* 1161; RJ Gilson, "A Structural Approach to Corporations: The Case against Defensive Tactics in Tender Offers" (1981) 33 *Stanford Law Review* 819. Moreover, managers championed a number of anti-takeover clauses in bylaws, including staggered boards, supermajority shareholder vote requirements and the most powerful, the poison pill; L Bebchuk, J Coates IV and G Subramanian, "The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy" (2002) 54 *Stan Law Review* 887.

[25] See JN Gordon, "The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices" (2007) 59 *Stanford Law Review* 1520. The legitimating mechanism of independent directors was part of the fiduciary standard for resistance of the board to hostile takeovers, because judicial approval of defensive measures appeared to be tied to informed decision making by independent directors.

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motivating the right CEO, and *ex post* by turning down managerial proposals that may not be in the best interest of the shareholders.

Thus, the main goal of independents is to improve corporate decision making from the inside, solving the managerial capture of the board.[26] From this perspective, in companies with dispersed ownership structures, board independence functions as a substitute for external regulation in order to reduce the agency problems between managers and shareholders: it is cheap for the government, and it spares courts and legislators the trouble of getting too implicated in the internal affairs of the corporations. So, in a broad sense, independent directors are called to improve corporate functioning from the inside without external legal guidelines.

2. Monitoring in Companies with a Concentrated Ownership Structure

Corporate governance issues are different in corporations with a controlling shareholder.[27] Large shareholders have both the incentives and the power to exert active monitoring over managers, and they usually hold board positions in the companies they control. Managers face a real possibility of being removed by the controlling shareholder if performance is below par. Thus, the shareholders franchise in corporations with concentrated ownership structure is a working monopoly of the controlling shareholders.

As a result, in jurisdictions with concentrated ownership structures, independent directors are not needed to monitor the managers—since they are already being monitored by the controlling shareholders. However, as empirical research has reported, the relevant problem here is the potential expropriation of the outside shareholders by the controlling shareholders through "tunneling" and related party transactions.[28] Empirical evidence has shown

[26] DC Clarke, "Three Concepts of Independent Directors" (2007) 32(1) *Delaware Journal of Corporate Law* 73.

[27] L Bebchuk and A Hamdani, "The Elusive Quest for Global Governance Standards" (2009) 157 *University of Pennsylvania Law Review* 1301, arguing that, looking to the future, the quest for global governance standards should be replaced by an effort to develop and implement separate methodologies for assessing governance in companies with and without a controlling shareholder.

[28] The expropriation problem has been empirically tested. Two different methods have been used to measure the ratio of private benefits. One uses the market value of double class shares, eg H DeAngelo and L DeAngelo, "Managerial Ownership of Voting Rights: A Study of Public Corporations with Dual Classes of Common Stock" (1985) 14 *Journal of Financial Economics* 33; L Zingales, "What Determines the Value of Corporate Votes?" (1995) 110 *Quarterly Journal of Economics* 1047 for the United States; H Levy, "Economic Evaluation of Voting Power of Common Stock" (1982) 38 *Journal of Finance* 79 for Israel; KH Chung and JK Kim, "Corporate Ownership and the Value of a Vote in an Emerging Market" (1999) 5 *Journal of Corporate Finance* 35 for Korea. The most ambitious study following this method corresponds to T Nenova, "The Value of Corporate Voting Rights and Control: A Cross-country Analysis" (2003) 68 *Journal of Financial Economics* 325, with data from 18 countries. The second method values the

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that minority expropriation hinders the development of financial markets and reduces economic growth.[29] From a policy point of view, this means that monitoring mechanisms aimed at reducing expropriation of the minority are indeed socially valuable.[30]

The presence of controlling shareholders changes both the goals of corporate governance and the available mechanisms to achieve these goals. Corporate governance' main goal in these jurisdictions is to control the controlling shareholder and to reduce the expropriation rate of minority shareholders. The idiosyncrasy of this kind of insiders lies in their own interest in the corporation: they are at the same time principals and agents, and this makes the well-known formula of monitoring and removal inoperative. This might explain why, in jurisdictions with concentrated ownership structures, the traditional legal design of the decision-making system is not entirely centred on the board. In fact, managerial powers are distributed between the board and the shareholder meeting. This might make sense if we consider that such firms display partial separation of ownership and control, which means that voting by the shareholders carries out both managerial and supervisory functions.[31]

Nevertheless, and contrary to the extended opinion among European corporate law scholars, this corporate governance structure—which gives more power to the shareholder meeting—does not solve per se the inefficiencies within the corporation. In fact, conflicts between controlling and non-controlling shareholders could even be aggravated in listed corporations, because the ability to interfere in management is effectively exercised by the controlling shareholder, rather than by the shareholder meeting as a whole, which opens the

premium price of blockholder transfers. See in this respect the seminal study of M Barclay and C Holderness, "Private Benefits from Control of Public Corporations" (1989) 25 *Journal of Financial Economics* 371, and the most important contribution in the area: A Dyck and L Zingales, "Private Benefits of Control: An International Comparison" (2004) 59(2) *Journal of Finance* 537, with data for 39 countries.

29 See R La-Porta, F Lopez-De-Silanes, A Shleifer and R Vishny, "Investor Protection and Corporate Valuation" (2002) 57(3) *Journal of Finance* 1147; Zingales, *supra* n 28; Dyck and Zingales, *supra* n 28; T Beck and R Levine, "Stock Markets, Banks and Growth: Panel Evidence" (2004) 28(3) *Journal of Banking and Finance* 423. Nevertheless, these papers use metrics of investor protection that have been subject to many criticisms. In particular, limited and ad hoc selection of variables, coding errors, a US bias, the absence of certain variables and the unsatisfactory definition of many variables have been raised by, amongst others, H Spamann, "The Antidirectors Rights Index Revisited" (2009) 23(2) *Review of Financial Studies* 467; U Braendle "Shareholder Protection in USA and Germany—Law and Finance Revisited" (2006) 7 *German Law Journal* 257.

30 See RJ Gilson, "Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy" (2006) 119 *Harvard Law Review* 1641. See also F Easterbrook and DR Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, 1991), reporting that legal rules are more effective to combat duty-of loyalty problems than the market.

31 See S Cools, "Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers" (2005) 30 *Delaware Journal of Corporate Law* 697.

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door for expropriation.[32] On the one hand, in the presence of a controlling shareholder, the efficiency of the voting mechanism decreases seriously.[33] On the other hand, the issues on which the general meeting decides have more to do with the contractual configuration of the corporation—especially regarding relations among shareholders—than with monitoring how the corporation is being managed. In fact, there is a strict separation and distribution of decision-making powers between the general meeting and the board of directors. This means that the controlling shareholders are controlled to some extent with regard to the decisions they take as shareholders in the general meeting, but not with regard to the decisions of the board, which can also be controlled by them.

This design of corporate decision making may work for close corporations, in which there is no separation of ownership and control (since, by definition, they are not highly institutionalised and are founded on a deeper contractual basis), but these arrangements do not fit well in the case of listed companies with a controlling shareholder. The majority rule plays in favour of the controlling shareholder and grants him extensive powers to govern the corporation (formally, the managers are the only ones accountable to the corporation, which explains the low rate of shareholder litigation in this regard). The controlling shareholder indeed has the power to designate—and remove—the managing directors and the other board members, so he makes sure that board decisions are taken in his interest (which is usually confounded with the so-called "interest of the company"),[34] but not necessarily in the interest of minority shareholders.[35] The corporate law of Continental European countries has moved some steps in the right direction in the last few years,[36] but control-

[32] M Burkart, D Gromb and F Panunzi, "Large Shareholders, Monitoring and the Value of the Firm" (1997) 112(3) *Quarterly Journal of Economics* 693.

[33] The Jury Theorem says that, assuming that shareholders vote for the correct option, as the number of shareholders increases, the probability that a majority vote taken at the shareholders' meeting will select the correct alternative tends towards certainty. This is useful for widely held firms, but in the presence of a controlling shareholder the effective number of voting shareholders is reduced to one. In other words, external shareholders have voting rights, but no voting power. For further analysis see MC Schouten, "The Mechanisms of Voting Efficiency" (2010) 3 *Columbus Business Law Review* 763.

[34] S Cools, "Europe's Ius Commune on Directors Revocability" (2011) 8(2) *European Company and Financial Law Review* 199, reports that the mandatory rule of at will revocability of company directors of European civil law is useful for the controllers to make directors to be faithful to them and complain with their wishes. In this sense, at will revocability contributes to intensifying the divergence of interests between controlling and non-controlling shareholders.

[35] See S Johnson, R La-Porta, F Lopez-de-Silanes and A Shleifer, "Tunneling" (2000) 90 *American Economic Review* 22.

[36] P-H Conac, L Enriques and M Gelter, "Constraining Dominant Shareholders' Self-dealing: The Legal Framework in France, Germany and Italy" (2007) 4(4) *European Company and Financial Law Review* 491, report that some jurisdictions, such as France and Italy, have introduced regulation to combat self-dealing. The Italian regulation is the leading one in Europe, and it designs a system of assignation of decision rights between the board (in the hands of independent directors) and the minority shareholders. See the regulations containing provisions relating to

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ling shareholders still exert the decision-making power of the corporation (both in the shareholder meeting and on the board) and they are not accountable to minority shareholders (whose investments are managed by them).[37]

From this point of view, it is clear that the traditional instruments of corporate law are insufficient to address the conflicts between controlling and minority shareholders in listed corporations. Nor can takeovers work either, when the controlling shareholder must be paid to leave the corporation. Hence the important question: can the introduction of independent outside directors be useful in addressing this problem? Perhaps so, but clearly the function of the independent directors must be restated. Their goal here from a regulatory point of view is not to improve the decision-making system of the corporation through monitoring, but to police the expropriation risk of these corporations.

Professors Bebchuck and Hamdani have argued that, when there is a controlling shareholder, independent directors will carry out essentially the same role, but with the difference of focusing on the controlling shareholder rather than on the CEO.[38]

Nevertheless, it is important to note that the inefficiencies caused by the managers–shareholders conflict do not exactly match the problems generated by controlling shareholders. Moreover, the tools that directors have in their power to monitor managers are unlikely to work when applied to blockholders. On the one hand, managers have the temptation of shirking, building empires or seeking perquisites and compensation. We have already argued that the general recipe to combat this type of cost is broad monitoring of decisions combined with the ability to nominate, remunerate and replace CEOs. On the other hand, the inefficiencies related to the presence of controlling shareholders are correlated with the opportunity to extract private benefits. Tunnelling through self-dealing and other kinds of related-party transactions is the real problem when there are controlling shareholders.[39] Therefore, the function of independent directors in corporations with concentrated ownership

transactions with related parties, adopted by Consob with Resolution No 17221 of 12 March 2010, later amended by Resolution No 17389 of 23 June 2010. The decision rights are assigned to the board, but companies may opt out and grant it to the shareholder meeting if the independent directors veto the transactions.

[37] An interesting exception to this lack of accountability appears in Nordic company law, where controlling shareholders can be held liable if they have acted in a managerial capacity ("shadow director liability"). This could explain why Nordic countries usually rank high in rankings of minority protection in spite of having very concentrated ownership structures. See JL Hansen, "The Report of the Reflection Group on the Future of EU Company Law—as Seen from a Nordic Perspective", Nordic & European Company Law Working Paper No 10-15 (2011), available at http://ssrn.com/abstract= 1869817.

[38] Bebchuk and Hamdani, *supra* n 27.

[39] See VA Atanasov, BS Black and CS Ciccotello, "Law and Tunneling" (2011) 37 *Journal of Corporation Law* 1, discussing the different ways in which the controlling shareholders may extract private benefits from firms, and exploring the legal ways to combat them).

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should be even more precise: to monitor the conflicts of interest of the controlling shareholder and prevent the risk of expropriation.

However, European jurisdictions have failed to make this distinction. In fact, both in the codes of best practices and in other regulations, such as listing requirements, independent directors are seen as a protection for shareholders specifically against managers, not against other shareholders. We believe that, in Europe, independent directors are being used for the wrong purposes. This may be another example of lobbying by the interest groups: notions of good corporate governance can be manipulated to turn out rules for their own purposes.[40] In the particular case of the corporations with controlling shareholders, they may have included independent directors on the board with the general assignment of supervising managers. In this sense, their presence is trivial and frivolous, because the inefficiencies in corporations with a concentrated ownership structure are due to minority expropriation, not managerial misbehaviour. The duty of monitoring directors is effortless and unstressed, basically because a shareholder who controls a company does not need an external monitor to help him to supervise a management team that he has the power to appoint. The controlling shareholder has the capacity and all the right incentives to be the best monitor of his investment in the company (and the other shareholders free ride on his effort).

Therefore, for independents to be effective, the regulators of countries with concentrated ownership structures need first to state their function clearly as the protection of minority shareholders from the block-holders. The definition of the function is especially relevant in the European jurisdictions, where the introduction of independent directors has been only a recommendation of the codes of best practice, without further implication in corporate law. This means that, in practice, the independent director shares with the other members of the board—including the executive directors—legal status, functions and liability. In this sense, in many jurisdictions there seems not to be a place for a special kind of director, entailed with a particular command and very probably regulated with a different set of rules according with it. European corporate law has to be adjusted if we want the independents to be effective in solving the relevant agency problem. The vague current definition of their function entails the risk of a lack of effectiveness of independent directors and, even worse, a legal cover for the activity of the controlling shareholders.[41] In other words, the legal design of independent directors is much more complex than commonly thought, but it is crucial as the first step to make them operational.

[40] M Ventoruzzo, "Takeover Regulation as a Wolf in Sheep's Clothing: Taking UK Rules to Continental Europe" (2008) 11 *University of Pennsylvania Journal of Business Law* 135.

[41] Bianchi *et al*, *supra* n 1 demonstrate that, even though 85.9% of Italian listed companies are formally compliant with a rule in the Italian code of best practice that requires the setting up of internal procedures to deal with related party transactions, only 32.6% have implemented the Code's recommendations in a proper way.

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Therefore, we conclude that, in countries with a concentrated ownership structure, board independence can only work as a complement of external regulation in the task of reducing minority expropriation problems. First, independent directors need a clear mandate and definition of legal status. Secondly, if independent directors are supposed to control *ex ante* third party transactions, a tandem of clear rules and open-ended standards of conduct against self-dealing may exist. Anti-self-dealing regulation is needed before it is enforceable. Thirdly, they also need to be provided with the means and abilities to do the job.

D. The Monitoring Tools of Independent Directors

In the previous section we focused on the different role that independent directors should perform in companies with a controlling shareholder as compared with their role in companies with dispersed ownership. However, even if we define the function correctly, we still face other problems. Which are the abilities that independents have to reduce minority expropriation? What can an independent director do if he identifies a suspicious transaction? Does he have the ability to prevent expropriation? In other words, the tools of independents against controlling shareholders might not be as powerful as the tools they can use against managers. Unlike managers, block-holders cannot be hired, fired or remunerated by the board, so independents have little *ex ante* deterrence power when there is a controlling stake.[42]

[42] The effectiveness of managerial remuneration to align the incentives of managers with those of shareholders is a highly debated topic. Interestingly, since executive pay is determined by the board of directors, the two mechanisms interact in complex ways. A Almazán and J Suárez, "Entrenchment and Severance Pay in Optimal Governance Structures" (2003) 58 *Journal of Finance* 519, BE Hermalin, "Trends in Corporate Governance" (2005) 60(5) *Journal of Finance* 2351, and P Kumar and S Sivaramakrishnan, "Who Monitors the Monitor? The Effect of Board Independence on Executive Compensation and Firm Value" (2008) 21(3) *Review of Financial Studies* 1371, present models where the board must determine the CEOs remuneration package and show that optimal pay-for-performance sensitivity may depend on board composition in ambiguous ways. In fact, the empirical findings are mixed. A negative relationship between CEO ownership and board independence has been documented in several papers, including D Denis and A Sarin, "Ownership and Board Structures in Publicly Traded Corporations" (1999) 52 *Journal of Financial Economics* 187; M Baker and P Gompers, "The Determinants of Board Structure at the Initial Public Offering" (2003) 46(2) *Journal of Law and Economics* 569; A Shivdasani and D Yermack, "CEO Involvement in the Selection of New Board Members: An Empirical Analysis" (1999) 54(5) *Journal of Finance* 1829; J Coles, ML Lemmon and YA Wang, "The Joint Determinants of Managerial Ownership, Board Independence, and Firm Performance" (2008), available at http://ssrn.com/abstract=1089758. In contrast, J Core, R Holthausen and D Larcker, "Corporate Governance, Chief Executive Officer Compensation, and Firm Performance" (1999) 51 *Journal of Financial Economics* 371, find that the proportion of outside directors is significantly positively related to the CEO's mix of pay, which is the annual and long-term incentive pay as a percentage of total compensation. Moreover, these relationships may change in the future as a result of the "say-on-pay" policies now being imple-

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What can be done *ex post*, once the suspected related party transaction is brought to the table? Independents can use three main opposition strategies: voting at board level, public disclosure and legal action.

1. Existing Tools within the Regulatory Framework

(a) Voting at Board Level

Rules on disclosure and procedures to solve conflicts of interest (like the obligation to abstain from voting on the issues when the director is a related party) are probably the main courses of reforms taken in some jurisdictions of Continental Europe regarding self-dealing regulation.[43] In most cases, anti-self-dealing provisions are addressed to curb expropriation by directors and, to a lesser degree, by dominant shareholders. These rules are supposed to perform a prophylactic function, in the sense that they prevent and control corporate deviance *ex ante*, before the decisions are made.

The most interesting jurisdiction for our purposes is Italy, because it increases the involvement of the independents in the approval of related party transactions.[44] In particular, in the event of transactions of greater importance (which are defined under quantitative parameters), the board has the power to authorise the transaction after a favourable report of the committee of independent directors; otherwise, the approval of the transaction falls to the shareholders' meeting. The new Italian regulation also increases disclosure requirements for related party transactions, which are still narrow in most jurisdictions.

The approval mechanisms in other jurisdictions are diverse. German law requires ratification by the supervisory board—which is not necessarily independent—only for cases when directors are on both sides of the transaction (conflicts of interest are not appreciated for other interested transactions).[45] The French law requires both the *ex ante* authorisation of the board of directors and the *ex post* ratification by the general meeting (in both cases, with the abstention of the interested party). But here the devil is in the details: the French rules do not apply to current transactions entered into at normal condi-

mented in the US and the UK. In particular, the Dodd-Frank Act requires the shareholders general meeting of all firms listed in the US to conduct periodic non-binding advisory votes on executive pay. A similar measure has been introduced in the UK.

[43] Conac et al, *supra* n 36. See also L Enriques, "The Law on Company Directors' Self-dealing: A Comparative Analysis" (2000) 2(3) *International Competition Law Journal* 297.

[44] In March 2010, the Italian exchange commission issued a regulation to control related party transaction, Resolution No 17221 of 12 March 2010, later amended by Resolution No 17389 of 23 June 2010.

[45] As Enriques, *supra* n 43, reports (332), traditionally the members of the supervisory board—banks and employees—were not particularly concerned about managers' diversion of assets, as long as there was no risk of the company defaulting, because of their preference for the maintenance of the incumbent managers.

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tions, or to shareholders with less than 10% of the voting power. At the other extreme of the range, Spanish law does not require any special procedure for the approval of self-dealing transactions; it only states that directors with an interest conflicting with that of the company in a particular transaction must abstain from voting on that transaction at board level.

An alternative regulatory strategy that avoids voting subtleties is the selective prohibition of specific categories of potentially risky transactions. For example, the French jurisdiction prohibits loans to managers and directors (in Germany they are only possible with the consent of the supervisory board). Also, German law prohibits concealed distributions to any shareholder, and states that, in the event of an interested transaction, any private benefit constitutes a de facto distribution to that shareholder. It is an extreme expression of the pro rata distribution rule.

There is still no empirical evidence on the effects of these regulations, so we do not know if the reforms have curbed expropriation, or if the benefits of the new rules and procedures outweigh their costs.

Summing up, we see that independents can oppose a self-dealing transaction by voting against it at board level. But, with the exception of Italy, procedure rules might not be enough if a substantial part of the board is "captured" by the controlling shareholder. Provided that the independents on the board have significant voting power relative to the controlling shareholder (for example, if they hold a majority of the seats), they can stop the transaction at board level. However, the opposition at board level cannot deter the suspected transaction because the block-holder can still pass the decisions using his voting power at the shareholders' general meeting. So, by voting against the transaction, independents can, at best, increment the costs for the large shareholder in terms of public exposure, which is discussed in our next point.

(b) Public Disclosure

The independents can threaten the block-holder with public disclosure of suspected transactions. This measure can have three different consequences, some of which are not particularly beneficial for minority shareholders. First, public disclosure can hurt block-holders indirectly if it causes lower security prices. However, this is not an efficient punishment for two reasons: lower prices are not especially damaging to the holders of large illiquid blocks; however, they do hurt minority shareholders who are trading for liquidity reasons. Secondly, future financing will be more expensive. This will protect minority shareholders in the future, but it will damage the growth prospects of the company and punish other stakeholders, such as employees. Moreover, this punishment will not be very effective for mature companies that can use retained earnings to invest and are more prone to expropriation problems. Thirdly, it may constitute a real and targeted punishment for the controlling block-holder if it induces the

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minority shareholders to take legal action against the block-holder. This brings us to our third opposition strategy.

(c) Legal Action

In our view, the most powerful tool at the disposal of independent directors is to threaten with legal action, but this threat will only be effective if two conditions are met: first, there must be good regulation; and secondly, there must be good enforcement.

First, *ex post* judicial review for compliance with the law rests on the after-the-fact examination of the fiduciary duties of managers and controlling shareholders.[46] If the board has broad powers to undertake many kinds of transactions, their members must be subject to legal scrutiny when the transaction is harmful for the interest of non-controlling shareholders. Law provides rules that implement fiduciary duties to particular cases—like the obligation of no competition, or the theft of the principal's opportunity—but the broad duties of loyalty must also be protected beyond the terms of the rules by open-ended standards. These standards of conduct of directors with executive powers towards the non-controlling shareholders should be clearly stated in jurisdictions that have a controlling shareholder because the actual interpretation of the "interest of the company" usually favours the interest of the controlling shareholder.[47] Further, not only directors but also controlling shareholders should owe fiduciary standards of conduct to non-controlling shareholders, and should be liable if they breach them. This must be so because corporate law provides the controlling shareholder with expansive default powers of administration. As we have already mentioned, they control the decision-making system of both the shareholders meeting (through voting power), and the board (through their capacity to nominate and remove directors). It is important to keep in mind that the functional core of fiduciary law is deterrence. The agents who exert control over the corporation should be accountable for the decisions they make affecting minority shareholders.[48]

Secondly, even if the regulation is accurate, there are still enforcement and litigation problems. Non-controlling shareholders face serious informa-

[46] RH Sitkoff, "The Economic Structure of Fiduciary Law" (2011) 91 *Boston University Law Review* 1040, reporting that the fiduciary obligation minimises transaction costs. Fiduciary governance plays a role in all fields in which the agency problem arises from incomplete contracting in the separation of control and non-controlling ownership.

[47] As shown in Johnson et al, *supra* n 35.

[48] Interestingly, Nordic company law seems an exception to this lack of accountability across European jurisdictions. In Nordic countries, controlling shareholders can be held liable held liable if they have acted in a managerial capacity ("shadow director liability") and the courts can strike down any decision made to unfairly advantage one shareholder at the expense of the company or other shareholders. See JL Hansen, *Nordic Company Law: The Regulation of Public Companies in Denmark, Finland, Iceland, Norway and Sweden* (DJØF Pub, 2003).

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tion and collective action problems when bringing a lawsuit, but at the same time, if standing—the legal right to initiate a law suit—is low, a small group of shareholders could engage in strategic litigation, endangering productive transactions. In this sense, the European jurisdictions have traditionally been more concerned about the risks of empowering minority shareholders than the benefits of making the controlling shareholders more accountable. In our view, if independent directors—with inside information—could threaten directors and controlling shareholders with a credible lawsuit, both investors' protection and deterrence would increase. We will come back to this idea in Section F, when we discuss our proposals for reform.

2. Limits to the Efficiency of Regulation

So far, we have argued that the effectiveness of the tolls that independent directors can use to control large shareholders depends crucially on the quality of the anti-self-dealing regulation. Voting will only be effective if there are *ex ante* rules that impose disclosure obligations and a procedure policy to overcome the conflict of interest in the decision-making system of the corporation. Disclosure policies will have real bite if they can induce the minority to file suits against the controlling shareholders; and legal action requires good standards that impose loyalty duties to managers and controlling shareholders towards the minority shareholders and good enforcement of those standards.

Therefore, good regulation is a necessary condition for independents to be effective.

Note, again, the striking difference in the relationship between independents and the legal framework in the two different regimes. In dispersed ownership structures, the value of independents comes from acting as a supplementary mechanism that relies mainly on *ex ante* controls (selection and remuneration of the managers) and, by so doing, reduces the need for legislation and *ex post* enforcement. In concentrated ownership structures, independents can only work as a complement to a strong enough regulation and enforcement of disputes between controlling and minority shareholders. The scarce literature studying the interrelationship between alternative controlling mechanisms has completely overlooked this important fact.[49]

[49] An exception is M Burkart and F Panunzi, "Agency Conflicts, Ownership Concentration, and Legal Shareholder Protection" (2006) 15(1) *Journal of Financial Intermediation* 1, who model the interaction between legal shareholder protection, managerial incentives, monitoring and ownership concentration when both the manager and the large shareholder can reap private benefits but the large shareholder can monitor the manager. Interestingly, better legal protection affects both the expropriation of shareholders and the blockholder's incentives to monitor. Because monitoring weakens managerial incentives, both effects jointly determine the relationship between legal protection and ownership concentration. When legal protection can facilitate monitoring, better laws strengthen the monitoring incentives, and ownership concentration and legal protection are inversely related. By contrast, when legal protection reduces

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Our next point is that, even with good regulation in place, independent directors are unlikely to be efficient in solving conflicts of interests within the firm, ie good regulation is a necessary condition but not a sufficient one.

Why does this happen? We will first show that good *ex ante* regulation is not a good substitute for *ex post* regulation and, secondly, that even if *ex ante* and *ex post* regulation are very good they will not lead to the most efficient choices with regard to self-dealing transactions.

(a) The Reduced Substitutability between Ex Ante and Ex Post Regulation

In the previous section we argued that the threat of litigation is a powerful tool to combat minority expropriation. However, it is also a very costly tool, which requires a high investment in enforcement institutions. In countries where the litigation system is underdeveloped (including Continental Europe), the most recent trend is to focus on strengthening internal governance mechanisms as a substitute for *ex post* litigation.[50]

As we have already discussed in the section on voting, Italy has introduced the most interesting changes on decision-making rules at board level. Rules governing decision making are useful both in reducing the cost of posterior litigation and in generating more public scrutiny of decisions. Nevertheless, by themselves, they will have little deterrence power.

This happens for several reasons. First, it is unlikely that a company with a controlling shareholder will give independents enough voting power to effectively oppose him, especially when he controls the nomination procedure. There is a contradiction in terms in simultaneously having an independent board and a controlling shareholder. Secondly, if litigation is ineffective because rules and standards on self-dealing are not clear, directors have no clear guide on how to vote. This can either render them irrelevant (if they vote at random) or it can make them very powerful if the controlling shareholder needs their cooperation to pass self-dealing transactions, and it may lead to collusion between them. The same happens with the reports that independent directors or other special committees must elaborate to inform others how to vote (eg the Italian case). Note also that these reports can only achieve accuracy and reliance if they can be subject to an *ex post* fairness review regarding the interests of minority shareholders. Thirdly, if litigation is ineffective because there is no enforcement, the decision by a board member to oppose the controlling shareholder is simply quixotic; one cannot expect an independent to put on the judge's hat.

the need for monitoring and they are substitutes, better laws weaken the monitoring incentives, and the relationship between legal protection and ownership concentration is non-monotonic.

[50] Z Goshen, "The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality" (2003) 91(2) *California Law Review* 393.

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(b) The Limited Efficiency of Good Regulation

All the self-dealing regulation that we have discussed above is founded on the idea that the benefits from the economic transactions of the corporation should be divided on a pro rata basis among the shareholders. However, a formal analysis of this type of legal mechanism shows that they can never be efficient in solving conflicts of interest. One can think of two different types of minority expropriation mechanism. The most obvious one is a pure transfer of resources from the firm to the controlling shareholder (eg he gets an interest free loan from the corporation), where a private benefit for the controlling shareholder is generated at the expense of a public benefit for the minority. This type is easy to identify, control and regulate, but is probably the less important. The most subtle type is a contract for inputs or services between the firm and the controlling shareholder. If the price is right, this transaction can generate a public benefit for all shareholders and a private benefit over and above the public benefit for the controlling shareholder. If the price is wrong, the operation can still generate high private benefits for the controlling shareholder at the expense of the minority. This type of transaction is very difficult to regulate, especially because of informational issues.

In particular, it is possible to prove that if self-dealing operations between the firm and the controlling shareholder can bring potential benefits both to the minority and to the controlling shareholder, and the controlling shareholder has superior information about these operations, the only efficient solution must give him a controlling rent over and above the pro rata division of surplus.[51]

Thus, any *ex ante* or *ex post* rule that is based on pro rata distribution (as all regulation in this matter is) will give an inefficient outcome, resulting in too much self-dealing and minority expropriation, or too little self-dealing and a lower firm value.

In this context, the role for regulation is limited and the expectations that have been placed on legal reform will be disappointed. Regulation cannot achieve efficiency and it cannot provide optimal decision rules; at best, it can be used to reduce expropriation, though at the cost of a lower company value. Higher efficiency can be achieved through the combination of a tough law that limits self-dealing activities and the right for the firms to opt out and contract the optimal level of private benefits. In this contractual setting, independents could be useful as surrogates for the minority in contracts between the corporation and the controlling shareholder.[52]

So far, we have seen that the tools that independent directors have with which to oppose the controlling shareholder are limited. Given these limita-

[51] See M Gutiérrez and M Sáez, "A Carrot and Stick Approach to Discipline Self-dealing by Controlling Shareholders", ECGI Law Working Paper No 138/2010 (2010), available at http://ssrn.com/abstract=1549403.

[52] *Ibid.*

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tions, a more realistic approach to the function that independents can play in companies with concentrated ownership structures is to think of them as an informational channel. By virtue of their position, independents have access to all sensible information which allows them to identify conflicts of interest. What remains unclear is whether they can put this information to good use. In Section F we return to this idea and identify ways in which independents could channel this information to the regulator and/or the minority shareholders.

E. Problems in the Profile, Selection and Incentives of Independent Directors

We have now identified the potential usefulness of independent directors, but for them to be efficient in carrying out their monitoring function with the tools at their disposal the correct nomination and motivation mechanisms must be in place. Who can be considered a fair, independent director? How are they selected? What are the incentives they have to perform their function? We now discuss the problems in the profile, selection and incentives of independents directors.

1. Profile

Concerning the profile, we should concentrate on two main features: independence and expertise. One may think that to be a good trustee-like director one must necessarily have expertise in business matters. Recent evidence on the financial crisis supports this hypothesis.[53] However, almost all the regulations and codes of best practice leave aside expertise and focus exclusively on independence.[54]

Who can be considered as an independent director? The short answer is easy: the director in question is not a member of the current senior management team. Typically, independents are senior executives of other companies, lawyers, university professors, ex-politicians, etc. Most of the regulation regarding outside directors has focused on defining independence through a negative approach (as having no familiar or corporate ties with the insiders, managers or block-holders), instead of giving a positive definition (as being a

[53] D Ferreira, T Kirchmaier and D Metzger, "Boards of Banks", ECGI Finance Working Paper No 289/2010 (2010), available at http://ssrn.com/abstract=1620551, and A Beltratti and R M Stulz, "Why Did Some Banks Perform Better during the Credit Crisis? A Cross-Country Study of the Impact of Governance and Regulation", Fisher College of Business Working Paper No 2009-03-012 (2009), available at http://ssrn.com/abstract=1433502, present evidence showing that banks with more independent boards who lacked financial expertise performed worst during the crisis.

[54] Sarbanes-Oxley is an exception in requiring that at least one of the members of the audit committee be a financial expert.

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disinterested trustee based on reputation). In our view, this formal definition of independency has two flaws.

On the one hand, it casts doubts that a workable definition of independence may ever exist. The current one overlooks the relevant fact that strong adherence to the controller can be grounded in friendship, in social life ties or even in shared beliefs of the role of managers and how intensely should be monitored—which is most likely if the "independents" themselves come from executive backgrounds.[55] In other words, the existing definitions of independence do not capture all the potential influences that may affect a director's behaviour. Moreover, the policy path of relying on independence requirements does not solve the problem per se, because it may be doubted that any expanded list of disqualifying factors could attempt to be comprehensive.[56] The key in this matter is not just the nature of the relationship (the structural bias, which of course, could be improved in the formal definitions), but the need or inclination to stay in good grace with the controller.[57]

On the other hand, directors are, above all, fiduciaries, who should act in the sole interest of their principals. The important characteristics that we should be looking for in a director are not independency but impartiality, trustworthiness and disinterestedness.[58]

For these reasons, nomination and motivation issues might be factors more relevant to the design of the monitoring board than independency itself. No affiliation with the insider is only a proxy for willingness to act in the interest of the non-controlling shareholders. There is no doubt that, among "managing" or "inside" directors, there are also individuals of conscience who take their fiduciary responsibilities seriously. In this sense, what really matters is the capacity to act as a disinterested trustee of the outsiders.[59] The "acid test" for these trustees is being capable of opposing the insiders' will.

[55] This remark was made a long time ago in RJ Gilson and R Kraakman, "Reinventing the Outside Director: An Agenda for Institutional Investors" (1991) 43 *Stan Law Review* 863. A recent empirical study has tested this hypothesis. B Hwang and S Kim, "It Pays to Have Friends" (2009) 93(1) *Journal of Financial Economics* 138, find that the existence of common backgrounds between CEOs and their nominally independent directors (what they call "socially dependent directors") affects monitoring negatively.

[56] See F Tung, "The Puzzle of Independent Directors: New Learning" (2011) 91 *Boston University Law Review* 1175.

[57] A Page, "Unconscious Bias and the Limits of Director Independence" (2009) 1 *University of Illinois Law Review* 237, argues that unconscious bias play an important role in decision making of independents.

[58] The idea of trust in corporate law is crucial, and it is not necessarily based in independency as argued in T Frankel, *Fiduciary Law* (Oxford University Press, 2010).

[59] L Enriques, H Hansmann and R Kraakman, "The Basic Governance Structure" in Kraakman *et al* (eds), *The Anatomy of Corporate Law* (Oxford University Press, 2009), 65, state that "Truly independent directors are board members who are not strongly tied by high-powered financial incentives to any of the company's constituencies but who are motivated principally by ethical and reputational concerns".

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An issue that has not received enough attention is how long an independent can remain as independent. There is evidence that CEOs with longer tenures dominate their boards.[60] Outside directors are easily captured by the board, which is not strange, because management typically selects its own independent directors. However, it may not only be a matter of retaining their position, but also a social matter: independent directors are not socially independent; they socialise with other members of the board. Over time, this will drive them to align themselves more with the insiders' interests than with the outsiders' interests. In this sense, we are asking the independent not just to monitor (as they would wish to be monitored in their own companies), but to challenge unsatisfactory performance—to challenge the controller—to be a maverick in a peer group, which can be very costly.[61] Independent directors face important costs and obstacles to monitoring, and in addition lack a positive incentive to monitor effectively and strongly (see Section E.3 below).

2. Nomination

The second question is who nominates independent directors. In general, the appointment of the members of the board of directors is a key problem in corporate governance. This issue is directly related to independency, because even a model independent director in abstract may try to conform to the interest of whoever has appointed him.[62] Independency, as we have already stated, has too many sides to be able to be embodied in a reliable concept. Despite this, in most jurisdictions independent directors are appointed by the controller, manager or controlling shareholder. Some codes of best practice, recognising this problem, recommend that independent directors be nominated by an independent nomination committee, but this recreates the same problem at the level of the nomination committee.[63]

[60] BE Hermalin and MS Weisbach, "Endogenously Chosen Boards of Directors and their Monitoring of the CEO" (1998) 88(1) *American Economic Review* 96, argue that greater CEO tenure and ownership and better past performance all contribute to greater CEO influence over the board, and thus serve as indirect measures of board capture.

[61] Macey, *supra* n 16, 90.

[62] See J Coles, L Daniel and L Naveen, "Co-opted Boards" (2010), available at http://ssrn.com/abstract=1699272, who find that co-opted independent directors (directors who joined the board after the CEO assumed office) are not effective monitors. In contrast, the fraction of independent directors who are not co-opted is a more incisive measure of monitoring effectiveness than is board independence.

[63] A good example of the difficulty in solving this problem is the Sweden Corporate Governance Code. The code was amended in 2010 to require that at least two of the members of the board who are independent of the company and its executive management are also to be independent in relation to the company's major shareholders (a shareholder controlling, directly or indirectly, at least 10% of the shares or votes in the company). Directors are nominated by a nomination committee, who should have at least one member who is also independent of the company, its executive management and its largest shareholder. However, the nomination committee is

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In theory, the selection and nomination system must guarantee first, that the appointed directors are independent of the controller, and second, that they are accountable to outside shareholders. However, managers and significant shareholders are the only agents with the capacity and incentives to sponsor a candidate, since dispersed shareholders face too many barriers to do it.

As a way out of this dilemma, some jurisdictions in Europe have created a new type of board member: the "minority director". These jurisdictions allow significant minority shareholders (or a group of shareholders owning some minimum stake) to nominate a number of directors to the board. Two interesting examples are the cases of Spain and Italy.

Spanish law has established a proportional voting system that provides for the right of a minority of shareholders to appoint directors in proportion to their stake in the capital of the corporation, for both listed and non-listed corporations. This rule has a long tradition in Spanish corporate law and, although its wording asserts the representation of minority shareholders on the board, in practice it is rarely used. The Italian law was reformed in 2005, and mandates to listed companies to right to reserve at least one seat on the board of directors to persons not appointed by the controlling shareholder.[64]

Note that, in both cases, we are not talking about independent directors. Although these minority directors undoubtedly have no affiliations with the management or with the controlling shareholder, they can be expected to represent the private interests of those significant shareholders. However, this is likely to be a second best option for companies with concentrated ownership, because with minority directors the board becomes more independent from the incumbent insiders. A board where the interests of significant minority shareholders are represented may reduce the extraction of private benefits because it becomes more competitive in the presence of more players.[65] Therefore the minority expropriation problem can be reduced.

This approach does not solve the problems with the nomination of the independent directors, though it does create a new type of director who is accountable to significant parties other than the controlling insiders. This

nominated by the shareholders general meeting, where the major shareholders can exert their power through their voting rights.

64 Art 47-ter of Law No 262 of 2005. Bylaws must implement a procedure by means of the proposal of alternative lists of candidates. The system is based on list voting. The law provides that at least one director should be appointed by the list that receives the second largest number of votes. See also M Ventoruzzo, "Empowering Shareholders in Directors' Elections: A Revolution in the Making" (2011) 8(2) *European Company and Financial Law Review* 105, who reports that the system has worked smoothly. In any case, the implementation is wider than in the Spanish case, in which the impact is incidental.

65 M Bennedsen and D Wolfenzon, "The Balance of Power in Closely Held Corporations" (2000) 58 *Journal of Financial Economics* 113.

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reflects the inherent problems for solving the trade-off between independency and accountability for independent directors.

The Spanish case is interesting in these respect because the appointment of an independent director is in theory possible through the regulation of cumulative voting, though the judiciary has clearly stated that an independent nominated by a significant shareholder is always an inside director.[66] Since he is accountable to the shareholder who nominates him, he cannot be independent. This is tantamount to stating that credible independents can only be elected by the majority (which supposedly represents the corporation's best interest). Note, however, that this is clearly wrong when there is a controlling shareholder who is an interested party.

A final issue is whether minority directors can work when significant minority shareholders are reluctant to take active part in corporate governance. This is the case with investment and pension funds, and any other shareholder for whom liquidity is important. Having a representative on the board makes these shareholders subject to insider trading regulation, and this is likely to be too costly for them. This might be the reason why in the US the institution of cumulative voting is rarely used.[67] To the extent that institutional investors are also becoming more prevalent in Europe, the same problem arises there.

3. Incentives

Why should independent directors be expected to discharge their functions effectively? Here, the legal and economic literature present different views of what could or should be the main motivations for the directors.

(a) Legal Liability

The focus of the legal literature is on the extension of liability for negligence. Theoretically, legal liability would help to motivate directors to supervise managers since they will fear adverse financial consequences if they perform this task negligently. On the other hand, the law has been reluctant to hold independent directors personally liable. The reasons are, first, that liability can make directors risk averse, and therefore it may induce them to "over-monitor"

[66] Further, if the controller is successful in convincing the judge that the significant investor is a raider, the director appointed by him could be removed, even in the case of an independent director. Nevertheless, it could still be a promising reform to combine the institutions of cumulative voting and electing independent directors. It is important to distinguish between raiders and monitors: a minority of professional directors would not threaten a replacement of operating management, a major shift in corporate strategy or spying on a competitor.

[67] In these jurisdictions minority representation on the board is alien to their business and legal culture. However, some scholars have advocated its virtues, eg JN Gordon, "Institutions as Relational Investors: A New Look at Cumulative Voting" (1994) 94 *Columbia Law Review* 124; B Black and R Kraakman, "A Self-enforcing Model of Corporate Law" (1996) 109 *Harvard Law Review* 1947.

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and to make conservative decisions. The second reason is that the fear of liability may prevent many talented professionals from seeking directorships. Moreover, even though most countries lean on liability to control the behaviour of directors, in practice independent directors rarely face personal payments.[68] The directors and officers liability (D&O) insurance policy lowers the likelihood of out-of-pocket payment and, as a result, the effectiveness of the liability.[69]

(b) Reputation and Career Concerns

In the economic literature, the traditional argument is that reputation and the market forces should make directors do a good job. Professors Fama and Jensen conjectured that

> "Our hypothesis is that outside directors have incentives to develop reputations as experts in decision control . . . They use their directorships to signal to internal and external markets for decision agents that they are experts . . . The signals are credible when the direct payments to outside directors are small, but there is substantial devaluation of human capital when internal decision control breaks down."[70]

Since then, independent directors have been expected to perform their monitoring functions efficiently motivated by reputational concerns. However, this is one of the biggest flaws in the conception of independent directors.[71]

There is consistent evidence from the US showing that directors who sit on boards of firms in trouble lose reputation and are less likely to receive new appointments. For example, outside directors have fewer new directorships after having served on boards of companies that experience financial distress,[72] after the board supports actions that are against shareholders' interests[73] or following

[68] Nevertheless, the risk of personal payment is not zero. Outside directors of US public companies face a higher risk of being sued than their counterparts in other countries: B Black and B Cheffins, "Outside Directors Liability across Countries" (2006) 84 *Texas Law Review* 1386. Exceptionally, the risk may lead to damages payments being made out of their own pockets in big scandals, as in the Enron and WorldCom cases, to send a message and ensure deterrence in the future: B Black, B Cheffins and M Klausner, "Outside Directors Liability" (2006) 58 *Stanford Law Review* 1055.

[69] On the other hand, M Gutiérrez, "An Economic Analysis of Corporate Directors' Fiduciary Duties" (2000) 34(3) *RAND Journal of Economics* 516, shows that the existence of an insurance contract may give more incentives for the shareholders to sue the director, because of the "deep pocket" effect. Thus, the reluctance of European companies to use D&O insurance may explain why litigation against corporate directors is so rare in Europe.

[70] EF Fama and MC Jensen, "Separation of Ownership and Control" (1983) 26 *Journal of Law and Economics* 301.

[71] The legal literature has also relied on reputation as the main driver of independents behaviourL Gordon, *supra* n 25.

[72] See SC Gilson, "Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Corporate Ownership and Control when Firms Default" (1990) 27(2) *Journal of Financial Economics* 355.

[73] See J Coles and C-K Hoi, "New Evidence on the Market for Directors: Board Membership and Pennsylvania Senate Bill 1310" (2003) 58 *Journal of Finance* 197.

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a financial fraud lawsuit in firms where they are directors.[74] Conversely, other studies have found that directors are more likely to receive additional directorships in the future when the firms on whose boards they sit perform well.[75]

However, reputational concerns may actually interfere with the efficiency of independent directors. There are theory models showing that career concerns may induce independent directors to favour overinvestment (underinvestment) in economic upturns (downturns),[76] and reputational concerns drive independent directors to reduce observable executive pay and replace it with (inefficient) hidden pay.[77] Recent empirical evidence supports these conflicting views on the reputational concerns of independents, finding that outside directors trying to protect their reputations are more likely to resign when they anticipate that the firm on whose board they sit will perform poorly or disclose adverse news.[78] That is when they are more needed. Moreover, it has been found that independent directors, trying to protect their reputations, fire CEOs too often, ie rather than acting in the best interest of shareholders they respond to shareholders' whims.[79] Also, when a director builds a good reputation he becomes a busy director, serving on many boards, and there is evidence showing that busy directors are less effective monitors.[80]

A final problem with reputation is that, to be effective, it requires accountability. However, independent directors lack accountability to outside investors for their performance.[81] The concern here is the independence from shareholders (they can be more or less independent from the controller, but what is always true is that they are completely independent from shareholders). Independence at the expense of accountability is a bad trade.

[74] E Fich and A Shivdasani, "Financial Fraud, Director Reputation, and Shareholder Wealth" (2007) 86 *Journal of Financial Economics* 306.

[75] See D Yermack, "Remuneration, Retention, and Reputation Incentives for Outside Directors" (2004) 59(5) *Journal of Finance* 2281; SP Ferris, M Jagannathan and AC Pritchard, "Too Busy to Mind the Business? Monitoring by Directors with Multiple Board Appointments" (2003) 58(3) *Journal of Finance* 1087.

[76] See F Song and AV Thakor, "Information Control, Career Concerns, and Corporate Governance" (2006) 61(4) *Journal of Finance* 1845.

[77] P Ruiz-Verdú and R Singh "Board Reputation, CEO Pay, and Camouflaged Compensation" (2011), available at http://ssrn.com/abstract=1786877.

[78] R Fahlenbrach, A Low and R M Stulz, "The Dark Side of Outside Directors: Do They Quit When They are Most Needed?", ECGI Finance Working Paper No 281/2010 (2010), available at http://ssrn.com/abstract=1585192.

[79] See Fisman et al, *supra* n 11.

[80] See E Fich and A Shivdasani, "Are Busy Boards Effective Monitors?" (2006) 61(2) *Journal of Finance* 689; L Renneboog and Y Zhao, "US Knows Us in the UK: On Director Networks and CEO Compensation", ECGI Finance Working Paper No 302/2011 (2011), available at http://ssrn.com/abstract=1763167; I Guedj and A Barnea, "Director Networks" (2009), available at http://ssrn.com/abstract=966555.

[81] H Hansmann and R Kraakman, "The End of History of Corporate Law" (2001) 89 *Georgia Law Journal* 439.

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(c) Monetary Incentives

Given the problems with liability and reputation, is there is an alternative way to motivate independent directors? Professors Fama and Jensen recommend avoiding the use of monetary incentives that could interfere with reputational concerns,[82] and company directors should never receive incentive compensation tied to company performance or their individual performance as board members. There are, however, two interesting exceptions to this rule, suggesting that the focus should switch from reputational concerns to monetary incentives. First, directors usually receive additional fees for meeting attendance. In a sample of S&P 1500 firms, Professors Adams and Ferreira[83] observe relatively small board meeting fees (with a mean value of $1,014 in 2003 dollars) and show that directors have fewer attendance problems when board meeting fees are higher, suggesting that directors respond even to small monetary incentives. Secondly, the fixed annual compensation of directors is sometimes paid in equity, using either restricted stock or stock options. Thirdly, Professor Yermack shows that, even though the value of these fixed awards is not tied to performance, their subsequent appreciation generates pay–performance sensitivity in the compensation of outside directors.[84] The total compensation obtained by an outside director of a Fortune 500 firm during his first five years in office ranges from $186,000 if he serves on a company in the twenty-fifth percentile in terms of stock market appreciation to $428,000 if he serves on a company in the seventy-fifth percentile. Obviously such a large difference would be a powerful motivation.

F. Rethinking the Role of Independent Directors in Companies with Concentrated Ownership Structures: A Proposal for Reform

In the previous analysis, we identified what the conditions necessary for independent directors to play a significant role in companies with concentrated ownership structures are. The basic facts are as follows:

First, the function of the independent directors must be restated. They should be instructed to prevent minority expropriation at the hands of the block-holders. This is what confers the independent a differential status as compared to other board members, and it should be recognised and clearly established in the regulations and codes of best practice enacted in jurisdictions with concentrated ownership structures.

[82] See Fama and Jensen, *supra* n 70.

[83] See R Adams and D Ferreira, "Do Directors Perform for Pay?" (2008) 46(1) *Journal of Accounting and Economics* 154.

[84] See Yermack, *supra* n 75.

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Secondly, because of the nature of this function, in companies with concentrated ownership structures, the presence of independents on the board can, at best, be considered as a complement to a strong-enough regulation and enforcement of disputes between controlling and minority shareholders. We have also seen that the efficiency of the tools that they have at their disposal to discharge their monitoring function (voting and threatening with disclosure and legal action) depend crucially on the quality of the regulation. Therefore, before even considering independent directors, the regulator in Continental Europe must tackle the difficult task of improving corporate law to deal with minority expropriation issues. One must bear in mind, however, that regulation cannot simultaneously reduce minority expropriation and produce investment efficiency. Therefore contractual solutions should be explored.

Thirdly, it is crucial to tackle problems with the nomination procedure and the design of incentives for the independent directors to guarantee accountability, expertise and motivation.

In view of these facts, we conclude that the system of independent directors itself is in need of reform. Solving these problems seems a daunting task, the cost of which could exceed the potential benefits (leaving aside that it may not be politically feasible). Therefore, it seems to us that there are three alternative courses of action:

(i) One should seriously consider the possibility of dumping all regulation concerning independent directors and give companies absolute freedom as to the composition of their boards. Firms may be heterogeneous, so optimal board composition may vary across firms. As we have seen, firm's information environments matter. Independent boards may add value at some firms but not at others. Moreover, in view of the evidence on the striking differences between formal and substantive compliance with the recommendations of the codes of best practice by European corporations, this may not really change the current situation[85]—though it would at least force the regulator to recognise the unsolved agency problems between controlling and minority shareholders.

(ii) Accept minority directors as a second-best option. Independents have proved inefficient in eliminating private benefits. With this option, the regulator could generate competition for those private benefits among significant shareholders. Rather than trying to get monitoring from outsiders, the regulator could rely on large enough groups of insiders to monitor each other. This could work well when significant shareholders do not have important liquidity needs.

(iii) If we are willing to make the effort of reshaping current regulation and enforcement to make sure that minority expropriation does not go unpunished, we still have to reform the figure of independent directors under an

[85] See Bianchi *et al*, *supra* n 1.

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efficient perspective. Nomination and motivation have to be reorganised at an acceptable cost, so as to achieve real operational improvements in monitoring companies. In this sense, we can think of two paths for the reform of the figure of independent directors: namely, to reinvent them either as some kind of "public gatekeepers" or as "fund managers" for the minority.

1. Independents as Public Gatekeepers for the Regulator

The first avenue for reform would convert independent directors from private gatekeepers to public third-party enforcers.[86] We are thinking here of independents as agents of the regulator rather than as agents of the shareholders. We believe that this would be a way to solve both the selection and motivation problems.

Regarding their function, independent directors would be expected to use their privileged information to identify and state a binding opinion in cases of conflicts of interests where a block-holder is a related party, with the command of controlling *ex ante* the legality of the transaction. Additionally, if they detect a potential fraud, they are compelled to report to the regulatory agency. There must be a gate and a gatekeeper: note that then the independent is an implementer of the law—they must be compelled by law to undertake enforcement role—so external regulation and enforcement is still required. The relevant standard of behaviour should be set externally, and they would be expected to help implement those standards. In normative systems, like the ones prevailing in Continental Europe, corporate law should provide a clear description or characterisation of unfair party-related transactions. These third-party enforcers "close the gate" by passive refusal to support misconduct, which disrupts misbehaviour.

Regarding nomination and motivation problems, just like other public servants, independents should be required to comply with some expertise requirements and they could be nominated by the regulator of the stock exchange, so as to also guarantee independence. In this sense, independents should be professional enforcers, well trained to implement the corporate compliance with the stated regulation. The seriousness of the recruiting process would increase/raise the reputation of this body of professionals insofar as it produces a class of professional enforcers who meet competence and credibility requirements.[87]

[86] JC Coffee, *Gatekeepers: The Professions and Corporate Governance* (Oxford University Press, 2006), 2, ("Typically, the term connotes some form of outside or independent watchdog or monitor –someone who screens out flaws or defects or who verifies compliance with standards or procedures"). For R Kraakman, "Gatekeeper: The Anatomy of a Third-Party Enforcement Strategy" (1986) 2 *Journal of Law, Economics and Organization* 53, the definition is narrower, and more focused on enforcement: gatekeepers are sophisticated actors who are able to avoid wrong conducts by withholding their cooperation.

[87] Nevertheless, there is room for some competition among these third-party enforcers. This framework was originally developed by Gilson and Kraakman, *supra* n 55, who showed that a

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It is also important that these third-party enforcers are adequately incentivised to undertake their duties. As in the case of other public servants (notaries or public registers), incentives would be provided through high fees[88] and restrictions to entry; similarly, they should be subjected to a duty-based liability, with sanctions imposed whenever they fail to fulfil their duty. Interestingly, an independent board is not needed: a small number could do the job. This position would require a full-time commitment, but such expert monitors are not tied to a particular corporation and could be hired to serve simultaneously on the boards of several companies.

2. Independents as Surrogates of the Minority

The second avenue would be to enhance the accountability of independent directors towards the minority shareholders. In this sense, the most promising path is to empower them to act on behalf of the minority in all legal matters concerning their interests and to take legal action against the controlling shareholders if expropriation has taken place.

We think of the independents as a mechanism that would facilitate the effective exercise of many of the "rights of the minority" granted by corporate law that are not enforced because of collective action problems. Therefore, they would use their privileged information to act as surrogates for the minority in all the matters where the role of the minority is already recognised by the law, such as information rights, voting in cases of conflicts of interest and the bringing about of lawsuits against the boards. Regarding information rights, they should have direct access to all company information and would be the vehicle for disclosing the relevant information to the minority. Regarding voting in cases of conflicts of interest, the rule of the majority of the minority should be adopted and the independent director would be expected to act as subrogate for the minority in all small but frequent transactions; moreover, he would be required to keep the minority informed and disclose whether they voted for or against each particular related party transaction. Finally, regarding litigation in derivative suits, any shareholder wishing to undertake legal action against the board could require the independent director to bring the suit to court if

market of independent expert outside directors could strengthened corporate governance and solve the agency problem between minority shareholders and the management of the company in which they invest. In their view, such a market can be efficiently organised by a central clearinghouse that is collectively financed by the institutional investors.

[88] Traditional wisdom supports the hypothesis that compensation is the wrong way to motivate independent directors. On the other hand, it is shown that the advantages of penalties over rewards are less-clear cut in the case of gatekeepers. In particular, A Hamdani and R Kraakman, "Rewarding Outside Directors" (2007) 105 *Michegan Law Review* 1677, note that the law's objective is not to enforce minimal standards of behaviour, but to secure the cooperation of sophisticated actors.

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he finds merit in the case. This would eliminate the need for minimum stake requirements to prevent frivolous suits.[89]

In this case, to avoid nomination problems, the real objective is to create a body of professionals whose expertise and reputation make them able and willing to challenge managers. Therefore, it would be necessary to professionalise the figure of the independent director as such: directors with the time and skills to monitor energetically in behalf of the shareholders. Their monitoring job would convert them into dissident directors. Note again that, for that purpose, an independent board is not needed. The position would require full-time commitment. The regulator could facilitate this process and guarantee independence by providing a "fit and proper" certification for would-be independent directors. If there is a real market for independent directors, the question of who elects the director loses some of its importance. In this sense, a professionalised pool of independent directors should exist prior to the election in each company.

With respect to incentives, these directors should act as fund managers for the minority, in the sense of taking care of the long-term value of their shares. In order to provide the necessary incentives, they should receive a fixed amount of shares at the beginning of their tenure that they would be obliged to keep until after they leave.

G. Conclusions

In this paper we have shown the inefficiencies of the institution of independent directors, especially in jurisdictions with ownership concentration, in spite of its success amongst legislators. In our view, if we continue taking for granted the desirability of independent directors as the best mechanism to solve agency problems in corporations, it may bring more costs than benefits.

The existence of independent directors may not solve the problems, though it may appear that they do. Therefore, insiders can pack the boards with independents in order to protect themselves from critics and stronger legal action. Thus the inefficiencies remain, but regulators and policy makers are either not aware of it or do not feel the necessity of developing alternative control mechanisms. The intense focus on independent directors deflects attention from other solutions that could be more effective.

89 Nevertheless, we must be aware of the procedural rules in civil law jurisdictions disincentive litigation, and therefore the incentives for litigation would still be small.

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