Deconstructing Independent Directors

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Abstract

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 analyze 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 companies would be better off choosing their board members at liberty. Nevertheless, we also present two different proposals for reform: independents as gatekeepers for the regulator and independents assurrogates of 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.

Keywords: Independent directors, Board of directors, Concentrated ownership, Monitoring, Corporate Law

JEL Classifications: G32; G34; K22

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SIR DESMOND:-Incidentally, to change the subject completely, Humphrey, the position on your board hasn't been filled yet?
SIR HUMPHREY:-No, not yet Desmond.
SIR DESMOND:-Because if it were to be offered, er…, should one be offered, er…Not for the money of course- what's 8,000 a year?
SIR HUMPHREY:-160 a week- part time.
SIR DESMOND:-Quite. But it would be a fascinating…Has anything been decided, informally?
SIR HUMPHREY:-Well, I'm fully aware that you are looking around for a couple of board seats, and I can tell you in complete confidence that… your name is… on the short list.
SIR DESMOND:-The short list!?
SIR HUMPHREY:-The problem is finding the appropriate candidate. I mean, there has to be some reason to appoint you, you see.
SIR DESMOND:-But I am a banker!
SIR HUMPHREY:-So, well, my dear chap, what do you know about?
SIR DESMOND:-Nothing. Nothing really. Damn it, Humphrey, I'm a banker.
SIR HUMPHREY:-Well, there must be some minority group that you can represent.
SIR DESMOND:-Bankers?
SIR HUMPHREY:-You see, the ideal appointee is a black Welsh disabled woman trade unionist. We are all looking around for one of them. You don't happen to know any, do you?
SIR DESMOND:-No.
SIR HUMPHREY:-This is not easy…Well, anyway I think it is within my power to. ..get you nominated and you need only put in appearances once or twice a month.
SIR DESMOND:-Are there lots of papers?
SIR HUMPHREY:-Yes, but it wouldn't be awfully necessary to read them.
SIR DESMOND:-Then I wouldn't have anything to say at the monthly meetings.
SIR HUMPHREY:-Splendid! I can see you're just the chap I'm looking for.

"Jobs for the boys"
Antony Jay and Jonathan Lynn
From the TV series "Yes, Minister"
Originally broadcasted by the BBC in year 1980

OUTLINE

1. 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 in boards to solve inefficiencies in corporations[1]. It is remarkable that the notion of independent directors has been quite 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. The 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 in the board as a bonding mechanism, signaling 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 theorized 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.**

The point we make is that the actual conception and design of independent directors are not suitable to solve the governance problems in firms with a controlling shareholder. 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

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[1] L. Enriques, H. Hansmann and R. Kraakman, *The Anatomy of Corporate Law,* p. 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 U.S, C. M. Elson, "Enron and the necessity of the objective proximate monitor", 89 *Cornell L. Rev.,* (2004), 496 (arguing 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 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. Bianchi et al. (2011) report compliance levels above 70% for most European countries.

[2] Chandler and Strine, "The new federalism of the American corporate governance system: preliminary reflections of two residents of one small state", 152 *U. PA. L. Rev.,* (2003).

of research on boards of directors has been on their role in the agency problem between managers and outside shareholders, typical of countries with dispersed ownership structures like 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. In fact it may increase their sufferings: if the current emphasis placed on the regulator on independent boards is wrong, but it leads the managers, the regulator and the minority to believe that the problem has been solved, they will not feel the necessity of developing alternative control mechanisms.

A clear conclusion appears after analyzing the problems that render independents an inefficient monitoring device for companies with concentrated ownership structures. The current focus of the regulators and codes of best practice on empowering independents is ineffective and companies would be better off choosing their board members at liberty. Nevertheless we also present two different proposals for reform: independents as gatekeepers for the regulator and independents as surrogates of 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. Therefore their selection process, tasks and incentives should be clearly outlined with this idea in mind. Both proposals are very radical, but we believe that radical chances are necessary if we want to save independents from irrelevance.

Therefore, despite common believes (or "desires"), independent directors could be more a problem than a solution. A relevant question then is why we did come up with this solution in the first place? And then, why do legislators trust this device as one of the best indicators of corporate governance quality? Our impression is that perhaps –as happens in other cases- it is just an easy solution, with an acceptable grade of acceptance by all the parties involved: outside investors fell more protected with them than without them, insiders prefer them to alternative more effective control measures and legislators are happy with a low cost "tasty" recipe that offers them an excuse for not getting involved in the reduction of minority expropriation problems. As a result, we are all interested in believing that the miracle medicine works.

To prove our point we will proceed as follows. In Section 2 we begin with a brief review of the academic literature on independent directors. In Section 3 we analyze which are the functions that independents perform and which of these functions are useful for the regulator. We then study in Section 4 which are the tools that the independents can rely on to perform these functions. Section 5 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 6 and we conclude in Section 7.

2. Brief overview of the theory and evidence on independent directors.

In this section we argue that, in contrast with 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, which they in turn will use to control managers. But this is also the information that they need to perform efficiently their advisory and networking roles. Therefore, the managers will have more incentives to share this information with board members if they can also benefit from these functions. This implies that a board that is too centered on monitoring and controlling the CEO may have more problems to get 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 (Adams, 2009) and several theoretical models of boards have been developed around this trade-off between the advisory and monitoring functions of boards (Raheja 2005, Adams and Ferreira 2007, Harris and Raviv 2008). These models imply that there is some optimal board composition that balances the gains from monitoring with the gains from advising[4]. 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[5].

A strand of the literature has focused on the link between board independence and performance. Some of these papers find no relationship (Baysinger and Butler, 1985; Hermalin and Weisbach, 1991; and Bhagat and Black, 2002) others find a positive relationship (Cotter, Shivdasani, and Zenner, 1997; Borokhovich, Parrino, and Trapani, 1996; Brickley, Coles, and Terry, 1994; and Byrd and Hickman, 1992) and still others find a negative relationship (Yermack, 1996; Agrawal and Knoeber, 1996; Rosenstein and Wyatt, 1997 and Klein, 1998). This lack of clear results seems consistent with the theoretical literature if we assume different companies choose optimally different levels of board independence, and that an independent board may destroy value for some companies.

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[3] For he interested reader Adams, Hermalin and Weisbach 2010 provide an in-depth review of the literature on boards.
[4] 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.
[5] See Adams, Hermalin and Weisbach (2010) and Hermalin and Weisbach (2003) for a review of this literature.

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 and are more likely to fire their CEOs following low performance (Fisman et al. 2005, Weisbach, 1988). Unfortunately, it is not clear whether they do this with the aim of improving performance or as a way to protect their reputations, i.e. whether they give too much variable compensation and fire the CEO too often. Interestingly almost all papers have concentrated on the US case.

Among the few papers that use data from other countries, Dahya et al. (2008) study the relationship between Tobin's Q and board composition in companies with a dominant shareholder in a sample of 22 countries. 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.**

3. The legal rationale for independent directors

From a regulatory perspective independents can be useful if they perform some 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 do carefully define the conditions of independence and specify clearly the convenience of a relative high number of independents in the board, they are very vague as to the task they are supposed to carry out.

Academics have identified three broad functions, which are common to all directors: monitoring, advising and networking. While the advising and networking role of 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 "managing" or "inside" directors or even by external firms (companies routinely hire consulting firms to perform these functions for them)[6]. Moreover, corporations should be capable of choosing the structure of the board which best suits their advising or networking needs, i.e. optimal board composition may vary across firms. And there is no reason for corporate lawmakers to be concerned about the advising or the networking roles of boards and whether they add or do not add value to the firm, because these functions do not generate a conflict between the insiders and the outside investors. Therefore,

[6] However, there must be some reason why firms prefer to have these people in 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.

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 is very different depending on the ownership structure of the corporation.

3.1. 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[7], but it also produces some natural conflicts of interests between directors and investors that the literature has deeply analyzed. Corporate governance in this kind of organization is about finding low cost mechanisms that reassure incumbent and potential new investors that the directors fulfill their fiduciary duties of care and loyalty and maximize shareholder value[8].

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 in market forces, and any other institution or device that exercises power over decision-making within a corporation.

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 program is the power of shareholders to remove and appoint directors, the so called "shareholders franchise". But 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[9]. So to make it work, the current regulatory framework needs to be changed[10].

Other strategies have also been tested. Market-oriented mechanisms, and specially 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[11]. So, takeovers are considered a crucial monitoring mechanism to control managerial discretion[12]. In fact

[7] K. J. Arrow, *The limits of organization,* (1974), pp. 68-70.
[8] J. R. Macey, *Corporate Governance. Promises kept, promises broken,* Princeton (2008), pp. 1-3.
[9] L. Bebchuk and S. Hirst, (2010), "Private ordering and the proxy access debate", available at ssrn.
[10] L. Bebchuk, "The myth of shareholder franchise", 93 *Virg. L. Rev.,* (2007), 675.
[11] Studies have found that there are significative positive abnormal returns on the investments of shareholders in companies that received takeover bids. M. C. Jensen and R. S. Ruback, "The market for corporate control: the scientific evidence", 11 *Journal for financial economics,* (1983), 5; G. A. Jarrell, J. A. Brickley, and J. M. Netter, "The market for corporate control: The empirical evidence since 1980", 2, *Journal of Economic Perspectives,* (1988), 52.
[12] A. Schleifer and R. W. Vishny, "A survey of corporate governance",52 *Journal of Finance,* (1997), 756.

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[13]. Both mechanisms can work as substitutes and increase directors' accountability to investors. Nevertheless, this mechanism is not perfect and it has been criticized for being too costly and/or too bloody and above all, it has been successfully fought against by the powerful lobby of managers[14]. So at 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)[15].

Interestingly, the decline in the market for corporate control coincided in time with the raise 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"[16]: 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: favoring 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 shareholders, and if they try to deviate, 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 function. But which are the abilities that 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 motivating the right CEO, and ex-

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[13] T, Baums and K. Scott, "Taking shareholder protection seriously? Corporate governance in the U. S. and Germany", 17 *Journal of applied corporate finance,* (2005), 59.

[14] The counter-argument against the efficiency-enhancing justification for hostile takeovers (and obviously supported by incumbent managers) argued the inefficiency of the market for corporate control due to its "short-termism", undervalued acquisitions, and other quick-buck strategies.

[15] Easterbrook and Fischel, "The proper role of a target´s management in responding to a tender offer", 94 Harvard Law Review, (1981), 1169; R. Gilson, "A structural approach to corporations: The case against defensive tactics in tender offers", 33 Stanford Law Review, (1981). Managers championed a number of anti-takeover clauses in bylaws, like staggered boards, supermajority shareholder vote requirements, and the most powerful, the poison pill; L. Bebchuk; J. Coates IV, G. Subramanian, "The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy", 54 *Stan. L. Rev.,* (2002), 887.

[16] J. N. Gordon, "The rise of independent directors in the United States, 1950-2005: Of shareholder value and stock market prices", 59 *Stanford Law Review,* (2007), 1520-1526. 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.

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[17]. 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 and without external legal guidelines.

3.2. Monitoring in companies with a concentrated ownership structure.

Corporate governance issues change in corporations with a controlling shareholder[18]. 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. And managers face a real possibility of being removed by the controlling shareholder if performance is subpar. *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 the independent directors are not needed in order to monitor the managers –since they are already being monitored by the controlling shareholders-. However, as empirical research has reported, here the relevant problem is the potential expropriation of the outside shareholders by the controlling shareholders through "tunneling" and related party transactions[19]. Minority expropriation hinders the development of financial markets and reduces economic growth[20]. From a policy point of view, this means that monitoring mechanisms aimed at reducing expropriation of the minority are indeed socially valuable[21].

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[17] D. C. Clarke, "Three Concepts of Independent Directors", 32 *Del.J.Corp.L.* (2007), p. 81.

[18] Bebchuk and Hamdani, "The elusive quest for global governance standards", 157 *U. Penn. L. Rev.* (2009), p. 1263 ss, arguing that, going forward, 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.

[19] 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 (H. DeAngelo and L. DeAngelo (1985, pp. 33 *et seq.*), L. Zingales (1995, pp. 1047 *et seq.*) for the United States, H. Levy (1982, pp. 79 *et seq.*) for Israel, K. H. Chung and J. K. Kim (1999, pp. 35 *et seq.*) for Korea, etc.). The most ambitious study following this method corresponds to T. Nenova (2003, pp. 325 *et seq.*), with data from 18 countries. The second method values the premium price of blockholder transfers. See in this respect
the seminal study of M. Barclay and C. Holderness (1989, pp. 371 *et seq.*), and the most important contribution in the area: A. Dyck and L. Zingales (2004, pp. 537 *et seq.*), with data for 39 countries.

[20] R. La Porta et al. 2002, Zingales 1995 and A. Dyck and L. Zingales 2004, Beck and Levine, 2004.

[21] R. J. Gilson (2006). Also, F. Easterbrook and D. R. Fischel (1991, p. 103), reporting that legal rules are more effective to combat duty-of loyalty problems than the market.

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 board-centered. 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[22].

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 door for expropriation[23]. On the one hand, in the presence of a controlling shareholder, the efficiency of the voting mechanism decreases seriously[24].

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 institutionalized and they are founded on deeper contractual basis), but finds many backwards when it is also applied to listed companies with a controlling shareholder. The majority rule plays in favor 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 has indeed the power to designate -and remove- the managing directors and the other board members, so he makes sure that board decisions

[22] S. Cools (2005), "Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers", 30 *Del. J. of Corp. Law.,* p. 697.

[23] M. Burkart et al., "Large shareholders, monitoring and the value of the firm", 112 Q. J. Fin. Econ. (1997), 693.

[24] 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, M. C. Schouten, "The mechanisms of voting efficiency", 3 Col. Bus. L. Rev., (2010), pp. 763 ss

are taken in his interest (which is usually confounded with the so called "interest of the company")[25], but not necessarily in the interest of minority shareholders[26]. The corporate law of Continental European countries has moved some steps in the right direction in the last years[27], but still controlling shareholders exert the decision making power of the corporation (both in the shareholder meeting and in the board) and they are not accountable to minority shareholders (whose investments are managed by them).

From this point of view, it is clear that the traditional instruments of corporate law are insufficient to address the conflicts among controlling and minority shareholders in listed corporations. And, of course, takeovers cannot work either when we have to pay the controlling shareholder to get him out of the corporation. So the question cannot wait, can the introduction of independent outside directors be useful in addressing this problem?

Maybe, 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.

Bebchuck and Hamdani (2009) have argued that, when there is a controlling shareholder, independent directors will carry out essentially the same role with the only difference of focusing on the controlling shareholder rather than on the CEO[28].

Nevertheless, it is important to notice that the inefficiencies caused by the managers-shareholders conflict do not match exactly with 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 block-holders. On the one hand, managers have the temptation of shirking, building empires, or seeking for prerogatives and compensation. We have already argued that the general recipe to combat this type of costs 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 deal with the opportunity to extract private benefits. Tunneling through self-dealing and other kinds of related-party transactions

[25] S. Cools, "Europe´s Ius Commune on Directors Revocability", 2 ECFR (2011), 199 ss, 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 intensify the divergence of interests between controlling and non-controlling shareholders.

[26] Johnson et al, "tunneling", 90 *Am. Econ. Rev.,*2000, 22.

[27] P-H. Conac, L. Enriques, M. Gelter, "Constraining dominant shareholders´ self-dealing: The legal Framework in France, Germany and Italy", 4 ECFR (2007), 491, report that some jurisdictions, like 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 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.

[28] L. Bebchuk and A. Hamdani, "The elusive quest for global governance standards", 157 *U. Penn. L. Rev.* (2009), pp. 1301-1302.

are the real problems when there are controlling shareholders[29]. Therefore, the function of independent directors in corporations with concentrated ownership should be even more precise: to monitor the conflicts of interest of the controlling shareholder and prevent the risk of expropriation.

But 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 against their own purposes[30]. In the particular case of the corporations with controlling shareholders, they may have included independent directors in the board, with the general assignment of supervising managers. In this sense, their presence is trivial and frivolous, because the inefficiencies in the corporations with concentrated ownership structure are due to minority expropriation, and not managerial misbehavior. 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 manager 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 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 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 directors, 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 lousy current definition of their function entails the risk of a lack of effectiveness of independent directors and, even worst, a legal cover of the activity of the controlling shareholders[31]. In other words, the legal design of independent directors is much complex than commonly thought, but it is crucial as the first step to make them operational.

Therefore, we conclude that, **in countries with 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

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[29] Atanasov et al, Law and tunneling, ssrn, (2011), (discussing the different ways in which the controlling shareholders may extract private benefits from firms, and exploring the legal ways to combat them).

[30] M. Ventoruzzo, "Takeover regulation as a wolf in sheep´s clothing: taking U. K. rules to continental Europe", 11 *U. Penn. J. Bus. L.* (2008), 135, 138.

[31] Bianchi et al. (2011) 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.

a clear mandate and definition of legal status. Second, 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 prior to its enforceability. Third, they also need to be provided with the means and abilities to do the job.

4. The monitoring tools of independent directors

In the previous section we have 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. But even if we define the function correctly we still face another problem. 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 shareholder 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[32].

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.

4.1. Existing tools within the regulatory framework

4.1.1. 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 course of reforms taken in some jurisdictions of Continental Europe regarding self-dealing regulation[33]. In most cases anti self-dealing provisions are addressed to curb expropriation by directors, and to a lesser degree, expropriation by dominant shareholders. These rules are supposed to perform a prophylactic function, in the sense that they prevent and control corporate deviance, but at the expense of an increase in the costs of the decision making system within the corporation.

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[32] 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 both mechanisms interact in complex ways. Almazan and Suarez (2003), Hermalin (2005) and Kumar and Sivaramakrishnan (2008) 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. And in fact the empirical findings are mixed. A negative relationship between CEO ownership and board independence has been documented in several papers, including Denis and Sarin (1999), Baker and Gompers (2003), Shivadasani and Yermack (1999) and Coles et al. (2008). In contrast, Core, Holthausen and Larcker (1999) 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 implemented 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.

[33] P-H Conac et al., "Constraining Dominant shareholders´self-dealing: The legal framework in France, Germany and Italy", 4 ECFR (2007). See also L. Enriques, "The law on company Directors´self-dealing: A comparative analysis", 2 Int. Comp. L. J. (2000).

The most interesting jurisdiction for our purposes is the Italian, because it increases the involvement of the independents in the approval of related party transactions[34]. In particular, in the event of transactions of greater importance (which are defined under quantitative parameters), the board has the power to authorize the transaction, after the favorable 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 the cases when directors are in both sides of the transaction (conflicts of interest are not appreciated for other interested transactions)[35]. The French law requires both the ex ante authorization 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 conditions, or to shareholders with less than 10 per cent of the voting power. On the other side 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 the 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 do not know if the reforms have curbed expropriation, and if the benefits of the new rules and procedures outweigh its 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 in the board have significant voting power vis a vis 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 does not block 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 publicity, which is discussed in our next point.

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[34] 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

[35] As L. Enriques (2000) reports (p. 332), traditionally the members of the supervisory board -banks and employees- were not particularly concern of managers´ diversion of assets, as long as there is not risk of the company defaulting, because of their preference for the maintenance of the incumbent managers.

4.1.2. Public disclosure

The independents can also 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. But is not an efficient punishment for two reasons: lower prices are not especially damaging to the holders of large illiquid blocks, however they hurt precisely minority shareholders that trade for liquidity reasons. Second, 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. Third, it may constitute a real and targeted punishment for the controlling block-holder if it induces the minority shareholders to take legal action against the block-holder, which brings us to our third opposition strategy.

4.1.3. 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 second, good enforcement.

First, ex post judicial review for compliance with the law rests on the after-the-fact exam of the fiduciary duties of managers and controlling shareholders[36]. 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 with a controlling shareholder, because the actual interpretation of the "interest of the company", usually favor the interest of the controlling shareholder[37]. Even more, not only directors but also controlling shareholders should owe fiduciary standards of conduct to non-controlling shareholders, and 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 nominating and removing 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.

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[36] R. H. Sitkoff, "The economic structure of fiduciary law", 91 B. U. L. Rev., (2011), 1040-1041, reporting that the fiduciary obligation minimizes 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.
[37] As shown in Johnson et al.,

Second, even if the regulation is accurate, we face enforcement and litigation problems. Non-controlling shareholders have serious information and collective action problems to bring a lawsuit, but at the same time, if standing is low, a small group of shareholders could engage in strategic litigation, endangering productive transactions. In this sense, the European jurisdictions have been traditionally 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 threat directors and controlling shareholders with a -credible- lawsuit, both investors' protection and deterrence would increase. We will come back to this idea in Section 6, when we discuss our proposals for reform.

4.2. 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 the 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. Notice again the striking difference in the relationship between independents and the legal framework in the two different regimes. In dispersed ownership structures their value comes from acting as a supplementary mechanism that relies mainly on ex-ante controls (selection and remuneration of the managers) and, by doing so, reduces the need for legislation and ex-post enforcement. In concentrated ownership structures they can only work as a complement of a strong enough regulation and enforcement of disputes between controlling and minority shareholders. The scarce literature studying the inter-relationship between alternative controlling mechanisms has completely overlooked this important fact[38].

Our next point is that, even with a good regulation in place, independent directors are unlikely to be efficient in solving conflicts of interests within the firm, i.e. 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, second, that even if ex-ante and ex-post regulation

[38] An exception is Burkart and Panunzi (2006) 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 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.

are very good they will not lead to the most efficient choices with regard to self-dealing transactions.

4.2.1 The reduced sustituibility between ex-ante and ex-post regulation

In the previous section we have 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 under developed (including Continental Europe) the most recent trend is to focus on strengthening internal governance mechanisms as a substitute for ex-post litigation[39]. 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 having simultaneously an independent board and a controlling shareholder. Second, if litigation is ineffective because rules and standards on self-dealing are not clear, directors have not 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 especial committees must elaborate to inform others how to vote (e.g. the Italian case). Notice also that these informs can only achieve accuracy and reliance if they can be subject to an ext post fairness review regarding the interest of minority shareholders. And third, if litigation is ineffective because there is no enforcement, the decision by a board member to oppose the controlling shareholder is simply courageous; one cannot expect an independent to put on the judge's hat.

4.2.2 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. But a formal analysis of this type of legal mechanisms shows that they can never be efficient in solving conflicts of interest. One can think of two different types of minority expropriation mechanisms. The most obvious one is a pure transfer of resources from the firm to the controlling shareholder (e.g. he gets a 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 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

[39] Goshen,Z. 2003,"The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality", Calif. L. Rev. 91, No. 2. pp.393-438.

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.

Gutiérrez and Sáez (2009) 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.

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 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 but at the cost of lower company value. Gutiérrez and Sáez (2009) demonstrate that higher efficiency can be achieved with a 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 of the minority in contracts between the corporation and the controlling shareholder.

So far we have seen that the tools that independent directors have within their power to oppose the controlling shareholder are limited. Giving these limitations, 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 6 we come back to this idea and identify ways in which independents could channel this information to the regulator and/or the minority shareholders.

5. 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? And, which are the incentives they have to perform their function? So we have to discuss the problems in the profile, selection, and incentives of independents directors.

5.1. Profile

Concerning the profile, we should concentrate in 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[40]. However almost all the regulations and codes of best practice leave aside expertise and focus exclusively on independence[41].

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, ... Most of the regulation regarding outside directors has focus 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 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 even exist. The current one overlooks the relevant fact that strong adherence to the controller can be grounded in friendship, social life ties, or even, in shared beliefs of the role of managers and how intensely should be monitored –most likely if the "independents" themselves come from executive backgrounds-[42]. In other words, the existing definitions of independence do not capture all the potential influences that may affect directors' behavior. Moreover, the policy path of relying on independence requirements, does not solve *per se* the problem, because it may be doubted that any expanded list of disqualifying factors could attempt to be comprehensive[43]. 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[44].

On the other hand, directors are above all, fiduciaries, who should act for the sole interest of their principals. The important characteristic that we should be looking at in a director is not independency but impartiality, trustworthiness, and disinterestedness[45].

For these reasons nomination and motivation issues might be factors more relevant in 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

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[40] Ferreira et al. (2010) and Beltratti and Stulz (2009), present evidence showing that banks with more independent boards who lacked financial expertise performed worst during the crisis.

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

[42] This remark has been made time ago. R. J. Gilson and R. Kraakman, "Reinventing the outside director: An agenda for institutional investors", 43 *Stan. L. Rev.* (1991), p. 875. A recent empirical study has tested this hypothesis. Byoung-Hyoung Hwang and Seoyoung Kim, "It pays to have friends", 93 J. Fin. Econ., (2009), 138. They found that the existence of common backgrounds between CEOs and their nominally independent directors (what they call "socially dependent directors") affects monitoring negatively.

[43] F. Tung, "The puzzle of independent directors: new learning", 91 Boston U. L. Rev., (2011), 1175, at 1185.

[44] A. Page, "Unconscious bias and the limits of director independence", *U. Ill. L. Rev.,* (2009), 237, argue that unconscious bias play an important role in decision-making of independents.

[45] The idea of trust in corporate law is crucial, and it is not necessarily based in independency, T. Frankel, *Fiduciary Law,* (2010).

outsiders[46]. And the “acid test" for these trustees is to be capable of opposing the insiders’ will.

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[47]. Outside directors are easily captured by the board, what is not strange because management typically selects its own independent directors. But it may be not only be a matter of retaining their position, it is also a social matter: independent directors are not socially independent, they socialize 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 wished to be monitor in their own companies), it is more a mandate to challenge unsatisfactory performance -to challenge the controller-, to be a maverick in a peer group, which is very costly[48]. Independent directors face important costs and obstacles to monitor, and in addition, they lack an affirmative incentive to monitor effectively and strongly (see the section on incentives below).

5.2. Nomination

The second question is who nominees 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 an independent director in abstract may try to conform to the interest of whomever has appointed him[49]. Independency as we have already stated, has too many sides to be able to conform a reliable concept. Despite this fact, in most jurisdictions independent directors are appointed by the controller, manager or controlling shareholder. Some codes of best practice, recognizing this problem, recommend that independent directors be nominated by an independent nomination committee, but this recreates the same problem at the level of this nomination committee.[50]

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

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[46] L. Enriques, H. Hansmann and R. Kraakman, *The Anatomy of Corporate Law,* p. 65 ("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").

[47] Hermalin and Weisbach (1998) 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.

[48] J. R. Macey, "*Corporate governance: Promises kept, promises broken*", Princeton (2008), 90.

[49] J. L. Coles et al. (2010), 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.

[50] 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 ten per cent 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 of the company’s largest shareholder. However the nomination committee is nominated by the shareholders general meeting, where the major shareholders can exert their power through their voting rights.

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 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 Spanish and the Italian cases.

The Spanish Law establishes 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. The rule has 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 has been reformed in 2005, and mandates to listed companies to reserve at least one seat on the board of directors to persons no appointed by the controlling shareholder[51].

Notice that, in both cases, we are not talking about independent directors. Although these minority directors have undoubtedly no affiliations with management or with the controlling shareholder, they can be expected to represent the interests of these other significant minority 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[52]. Therefore the minority expropriation problem can be reduced.

This approach does not solve the problems with the nomination of the independent directors but it creates a new type of director that is accountable to significant parties other than the controlling insiders. This reflects the inherent problems for solving the tradeoff 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, but the judges have clearly stated that an independent nominated by a significant shareholder is always an inside director[53]. Since he is accountable to the shareholder who nominates him he cannot be independent. This is tantamount to state that credible

[51] Articles 147-ter ff. 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, law provides that at least one director should be appointed by the list that receives the second largest number of votes. Ventoruzzo reports that the system has worked smoothly (M. Ventoruzzo, "Empowering shareholders in Directors´ Elections: A revolution in the making", ECFR (2011), 105. In any case, the implementation is wider than in the Spanish case, in which the impact is incidental.
[52] Bennedsen and Wolfenzon 2000.
[53] Further, if the controller is successful 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. But still, it could 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 a competitor.

independents can only be elected by the majority (which supposedly represents the corporation's best interest). Notice 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[54]. To the extent that institutional investors are also becoming more prevalent in Europe the same problem arises.

5.3. Incentives

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

5.3.1 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 negligently this task. But 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" 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 behavior of directors, in practice independent directors rarely face personal payments[55]. The D&O insurance policy lowers the likelihood of out-of-pocket payment, and as a result, the effectiveness of the liability[56].

5.3.2 Reputation and career concerns

On the other hand in the economic literature the traditional argument is that reputation and the market forces may make them do a good job. Fama and Jensen (1983)

[54] In these jurisdictions minority representation on the board is alien to their business and legal culture. However, some scholars have advocated its virtues, Gordon, "Institutions as Relational Investors: A new look at cumulative voting", 94 Colum. L. Rev, (1994), 124; B. Black and R. Kraakman, "A self-enforcing model of corporate law", 109 Harv. L. Rev., (1996), 1947-1949.
[55] Nevertheless, the risk of personal payment is not zero. Outside directors of U.S. public companies face a higher risk of being sued than their counterparts in other countries, Black and Cheffins, "Outside directors liability across countries", 84 *Tex. L. Rev.,* (2006), pp. 1386 ss. Exceptionally the risk may lead to make damages payments out of their own pockets in big scandals, like in Enron and WorldCom cases, to send a message and ensure deterrence in the future, B. Black et al, "Outside directors liability", 58 *Stan. L. Rev.,* (2006), pp. 1055.
56 On the other hand Gutiérrez (2000) shows that the existence of the 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.

conjectured “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. . .”. 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 of the conception of independent directors[57].

There is by now consistent evidence for 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 (Gilson, 1990) after the board supports actions that are against shareholders’ interests (Coles and Hoi, 2003) and following a financial fraud lawsuit in firms where they are directors (Fich and Shivdasani, 2007). Also Yermack (2004) and Ferris, Jagannathan, and Pritchard (2003) find that directors are more likely to receive additional directorships in the future when the firms on whose boards they sit perform well.

However, reputational concerns may actually interfere with the efficiency of independent directors. Song and Thakor (2006) present a theoretical model where career concerns may induce independent directors to favor overinvestment (underinvestment) in economic upturns (downturns). In a similar fashion Ruiz-Verdú and Singh (2011) develop a model where reputational concerns drive independent directors to reduce observable executive pay and substitute for (inefficient) hidden pay. Recent empirical evidence supports these conflicting views on the reputational concerns of independents. Fahlenbrach, Low and Stulz (2010) find 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. That is when they are more needed. Fisman et al. (2005) show that independent directors trying to protect their reputations fire CEOs too often, i.e. rather than acting in the best interest of shareholders they respond to shareholders whims.

Moreover, 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 (Fich and Shivdasani, 2006; Renneboog and Zhao, 2011 and Guedj and Barnea, 2009).

A final problem with reputation is that, to be effective it requires accountability. However independent directors lack accountability to outside investors for their performance[58]. 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.

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[57] The legal literature has also relied on reputation as the main driver of independents behavior, Gordon, 59 *Stan. L. Rev.,* (2007), 1465;

[58] H. Hansmann and R. Kraakman, "The end of history of corporate Law", 89 *Geo. L. J.,* (2001), 439, 442.

5.3.3 Monetary incentives

Given the problems with liability and reputation, is there is an alternative way to motivate independent directors? Fama and Jensen (1983) recommend avoiding the use of monetary incentives that could interfere with reputational concerns and companies directors have never received incentive compensation tied to company performance or their individual performance as board members. There are however two interesting exceptions to this rule that suggest 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, Adams and Ferreira (2008) find relatively small board meeting fees (with a mean value of $1,014 in 2003 dollars), and they show that directors have fewer attendance problems when board meeting fees are higher, suggesting that directors respond even to small monetary incentives. Second, the fixed annual compensation of directors is sometimes paid in equity, using either restricted stock or stock options. Yermak (2004) shows that, even though the value of these fixed awards is not tied to performance, their subsequent appreciation generate pay-performance sensitivity in the compensation of outside directors. The total compensation obtained by an outside director of a Fortune 500 firms during his first five years in office ranges from $186,000 if he serves on a company in the 25th percentile in terms of stock market appreciation to $428,000 if he serves on a company in the 75th percentile. Obviously these large differences would be a powerful motivation.

6. Rethinking the role of independent directors in companies with concentrated ownership structures: A proposal for reform

In the previous analysis we have identified which are the conditions necessary for independent directors to play a significant role in companies with concentrated ownership structures. 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 recognized and clearly established in the regulations and codes of best practice enacted in jurisdictions with concentrated ownership structures.

Second, 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 of a strong enough regulation and enforcement of disputes between controlling and minority shareholders. And we have 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. However, one must bear in mind that regulation cannot simultaneously reduce minority expropriation and produce investment efficiency, therefore contractual solutions should be explored.

And third, 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, whose costs may exceed the potential benefits (leaving apart 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 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 (Bianchi et al. 2011). But at least it would force the regulator to recognize 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 would rely on a large enough group of insiders to monitor each other. This can 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 efficient perspective. Nomination and motivation have to be reorganized at an acceptable cost, so as to achieve real operational improvements in monitoring companies. In this sense we can think of two paths for 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.

6.1. Independents as public gatekeepers for the regulator.

The first avenue for reform would convert independent directors from private gatekeepers to public third-party enforcers[59]. We are thinking of independents as agents of the regulator rather than as agents of the shareholders. Moreover, we believe this would be a way to solve 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-

[59] J. C. Coffee, *Gatekeepers: the professions and corporate governance,* Oxford University Press (2006), p. 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", 2 *J. L. Econ & Org.,* (1986), pp. 53-56, the definition is narrower, and more focused on enforcement: gatekeepers are sophisticated actors who are able to avoid wrong conducts by withholding their cooperation.

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: Notice 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 behavior 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 characterization of unfair party-related transactions. These third-party enforcers "close the gate" by passive refusal to support misconduct, which disrupts misbehavior.

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 guaranty 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 pass on the reputation of this body of professionals in so far as it produces a class of professional enforcers who meet competence and credibility requirements[60]. It is also important that these third-party enforcers are adequately incentivized to undertake their duties. As in the case of other public servants (notaries or public registers), incentives would be provided through high fees[61] and restrictions to entry; similarly they should be subjected to a duty-based liability, sanctions are imposed whenever they fail to fulfill their duty. Interestingly, an independent board is not needed: a small number can 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 board of several companies.

6.2. 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 them 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 of the minority in all the matters where the role of the minority is already recognized by the law, such as information rights, voting in cases of conflicts of interest

[60] Nevertheless, there is room for some competition among these third-party enforcers. This framework was originally developed by Gilson and Kraakman (1991), who showed that a 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 organized by a central clearinghouse that is collectively financed by the institutional investors.

[61] Traditional wisdom supports 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. (A. Hamdani and R. Kraakman, "Rewarding outside directors", 105 *Mich, L. Rev.* (2007), pp. 1677. As they note, the law´s objective is not to enforce minimal standars of behavior, but to secure the cooperation of sophisticated actors.

and the bringing about of lawsuits against the boards. Regarding information rights they should have direct access to all company information and they 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 of 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 he finds merit in the case. This would eliminate the need for minimum stake requirements to prevent frivolous suits[62].

In this case, to avoid nomination problems the real objective is to create a body of professionals whose expertise and reputation should make them able and willing to challenge managers. Therefore it would be necessary to professionalize the figure of the independent director as such: directors with time and skills to monitor energetically in behalf of the shareholders. Their monitoring job would convert them into dissident directors. Notice 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 in part importance. In this sense, a professionalized 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.

7. 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 among 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 but it may appear that they do it. 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 which could be more effective.

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

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