

THE ROLE OF THE INDEPENDENT DIRECTOR IN CEO SUPERVISION AND TURNOVER

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Abstract

A considerable amount of research has been done on the figure of the CEO*, approaching it from many angles. Our analysis focuses on the role played by the independent director in the supervision and turnover of the chief corporate executive. In the process, we have carried out a comprehensive reflection on the independent director, consulting the latest literature and including the results of the most recent empirical evidence. We have noticed that the role of the independent director often goes beyond the tasks that are usually considered specific to this function, namely, supervision of the company's senior management. However, the directors' independence cannot be built by requirements. It is a personal quality of the individual that transcends the various problems raised by agency theory**. We believe that correct CEO supervision can only be effectively undertaken if the independent directors have these personal qualities. It seems that companies with a larger number of independent directors are more likely to replace the CEO when performance is not as expected. This can only happen if the independent directors enjoy effective independence.

Keywords: Board of Directors, independent director, CEO supervision and turnover.

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* CEO: *Chief Executive Officer* is the title given to the company's executive president. Chairman is used to refer to the Chairman of the Board of Directors.

** Agency theory was developed in 1973 by Ross and subsequently expanded by the work of Jensen and Meckling in 1976. The model is based on the relationship between the principal (in this context, this would be the shareholders) and the agent (the managers). The principal delegates different functions to the agents. The two parties' interests diverge: the shareholder seeks sustained, long-term profit maximization while the manager may only seek increased compensation and prestige. This may generate situations in which the two parties' interests come into conflict. To reconcile the agent's interests with the principal's, agency theory proposes a series of contracts such as management compensation schedules, based on stock options or company shares.

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1. Introduction: Why has the independent director appeared?

In recent decades, the world economy – and the financial markets in particular – has undergone an unprecedented globalisation process. The presence of international investors in companies' equity has required the convergence of certain criteria that enable the investor to compare and evaluate the enormous variety of financial assets and instruments using reliable information. Globalisation and the opening of capital markets, together with the growth of a middle class with investing capacity, have given rise to another highly significant phenomenon – the fragmentation of corporate equity ownership and the emergence of a large number of small investors. One direct consequence of this process has been to widen the gap between corporate ownership and corporate management.

The problems generated by the separation between the ownership and management of large corporations have been extensively discussed in the literature (Berle and Means, 1932; Jensen and Meckling, 1976; Fama and Jensen, 1983). This article focuses on the control that the Board of Directors must exert on the performance of the CEO and the executive team, highlighting the role played by the independent director¹. This issue offers considerable current interest. The accumulation of power in the hands of some CEOs, to the detriment of the role that should have been played by the Board of Directors in its supervisory function, has led to undesired effects, such as those observed in the recent bank crisis.

Since the Cadbury Report was published in 1992 in the United Kingdom, many countries have adopted codes of good corporate governance with the goal of satisfying these needs and addressing the situation created by the new phenomena. The codes of good governance are aimed at protecting shareholders' interests. According to the Olivencia Code, conflicts of interest are those in which the company's interests conflict (directly or indirectly) with the director's personal interests. It is in this type of situation that the independent director must perform his role, contributing an objective criterion that is bereft of any outside influence, for the benefit of the shareholders as a whole.

The codes of good governance have provided valuable recommendations for improving «effectiveness, responsiveness, responsibility and transparency in the governance of the companies that turn to the financial markets»². It seems logical that it is the listed companies

¹ The Webster's Dictionary defines "independent" as "free from the influence, control, or determination of another or others". Depending means being influenced or determined by something else.

² Olivencia Report, 1998.

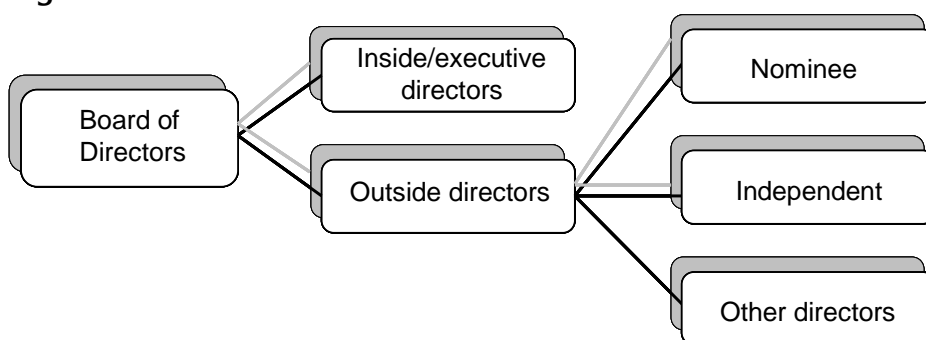
that have been under greatest pressure to implement the recommendations proposed by the various codes, as these have the greatest capitalization and shareholder fragmentation.

Our paper has been structured as follows: First, we define the terminology used in Spain when referring to corporate directors. Second, we discuss the influence of legislation and the main codes of good governance. We also devote a section to the distinctive qualities that must predominate in the independent director. This is followed by a review the independence criteria established by the unified code of good governance. In the following section, we compare the features and requirements attributed to the independent director in the leading international codes. The core of this paper is the chapter on the role of the independent director and the supervisory function he must perform on the CEO. We close with the conclusions.

2. Director typology

Before discussing the influence of legislation and the role of the codes of good governance on membership of the Board of Directors, it would be wise to first clarify a series of definitions concerning director typology. Boards of Directors are mainly composed of inside directors and outside directors. The terminology used in Spain is translated in Figure 1.

Figure 1



Source: Authors.

Executive directors: These are directors who perform senior management functions or are employees of the company in question. It is they who manage the company's day-to-day affairs and who are best qualified to report to the other Board members on the company's progress. The Unified Code of Good Governance (UCGG) recommends that the number of executive directors be the least necessary to cover reporting and coordination requirements.

Outside directors: These are directors who are not employed by the company nor do they have any type of professional relationship with the company, except the directorship. There are three types of outside director: nominee, independent and other.

Nominee directors: These are directors with a shareholding equal to or greater than that legally considered significant or who have been appointed directors by virtue of their shareholder status. Nominee directors are also considered to be those who represent significant shareholders. A director is also considered to be a nominee director if he is a senior executive or director of any of the company's parent companies.

Independent directors: These are directors appointed for their personal and professional qualities, who can perform their functions without being conditioned by relationships with the company, its significant shareholders or its managers.

Other directors: These are directors who cannot be considered nominee or independent directors.

The definition of “other directors” is often given to a director previously classified as an executive, nominee or independent director but who now no longer meets one or more of the requirements specified for these categories. The presence of this type of director can be justified because it is considered necessary that they remain on the Board of Directors (because of their experience and knowledge). For example, executives who cease to perform management duties due to retirement would be classified as “other directors”.

3. Influence of legislation and codes of good governance

In Spain, the laws governing listed companies are the Public Limited Companies Act and the Stock Market Act. According to the Stock Market Act, all listed companies must approve and publish an annual corporate governance report (art. 116) in which they give account of their compliance with the recommendations proposed by the Unified Code of Good Governance. Although it is not obligatory to implement the recommendations of the codes of good governance, it is considered that compliance with these recommendations contributes to improving the company’s performance by helping the Board of Directors to carry out its duties in the best interest of the shareholders (*Combined Code on Corporate Governance*).

Considering the different business realities that exist, it may happen that good governance can be achieved by means other than those proposed by the codes of governance. Accordingly, the laws governing the functioning of listed companies provide for the application of the *Comply or Explain* criterion³, in which listed companies are required to state in their annual corporate governance report the degree to which they follow the recommendations proposed by the currently valid code of governance⁴. According to this criterion, if a company does not apply any of the recommendations, it must explain the rationale which has led it to decide not to comply with the recommendations proposed. Thus, it is left to the market to judge whether the conducts followed are justifiable on the basis of the information provided.

When one talks of the *composition* of the Board of Directors, normally one is referring to the nature of the directors who are its members. There is a general consensus among the codes of corporate governance that the number of outside directors should be sufficient to maintain the Board’s independence and, consequently, should be in a majority with respect to the executive directors. Depending on the weight of the various shareholders, there should also be an appropriate ratio between nominee and independent directors, so that the representativeness criterion stipulated in the Public Limited Companies Act is met. In the case of Spain, the UCGG provides that independent directors must represent at least one third of the total Board membership (Recommendation 13).

³ In the case of Spain, the Comply or Explain criterion is defined in Article 116 of the Stock Market Act.

⁴ In the case of Spain, this is the Unified Code of Good Governance (UCGG), 2006.

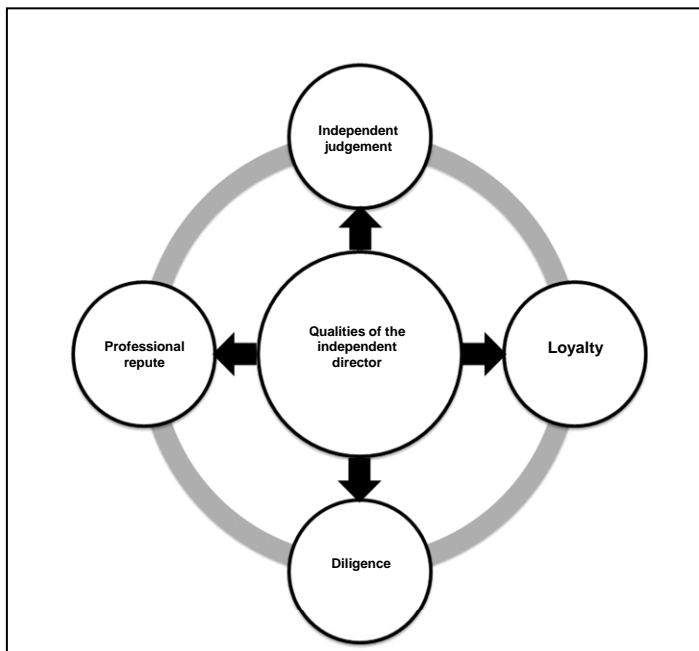
Appendix 1 lists a series of recommendations given in the leading codes of good governance concerning membership of the Board of Directors and the presence of independent directors.

4. Qualities of the independent director

There is an abundant literature on the skills that managers must have. In this section, we will focus on those skills in which the independent director must excel, commenting on those that are directly mentioned in the legislation and the codes of good governance (Figure 2). With the goal of including recent empirical evidence, we will also refer to some of the most significant research work.

Figure 2

Qualities of the independent director



Source: Authors.

Independent judgement

The ultimate purpose of the independent director is to objectively safeguard the interests of the shareholders (and specifically those holding floating equity⁵) on the Board of Directors. This purpose is fulfilled in different ways but perhaps the most important is to provide an impartial, professional opinion on the decisions that must be made by the Board. This is the main quality that the independent director must have: independence and impartiality in his decision-making.

⁵ The term floating equity refers to the shares in a company that can be routinely traded on the stock market. This term is used in contrast to captive equity, which are strategic equity holdings held by significant shareholders and members of the Board of Directors.

Many interests are represented within Boards of Directors: senior executives, institutional investors, shareholders with large holdings in the company's equity, and minority shareholders. In principle, all should wish the best future for the company but it is also possible that conflicts of interest may arise. The independent director plays a fundamental role in neutralising these conflicts. By having no ties with the managers and representative shareholders, he should be able to give a truly objective opinion for the benefit of the company.

Loyalty

Article 127 (ter.) of the Public Limited Companies Act provides that company officers *must act as loyal representatives*. This duty may seem overly abstract and confusing. In legal terms, the duty of loyalty implies carrying out all the activities that may be required to achieve the company's corporate purpose. With the goal of increasing effectiveness of the duty of loyalty, the Aldama Report gives more precise recommendations: a loyal director must avoid conflicts of interest between the company officers or their direct family and the company, reporting the existence of such conflicts (if they arise) to the Board of Directors. A loyal director must not hold any position in companies that are competitors of the company he is a director of. Under no circumstances must he use confidential company information for private purposes. And he must not make any inappropriate use of the company's assets or use for his personal advantage the business opportunities that come to his knowledge by virtue of his directorship.

Diligence

It is stated that «*company officers must perform their duties with the diligence of an ordered business person and a loyal representative*»⁶. As is the case with the duty of loyalty, the concept of diligence, as it is defined in the Act, is rather confusing. Consequently, the Aldama Report provides a series of criteria to help give it more substance.

First of all, a diligent director must make sure that he can effectively devote the necessary time and effort to perform the tasks that befall him as an officer of the company. His involvement in the Board of Directors must be active, saying whatever he considers to be best for the company's interests. In order to achieve this goal, he must not spare effort in obtaining the information he needs and, if he considers it appropriate, he should not hesitate to ask for any advice he considers appropriate.

Keeping well-informed on the company's affairs depends on each director's attitude. Therefore, it is important to have a particularly active attitude, so that the information obtained is as thorough and accurate as it can be. It is vital that the director have the best information available if his opinions are to be truly impartial and independent.

Professional repute

The Board of Directors must be considered as a single body, in spite of the possible internal conflicts that may arise. Accordingly, independent directors should be appointed applying a team approach. It is the Board of Directors as a whole that must pool the knowledge and skills that will enable it to direct and supervise the company in the best way. The Board of Directors'

⁶ Public Limited Companies Act, article 127.

qualities and effectiveness are the product of the aggregate qualities of the individual directors. The independent directors must contribute a series of skills to the Board that will enable the best team to be formed. A diversity of knowledge and skills that complement each other gives added value to the Board's work. The basic requirement is professional repute and it is common for Boards of Directors to include representatives from the academic world, people who have held senior positions in the Civil Service and professionals who have worked in industries that are very different from the company's. To illustrate the varied background of independent directors, the table below summarises the results obtained by the consultancy firm Spencer Stuart in 2009 in its Boards of Directors Index.

Table 1

Habitual professional activity of the independent director	Ibex 35
Activities related with the business world	83%
Academics	11%
Civil Service	6%
Retired executives	16%
Runs own businesses	16%
Independent professionals (lawyers, tax consultants, etc.)	16%
Executive presidents in another company	10%
Non-executive chairmen	8%
CEOs	6%
COOs	5%
Other type of manager	4%
Employers (large companies)	3%

Among other factors, professional repute is determined by past performance and results. Gupta et al. (2008) studied the quality of new independent director appointments in the United Kingdom. The authors conclude that the quality of a new directorship correlates positively with the results achieved by the company where the director was previously employed. To put it another way, the results that have greatest impact on achieving a higher quality directorship are those that are closest in time to the present.

5. Independence criteria defined in the Unified Code

Section III, point 5 of the Unified Code provides a series of criteria whose purpose is to safeguard the directors' independence. These criteria refer to circumstances that it is considered could give rise to conflicts of interest and, consequently, could induce the director to make a decision that is not in the best interests neither of the company nor of the shareholders. It is ultimately the company, through its decision-making bodies, that is responsible for certifying that these requirements are effectively met.

Previous employees or executive directors of other group companies cannot be considered independent directors until at least three to five years have passed since termination of the professional relationship. This is a reasonable requirement as anyone who has worked in a company for any period of time may have developed some kind of link or relationship with other employers or managers that could interfere with their work as independent director

(overriding the independence of judgement). Likewise, directors receiving from the company any money other than the compensation agreed for performance of their directorship cannot be considered independent directors. When there is a financial tie between the company and the director, and this tie can be broken unilaterally by the company, this creates incentives that may interfere with the director's independence.

Partners of the external auditor or officers responsible for drawing up the audit report cannot be appointed independent directors (unless three years have passed since they held this position). People who have or have had (during the last year) any significant business relationship with the company must also be ruled out as independent directors. Spouses and relatives (to the second degree) of executive directors or senior managers of the company are also ruled out. All of these cases refer to situations in which it is obvious that the director's independence is in doubt. These are circumstances in which there is a real risk of decisions being made that do not represent the company's best interest.

The Unified Code introduces a novelty by stating that no director can be considered independent if he has not been proposed by the appointments committee. The appointments committee must be composed of outside directors, which in theory qualifies it to choose directors who are independent from the executive team. This measure, together with the other criteria mentioned, does not guarantee the director's independence. For this reason, as we have pointed out at the beginning of this section, it is the company, with its Board of Directors, that must determine its directors' independence.

6. The features and requirements of the independent director in leading codes

In order to analyse the figure of the independent director from a general viewpoint, we have compared the features and requirements of the independent director in the leading codes of good governance. The purpose of this analysis is to identify those recommendations for which there is most consensus. The results obtained are shown in Table 2.

Table 2

		ANALYSIS OF THE QUALITIES AND REQUIREMENTS OF INDEPENDENT DIRECTORS IN THE CODES OF GOOD GOVERNANCE																
		Represent the floating equity's interests	There must be no link with the management team	Integrity, experience and professional repute	Supervisory function	Broaden the Board's "vision". Strategic contribution	Contribute impartial, objective judgement	Independent from shareholders' monitoring groups	Classified by the Board as independent	Proposed by the appointments committee	Exclusion of former executives or employees**	Exclusion of senior managers' relatives	Exclusion of financial ties with the company	Not be a director of another listed company that has nominee/outside directors in the company in question	Limitations on equity holdings***	Exclusion of auditors, consultants or other professionals having a previous relationship with the company		
CODES	SPAIN	Olivencia Report (1998)	x	x	x	x	x	x			x	x	x		x	x		
		Aldama Report (2003)	x	x	x	x		x	x		x	x	x	x			x	
		Unified Code of Good Governance (2006)		x	x				x		x*	x	x	x	x		x	
	INTERNATIONAL	Cadbury Report (1992) United Kingdom		x	x	x	x	x		x	x		x	x			x	
		Higgs Report (2003)		x	x	x	x	x	x	x	x	x	x	x			x	
		NYSE 303A Corporate Governance Standards (2003) United States		x						x		x	x	x			x	
		European Commission Recommendation (2005/162/CE)	x	x		x		x	x			x	x	x			x	
		Combined Code on Corporate Governance (2008) United Kingdom		x	x			x	x	x		x	x	x	x		x	
		Code de Gouvernement d'entreprise des sociétés cotées (2008)	x	x	x					x	x		x	x	x	x		x
		Deutscher Corporate Governance Kodex (2009)		x	x	x				x			x	x	x			x
Hong Kong Code on Corporate Governance (2004)		x	x		x	x	x	x			x	x	x	x		x		

*Almost all the codes of good governance recommend selecting independent directors by means of a formal selection process supervised by the appointments committee. The Unified Code of Good Governance specifies as a criterion of independence (and not as a mere recommendation) that the candidate be proposed by the appointments committee.

** Most codes of good corporate governance do not allow appointment of former employees as directors until a period of 3-5 years has elapsed.

***Normally, independent directors are not forbidden from holding shares in the companies, although a maximum limit is stipulated in order to guarantee effective independence.

Most of the requirements given in the codes of good governance refer to circumstances that can potentially give rise to conflicts of interest between the director and the company. Thus, we see that the variables that are stressed most are those that refer to ties between the director and the company (ties with the management team, independence from controlling shareholding groups, exclusion of former executives, exclusion of relatives of the management team, exclusion of financial ties with the company and exclusion of auditors and consultants). Particular emphasis is also given to the recommendations concerning the independent director's integrity, experience, expertise and professional repute.

Considering the variables analysed and the fact that our study is focused on the independent director, the most comprehensive codes in this respect are, in our opinion, the Olivencia Report, the Aldama Report, the Higgs Report, Le Code de Gouvernement d'entreprise des sociétés cotées, and the Hong Kong Code on Corporate Governance.

7. Independent directors: CEO supervision and turnover

As has been pointed out, the equity of listed companies has become increasingly fragmented in the hands of shareholders with small holdings. Many people hold small portfolios containing shares of different companies. The company is owned by the shareholders as a whole. As the number of shareholders with small holdings in listed companies increases, shareholders are forced to delegate administration, management and supervision of the company to third parties, widening the gap between company ownership and management. The Board of Directors is responsible for performing administration and supervision functions on behalf of the shareholders. The shareholders need independent directors who represent their interests, unaffected by any conflict of interests or influence by significant shareholders.

Arguments for and against

The figure of the independent director is a major area of focus for academics specialised in the governance of listed companies. Study of the independent director has taken on increased importance in the aftermath of the corporate scandals that have emerged in recent years (Enron, Worldcom, Parmalat, etc.). These scandals have been related with conflicts of interest between the companies' managers and their shareholders; for example, short-term compensation of the chief executive versus the company's long-term, sustained performance. Within this context and from the perspective of agency theory, the independent director has been highlighted as a basic governance instrument for neutralising problems between the principal (shareholders) and the agent (managers). As shown in Table 3, this is not the only reason justifying the existence of independent directors. There are other reasons that appear recurrently in the various codes of good governance. In addition to the function of correcting possible conflicts of interest and safeguarding the corporate interest in the decisions that must be made by the Board of Directors, there is also the function of improving the quality of the company's governance and ensuring effective supervision of the executive team. When discussing the qualities in which the independent director must excel, we have already mentioned professional repute. This quality is crucial for improving the quality of governance. Likewise, only a person who is completely dissociated from the management team can provide effective supervision.

Table 3

Reasons supporting the existence of the independent director	Main arguments against the independent director
1. Correct potential power imbalances and conflicts of interest.	1. The CEO controls membership of the Board of Directors.
2. Safeguard the company's interests in the decisions made by the Board of Directors.	2. He has no incentive to go against the executive team.
3. Improve the quality of the company's governance.	3. He is not in touch with the organization's day-to-day affairs. Information costs.
4. Provide effective management supervision.	4. The fact that he receives compensation negates his independence.

Source: Authors.

However, in spite of the many arguments in favour, a number of criticisms have been made of the independent director. The reasons given to back such opinions seek to refute the independent director's true independence or his ability to provide an impartial perspective in decision-making. One of the more prevailing theses, supported by several research papers, states that the CEO controls membership of the Board of Directors through his influence on the selection of outside directors. Thus, Shivdasani and Yermack (1999) say that when the CEO is a member of the appointments committee or when this committee does not exist, companies tend to hire less independent directors and more "gray" directors⁷ with conflicts of interest. Nowadays, thanks to the recommendations made in the codes of good governance, this situation usually does not arise. As a general rule, compensation and appointments committees are usually composed solely⁸ of outside directors and their chairmen are independent. However, there is a risk of formal compliance with the requirements while ignoring the legislator's "spirit", with the result that it is the CEO who effectively exerts power and his influence pervades all areas of the organization. It seems that this view has some following among the more critical sectors.

CEO control in the choice of Board members is not the only criticism made against independent directors. They are also accused of not having any incentive to go against the management. According to the critics, an independent director will never effectively supervise those very people who have put him where he is. This argument is used jointly with that of the compensation of the independent directors. If the company's management is involved directly or indirectly in the selection process and, at the same time, it is able to weigh on the various committees, it does not seem unreasonable to think that any outspoken disapproval of the executive team may endanger the independent director's continued tenure. If such views were to be true, it would follow that the independent director's supervisory role would be effectively

⁷The expression "gray directors" is used in the academic world to refer to those directors who, even though they may be classified as outside or independent, have some type of relationship with the company that may lead to conflicts of interest.

⁸ Recommendation 44, Unified Code of Good Governance.

invalidated and, furthermore, it would become apparent that an independent director stands to lose much more than he could gain if he chooses to take a critical stance towards the company's management.

The third argument against the independent director focuses on the level of knowledge about the organization that an independent director can have. According to this thesis, independent directors are unable to make decisions that can have a positive influence on the company's performance since they are not involved in the company's day-to-day affairs. Although it is true that the independent director is usually not familiar with the problems that may arise routinely in the company to the same level of detail as the executives, it can also be argued that his function is different from that of other employees of the company. The independent directors contribute value to the company through their knowledge of the industry, their strategic vision, by supervising the executives' work, safeguarding the company's general interest, etc. It is true that they are not aware of the minutiae of the organization's functioning to the same degree as a manager. But this cannot be used as an argument against them, since their job is different. In any case, when faced with any important decision, it is the independent director's obligation to examine in detail all possible consequences and implications in each area of the company. Therefore, the level of knowledge of the company will depend on the director's personal area of responsibility and one neither can nor should generalise that independent directors lack the necessary knowledge to make the organization's important decisions.

On some occasions, as some academics have pointed out, obstacles may arise in obtaining information about the company. Lee et al. (1992) warn that another way in which the CEO can control the Board of Directors is through the information provided to the outside directors. As Jensen (1993) points out, the CEO almost always decides the agenda and the information provided to the Board. Thus, independent directors may find themselves in the situation that the CEO does not provide them with quality information or directly omits significant information on his management. Jensen (1993) concludes that this information constraint limits the ability – even of the most talented directors – to make an effective contribution to control and appraisal of the CEO, and to the company's strategy.

When faced with this type of situation, the director can publicly disclose this fact or resign from the Board. The latter option, resignation, conveys information that the markets usually do not view positively (Gupta and Fields, 2009). Indeed, if an independent director resigns due to the circumstances described above, this can have a very negative effect on the share price of the company in question, forcing the company's management to make the necessary changes to regain the correct course. Thus, an independent director's resignation may be an effective control mechanism in specific situations.

The study performed by Duchin et al. (2010) highlights the importance of information in guaranteeing the independent directors' effectiveness. The authors state that the independent directors' effectiveness depends on the cost of obtaining information from the company. When the cost of obtaining information is low, the company's performance improves when outside directors are added to the Board of Directors. However, when the cost of obtaining information is high, its performance deteriorates when outside directors are added.

There is a fourth criticism that is made of independent directors. As there will be a specific section on the compensation of independent directors, we will leave discussion of this point for a later stage. We will simply mention here the two-fold problem raised by the compensation of independent directors: 1. Beyond what salary level can the directors' independence be at risk?

2. How can you be independent from the people who pay you? It is not possible to find a solution for these two problems without considering each director's personal qualities and traits.

Analysis of the role of the independent director

As Bhagat and Black (2002) point out, the literature presents two different models for analysing the independent director's role in businesses' performance. The first model examines directly the relationship between the Board's membership and the company's performance. The second model studies the relationship between membership of the Board of Directors and its response to specific situations such as, for example, replacing a CEO, rewarding executives with golden parachutes, buying other companies and defending against takeover bids.

In the following pages, we analyse the major contributions to the literature on the subject, taking into account the two models generally used. There will also be an additional section devoted to analysing the papers that have made significant contributions in various areas and a further section on the compensation of the independent director.

Company valuation and performance

The idea that relates independence of the Board of Directors with improved performance by the firm is widely held both among the academic community and among reformers. However, in spite of being a widely held idea, there is no clear consensus in the literature on the relationship between improved performance and a greater presence of independent directors on the Board of Directors. There are authors who say that they have found positive relationships between the study variables (Baysinger and Butler, 1985; Pearce and Zahra, 1992; Rosenstein and Wyatt, 1990; De Andrés and Vallelado, 2008; Krivogorsky, 2006); others, however, maintain that the relationship is negative (Shivdasani and Yermack, 1999; Agrawal and Knoeber, 1996; Klein, 1998). There are also authors who have not found any statistically significant relationship between the variables (Bhagat and Black, 2002; Hermalin and Weisbach, 1991; MacAvoy et al., 1983).

As Dalton et al. (1998) point out, these conflicting findings may be due to the nature of the various performance indicators used by the authors. First of all, the question arises of the repercussion of the decisions made by the Board of Directors and by the management team. To what extent can these decisions affect accounting or market-based financial indicators? The fact is that there is no generalised agreement on this issue. The use of accounting criteria has been criticised because they are susceptible to tampering, systematic understatement of assets' true value, distortions arising from different depreciation criteria, different account consolidation criteria, etc. Significant objections can also be made to market-based measures, as they are beyond managers' control. In spite of these criticisms, the use of market-based indicators also has some positive attributes: risk-adjusted results, not affected by different industrial and multinational contexts, greater ease in comparing companies in different contexts, etc. Other factors that account for the lack of homogeneity in the results arise, for example, from sampling differences and lack of consensus in the definitions of the variables used.

The relationship between a larger number of independent directors and improved performance is grounded on two main reasons: 1. Greater management supervision implies that managers will work harder and better in favour of the interests of the shareholders as a whole. 2. The

independent directors' experience and professional reputation may contribute notably to the company's strategic decisions.

However, this issue cannot be reduced to mere numeric requirements; it is more complex than that. From the information contained in the study performed by Duchin et al. (2010), we have drawn up a table that summarises the three different visions of this issue. This approach focuses attention on the CEO's ability to choose the new directors and the Board of Directors' membership before the changes are made.

The first vision, advocated mainly by those who are sceptical about good governance reforms, is the so-called "window-dressing" approach. This view maintains that increasing the number of independent directors on the Board of Directors has no effect whatsoever on the company's performance, as the CEO controls the candidate selection process and uses it to put his allies on the Board. In this case, the directors play a decorative role, far removed from any supervisory task, helping the CEO to strengthen his position in the company. Following this reasoning, the recommendations contained in the codes of good governance that specify certain percentages are futile, as the CEO can choose directors who are independent under the terms of the law but are actually dependent upon him on a personal basis.

The "consolidating" vision, argued mainly by those who support the good governance reforms, maintains that any increase in the Board of Directors' independence has beneficial effects. The reasoning behind this thesis is that managers do not like independent directors and will try to avoid their supervision. Market forces are insufficient in themselves to establish an optimal number of independent directors on the Board, which is why the various recommendations and improvements that have been implemented by the codes of corporate governance are effective. Legislation is an obstacle that cannot be readily sidestepped by the CEO and his team, which is why the new directors' independence should be effective, increasing and guaranteeing supervision of the company's executives.

The third vision, called "optimising", states that the additional independent directors who have been appointed as a result of the good governance reforms may have adverse effects on companies' performance. This idea is grounded on the perception that companies structure their Boards of Directors in the best manner possible. The baseline position would be an optimal point from which any change that might be made would give rise to a less efficient suboptimum. It is true that each director typology has its own particular features; each one has its strengths and weaknesses. Hence the dilemma of having to choose between one or the other. This problem is solved by the company itself with experience and the various significant events that shape its functioning. However, the changes brought about by new legal requirements may have adverse effects. This view may also explain why there is such a divergence of results in the studies that have sought to relate the appointment of independent directors with improved performance. The addition of an independent director would be beneficial for a given company if its Board membership started from a point that was not optimal. Otherwise, the effect will be negative.

Leaving to one side the various technical aspects that work against homogeneity of the results, a greater presence of independent directors on the Board of Directors cannot be justified by a supposed relationship between the Board's independence and improved performance. The lack of consensus in the literature and the scientific evidence lead one to doubt the veracity of this type of statement.

Table 4

Effects of appointing independent directors to the Board

Vision	Window-dressing	Consolidating	Optimising
Who advocates it?	Sceptics about the reforms	Reformists	Some academics
Main arguments	Setting goals by regulating the number of independent directors does not improve companies' governance. The executive team can choose directors who are "independent" according to legal requirements but disposed favourably to management.	Executives do not like independent directors. The management team tries to evade their supervision. Market forces are insufficient to establish an optimal number of independent directors. The management team cannot easily sidestep legislation and, consequently, the new directors' independence will be effective.	Boards of Directors are formed in such a manner that they maximize the company's value. The executive team finds itself in a dilemma when it has to choose between executive directors or independent directors; each one has different strengths and weaknesses
Effect of increasing the number of independent directors on the company's performance	It has no effect at all. The CEO uses the figure of the independent director to put his allies on the Board.	Positive. An increased number of independent directors on the Board increases supervision of the management team.	Negative. Adding independent directors may lead to a suboptimal composition and, therefore, may detract from the company's performance.

Table obtained from the information given in Duchin et al. (2010).

Replacement of the CEO, takeover bids and MBOs

Unlike the situation with the studies mentioned in the previous section, the literature shares a broad consensus when it comes to analysing situations in which the Board of Directors has to make specific decisions. A large number of articles have been published documenting evidence of specific situations in which companies with Boards of Director with a majority of independent directors are able to create higher value for the shareholder.

Of particular interest are the contributions made to the supervision of the chief executive. Membership of the Board of Directors, particularly the proportion of outside and inside directors, should have a significant impact on the likelihood of deposing the CEO (Boeker, 1992). To a certain extent, this is because the Board of Directors is the shareholders' first line of defence against incompetent managers (Weissbach, 1988). Consequently, when faced with inappropriate management, the Board of Directors is the body responsible for vetoing the management and facilitating a change of leadership.

A number of studies have been performed that highlight the relationship between poor performance and CEO turnover (Coughlan and Schmidt, 1985; Warner et al., 1988). However, these studies do not address the possible effects that a higher number of independent directors on the Board may have on the turnover of chief executives. Within the decisions that are

included in the supervision function, one of the most important tasks is the replacement of the CEO when he does not adequately perform his role. Following the theses proposed by agency theory, a Board of Directors can only be objective in its decisions when it is independent (Fama, 1980). Accordingly, from the purely conceptual viewpoint, the Boards with a majority of independent directors would be more likely to replace the CEO when his management is not obtaining the required results.

One of the most heatedly debated papers in this line of research is that of Weisbach (1988). This author includes the Board's independence as one of the model's variables. The results obtained describe a positive correlation between CEO resignations/stand-downs and the evolution of the share price when there is a majority of independent directors on the Board of Directors. Based on unexpected share returns on the day when the resignations are announced, the author concludes that the directors create value for the company when they remove poor-performing managers. Fama and Jensen (1983) suggest that an outside director will try to preserve his human capital as a successful director and will therefore move for the removal of the inadequately performing CEO, thereby signalling to the market that he has a high capacity to act as a "decision controller".

As regards the selection of a new CEO, Borokhovich et al. (1996) argue that when the chief executive is dismissed, the likelihood that the Chairman will be an outsider increases proportionately to the percentage of outside directors in the company's governing body.

Other leading researchers have studied what happens when an independent director enters or leaves a company. Gupta and Fields (2009) warn that the resignation of an independent director sends a negative signal to the market. This information is less negative when the Board of Directors has a sufficient proportion of independent directors before the resignation. Another study that addresses the exit of independent directors has been published by Farrell and Whidbee (2000). The authors find a higher likelihood of turnover for those independent directors who show a greater degree of alignment with the outgoing CEO. Hsu-Huei et al. (2008) analysed the market reactions in Taiwan when new appointments of independent directors are announced and identified a positive correlation between the two factors. As the presence of independent directors on Taiwanese Boards of Directors is not addressed in the legislation, they conclude that the appointment of independent directors has more beneficial effects in those countries with less effective mechanisms for good governance.

The chief executive's salary has also been addressed from the viewpoint of independent directors. For example, Ryan and Wiggins (2004); Mishra and Nielsen (2000); Hooy and Tee (2010), document positive relationships between a performance-based compensation for the CEO and the presence of independent directors on the Board of Directors. Similarly, Mayers and Smith (2010) find evidence for a relationship between a higher number of independent directors and the part of managers' salaries that is performance-indexed. The authors point out that executives' salaries are more sensitive to changes in the ROA when the proportion of independent directors on the Board of Directors is higher.

Another highly prolific field of research has been that which has sought to relate independent directors with various variables that come into play when a takeover bid occurs. Byrd and Hickman (1992) find that when a company makes a takeover bid and at least 50 percent of its Board membership includes independent directors, the unexpected share returns on the same day of the announcement are much higher. However, the relationship they describe is not linear, which suggests that it is also possible to have too many independent directors.

The study by Cotter et al. (1997), which analyses the situation from the viewpoint of the target company of the acquisition, concludes that the presence of independent directors increases the gains of the shareholders of the acquired company, and that companies with a majority of independent directors are more likely to implement defence measures (poison pills, etc.) to increase the shareholder's wealth. Furthermore, when a takeover bid is not well received by the market and the share prices of the target company fall considerably after announcement of the bid, the operation is less likely to go through in the case of those companies with a greater presence of independent directors (Paul, 2007).

In the case of independent directors and MBOs⁹, Lee et al. (1992) suggest that shareholders of companies with Boards controlled by independent directors obtain greater returns than other companies in management buyouts. Given the nature of this type of operation, the likelihood of conflicts of interest arising between the management and the shareholders is much greater. In their desire to obtain control of the business, managers may have incentives to make decisions that have a negative impact on the share price, thereby reducing the operation's cost. However, the management team has the obligation to safeguard the shareholders' interests. If they buy the business, this obligation becomes a duty to obtain the best possible price for the shareholders. If the management does not possess the necessary ethical standards and the company lacks defence mechanism, the problem worsens considerably. In this type of situation, the role that must be played by the independent director becomes vitally important. The results obtained by Lee et al. indicate that this role is by no means trivial since, as has been pointed out, the shareholders of companies with a larger number of independent directors receive more value in this type of operation.

Other factors

The influence of the independent director has also been studied on a broad range of variables that are of great importance for companies. For example, evidence has been found that the presence of venture capital firms as equity holders correlates positively with the presence of independent directors on the Board of Directors (Baker and Gompers, 2003).

Musteen et al. (2010), analysing a sample of 324 companies included in the *Forbes* list of most admired US companies, identify that companies with a larger number of independent directors (together with the Board size variable) have a better reputation.

Studying S&P 500 companies with founding family shareholders, Anderson and Reeb (2004) state that the highest valued listed companies are those in which the presence of independent directors balances that of family representatives on the Board.

The independent director and strategy

Recent empirical evidence enables us to gain a better understanding of the reality underlying the figure of the independent director. The results obtained lead us to think that, on many occasions, the role of the independent director goes beyond the relationships and tasks stipulated in legislation and in the codes of good governance.

⁹ Management Buyout. A MBO is a type of operation in which a given company's management team takes control of the company by buying the shares held by the other shareholders.

It may be interesting to ask ourselves again exactly why do companies appoint independent directors. The obvious answer has been discussed in previous sections: there are regulations and a series of recommendations that stipulate their presence on the Boards of Directors of listed companies. However, this answer does not seem to reflect what is actually happening on the supervisory bodies of large companies.

In a study of the 1,000 largest listed companies in Japan, Miwa and Ramseyer (2005) find that appointment of independent directors is not a random process. According to the results obtained by the authors, each appointment is for a specific reason. For example, companies that need to borrow heavily or have less mortgageable assets are more likely to recruit directors from the bank industry. Likewise, companies in the construction industry with significant sales to the public sector are likely to recruit directors belonging to the Civil Service and the Government. This latter factor has been studied in depth (for the Korean case) by Kim and Lim (2008), who identify a positive relationship between a company's valuation and the proportion of directors with prior experience in Government positions.

Likewise, the study performed by Bhagat and Black (2002) reveals important information about the behaviour of large companies in the appointment of independent directors. The results obtained help us gain a better understanding of the rationale underlying this type of decision. According to the authors, companies with low or negative returns tend to contract more independent directors with the aim of improving their situation. It seems that the Boards of Directors, with their decisions, support and follow the convention that a higher number of independent directors on the Board helps improve companies' performance. However, the authors point out that there is no evidence that this strategy actually works. Indeed, the information obtained by Bhagat and Black suggests the complete opposite of what common sense would dictate, i.e., companies with more independent directors do not perform better than the others.

The results obtained by these authors indicate that, while they accept legal requirements and the recommendations of the codes of good governance, companies choose members for their Board of Directors on the basis of their specific needs. Accordingly, it seems that what really matters in an independent director is not his independence, but his contacts and possible strategic contributions arising from his knowledge of a particular industry. Thus, the independent director may become a significant strategic tool for the company.

To conclude this section, Table 5 summarises the main contributions made by the leading authors on the subject of independent directors.

Table 5

Main contributions on the role of the independent director

Factor	Authors	Contributions
Compensation of independent directors and personal profile	Linn and Park (2005)	Companies with better investment opportunities compensate their independent directors more generously.
	Marchetti and Stefanelli (2009)	Companies compensate more generously those directors who are better known.
Independent directors and strategy	Kim and Lim (2008)	There is a positive relationship between a company's valuation and the proportion of directors with prior experience in Government positions.
	Miwa and Ramseyer (2005)	Appointment of independent directors is not a random process. Companies appoint independent directors on the basis of their needs (contacts with banks, with the Government, etc.).
Independent directors and performance	Agrawal and Knoeber (1996)	A higher holding by "insider" directors in companies' equity relates positively with better performance, while more independent directors on the Board, more financing via debt and a higher involvement in control activities relate negatively with performance.
	Baysinger and Butler (1985)	Companies with a higher percentage of independent directors obtain better results. The beneficial effects are seen on Boards of Directors with low levels of independence.
	De Andrés and Vallelado (2008)	Membership and size of the Boards of Directors of banks show an inverted U-shaped correlation with the company's performance.
	Duchin et al. (2010)	Outside directors' effectiveness depends on the cost of acquiring information from the company.
	Hermalin and Weisbach (1991)	It seems that there is no relationship between membership of the Board of Directors and corporate performance.
	Klein (2002)	There is a negative relationship between Board independence and abnormal returns.
	Krivogorsky (2006)	The results obtained show a marked positive relationship between the proportion of independent directors on the Board of Directors and a number of profitability ratios.
Entry and exit of independent directors	Pearce and Zahra (1992)	The presence of independent directors on the Board is associated positively with financial return indicators.
	Shivdasani and Yermack (1999)	Appointment of an independent director has less impact on the share price when the CEO is involved in the selection process.
	Hsu-Huei et al. (2008) Bhagat and Black (2002)	Appointment of an independent director has a positive impact on the market. Low-performing companies tend to increase the independence of their Boards of Directors. However, it cannot be said that this strategy works. Companies with more independent directors do not perform better.
	Farrell and Whidbee (2000)	A higher turnover is more likely for those independent directors who are more aligned with the outgoing CEO.

Table 5 (continued)

Factor	Authors	Contributions
Entry and exit of independent directors	Gupta and Fields (2009)	The resignation of an independent director sends a negative signal to the market. This information is less negative when the Board of Directors has a sufficient proportion of independent directors before the resignation.
	Hermalin and Weisbach (1991)	It is more likely that additional independent directors will be appointed when companies' performance deteriorates. Boards of Directors tend to lose independence as the CEO grows in his career.
	Rosenstein and Wyatt (1997)	The market responds positively when companies appoint independent directors.
CEO replacement	Boeker (1992)	The CEO is less likely to stand down when the company's shareholding structure is more fragmented and the company's Board of Directors has a higher percentage of executives as members.
	Borokhovich et al. (1996)	When the chief executive is dismissed, the likelihood of the Chairman being an outsider increases with the percentage of outside directors on the company's Board.
	Fama and Jensen (1983)	An outside director will try to preserve his human capital as a successful director. He will therefore move for the removal of a bad CEO.
	Hermalin and Weisbach (1991)	CEO turnover correlates negatively with companies' performance. This correlation increases when the Board of Directors has greater independence.
	Weisbach (1988)	There is a greater likelihood of resignation among those CEOs whose companies are performing poorly and their Boards of Directors have a majority of outside directors.
CEO compensation	Hooy and Tee (2010)	Sensitivity of the CEO's compensation to performance is higher in those companies with more than 50% of independent directors.
	Mayers and Smith (2010)	There is a positive relationship between the structure of the Board of Directors and the extent to which executives' compensation is performance-linked. Compensation is more sensitive to the ROA when the percentage of outside directors is high.
	Mishra and Nielsen (2000)	There is a positive relationship between the percentage of independent directors and the sensitivity of the CEO's salary to performance.
	Ryan and Wiggins (2004)	Compensation in the form of stock is higher for those managers whose companies have a higher number of independent directors.
Takeover bids	Byrd and Hickman (1992)	Companies making a takeover bid and which have at least 50% of independent directors obtain significantly higher abnormal returns on the day of the announcement than the companies with less independent directors.
		When the Board of Directors is independent, the acquisition premium, the premium revision, and the shareholder gains during the tender period are higher.
		When a takeover bid is not well received by the market and the share price of the target company falls considerably after announcement of the acquisition, the operation is less likely to go through in the case of companies with a greater presence of independent directors.

Table 5 (continued)

Factor	Authors	Contributions
MBOs	Lee et al. (1992)	The results suggest that companies with Boards controlled by independent directors obtain higher returns than other companies when they are bought by the management.
Other factors	Anderson and Reeb (2004)	The companies with founder family equity holdings with the highest net worth – included in the S&P 500 index – are those in which the presence of independent directors balances family representatives on the Board.
	Baker and Gomers (2003)	Companies backed by venture capital firms have less inside directors and more independent directors.
	Musteen et al. (2010)	Companies with large Boards of Directors with a higher proportion of outside directors have a better reputation than companies with small Boards and high proportions of inside directors.

Compensation of the independent director

One of the critical problems involving the independent director arises from the compensation they must receive. The salary of directors given the attribute of independent must be balanced if it is wished to guarantee their independence. There are no precise criteria for identifying high compensations that could imperil the directors' independence. However, if the income from the directorship represents a high percentage of the director's salary, his criterion may lose a certain degree of independence from the person or committee who has appointed him to this position.

The opposite case also causes problems. If the salary received is too low, the company may have difficulties in finding qualified directors willing to take on the dedication and responsibility required by the position. Consequently, the appointments committee faces a major dilemma when determining the compensation of independent directors.

The problem of independent directors' compensation has not been studied by the academic community with the depth at which the various systems of executive compensation have been approached. Neither does legislation or the codes of good governance address this problem to any significant degree. The Unified Code of Good Governance confines itself to recommending *«that the compensation of outside directors be that required to reward the dedication, qualification and responsibility required by the position; but not so high as to compromise their independence»*¹⁰. The EU recommendation of 30 April 2009 on compensation schemes of listed companies provides a series of principles which should be taken into account when drawing up compensation schemes for directors. Given their content, these principles may be very useful for creating compensation schemes for independent directors.

First of all, the compensation scheme for directors should foster the company's *long-term* sustainability. Furthermore, compensation should be tied to the company's results. This second

¹⁰ Recommendation 37, Unified Code of Good Governance.

point implies that the variable part of the salary should be linked in some way to performance criteria (quantifiable, established beforehand and not just financial). In order to guarantee that the decisions made by the directors are the most favourable for the company in the long term, it is proposed that part of the variable performance-linked salary be deferred. This would enable the results obtained to be checked against the goals proposed. If the pre-established requirements are not met, the director will receive the part corresponding to his fixed compensation, losing the variable part. Stock options are excluded from any possible compensation of independent directors, as they endanger his effective independence.

Although compensation schemes for independent directors have not been studied in depth, this is not the case of the possible relationships between the compensation of independent directors and other variables. Thus, Marchetti and Stefanelli (2009) study whether there is any relationship between the compensation of independent directors and their personal profile. The results obtained indicate that companies compensate more generously those directors who are more widely known.

Linn and Park (2005) assure that the compensation of independent directors is related with the company's investment opportunities. In other words, the companies with more investment opportunities compensate their independent directors more generously than those with more limited investment spectra.

8. Final reflections

From a theoretical viewpoint, the figure of the independent director has raised high expectations as regards improving corporate governance. Many of the recommendations included in the codes of good governance are based on agency theory and, therefore, focus on highlighting situations that can generate conflicts of interest. This approach is insufficient, as it raises the risk of making «*an interpretation (of the director's independence) that is closer to the letter than to the spirit of the name*»¹¹, complying with the minimum requirements for eligibility for independent directorship while not guaranteeing effective independence.

Following the thesis proposed by Canals (2008), we have wished to highlight in this study that directors' independence is something that transcends compensation or the criteria that may be included in the regulations. Independence cannot be produced by an optimal combination of requirements. Rather, it is a feature of the individual that emanates from virtues and qualities that have been cultivated during his life. It therefore seems wise that the recommendations contained in the codes and in the law itself should include the possibility of ignoring some of the rules with the goal of seeking the best solution, without sticking too closely to the letter.

The compensation of independent directors continues to be an open issue. In spite of the ideas given in the EU recommendation of 30 April 2009, it seems that the only financial criterion that safeguards the director's independence is that the compensation obtained from the directorship should not represent a high percentage of his total income. Among the possible solutions for this problem, we would stress the need for greater transparency in each director's compensation, making public not only the sums received for the directorship but also the other sums that may be received from other positions.

¹¹ Olivencia Report.

The presence of independent directors in the governance of companies can be justified for several reasons but, as we have seen in the section devoted to the role of independent directors, a greater presence of independent directors on the Board of Directors cannot be justified by better performance. However, independent directors play an important role in the supervision and replacement of the CEO. The research performed to date indicates that poor-performing companies with a strong presence of independent directors are more likely to replace the chief executive. This can only happen if the independent directors have effective independence. But, at the same time, as independence is a personal feature, adequate supervision of the CEO can only be undertaken if the independent directors possess certain subjective qualities.

Recommendations by codes of corporate governance concerning Board of Director membership

	Code	Recommendations
SPAIN	Olivencia Report (1998)	The Board of Directors should include a reasonable number of independent directors who are people of good professional renown and dissociated from the executive team and significant shareholders. (Recommendation 2) Outside directors (nominee and independent directors) should have an ample majority over executive directors in the membership of the Board of Directors, and the proportion between nominee and independent directors should be established taking into account the relationship between significant equity holdings and the rest. (Recommendation 3)
	Aldama Report (2003)	There should be an ample majority of outside directors on the Board and, among these, a very significant percentage of independent directors, taking into account the company's shareholding structure and the equity capital represented on the Board. (Point 3)
	Unified Code of Good Governance (2006)	Nominee outside directors and independent directors should make up an ample majority of the Board and the number of executive directors should be the minimum necessary, taking into account the complexity of the corporate group and the percentage share of the executive directors in the company's capital. (Recommendation 10) Independent directors should represent at least one third of the total number of directors. (Recommendation 13)
INTERNATIONAL	Cadbury Report (1992)	We recommend that the calibre and number of non-executive directors on a Board should be such that their views will carry significant weight in the Board's decisions. To meet our recommendations on the composition of sub-committees of the Board, all Boards will require a minimum of three non-executive directors, one of whom may be the chairman of the company provided he or she is not also its executive head. (4.11)
	Higgs Report (2003)	At least half of the members of the Board, excluding the chairman, should be independent non-executive directors. (9.5)
	NYSE 303A Corporate Governance Standards (2003)	Listed companies must have a majority of independent directors. (303A.01)
	European Commission Recommendation (2005/162/EC)	A sufficient number of non-executive or supervisory directors should be appointed to companies' Board of Directors or Supervisory Board to guarantee adequate handling of serious conflicts of interest involving the company's officers. (Section II, point 4)
	Combined Code on Corporate Governance (2008)	The Board should include a balance of executive and non-executive directors (and in particular independent non-executive directors) such that no individual or small group of individuals can dominate the Board's decision taking. (A.E Main Principle) At least half the Board, excluding the chairman, should comprise non-executive directors determined by the Board to be independent. A smaller company should have at least two independent non-executive directors. (A.3.2)
	Code de Gouvernement d'entreprise des sociétés cotées (2008)	The independent directors should account for half the members of the Board in widely-held corporations and without controlling shareholders. In controlled companies, independent directors should account at least for a third. (8.2)
	Deutscher Corporate Governance Kodex (2009)	To permit the Supervisory Board's independent advice and supervision of the Management Board, the Supervisory Board shall include what it considers an adequate number of independent members. (5.4.2)
Hong Kong Code on Corporate Governance (2004)	Every Board of Directors of a listed issuer must include at least three independent non-executive directors (Main Board Listing Rules 3.10) The Board should have a balance of skills and experience appropriate for the requirements of the business of the issuer. The Board should ensure that changes to its composition can be managed without undue disruption. The Board should include a balanced composition of executive and non-executive directors (including independent non-executive directors) so that there is a strong independent element on the Board, which can effectively exercise independent judgement. Non-executive directors should be of sufficient calibre and number for their views to carry weight. (A.3 Board Composition)	

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