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The Rise of the Independent Director: A Historical and Comparative Perspective

Abstract

The paper provides a historical analysis of the rise of the independent director in the US and the UK. These two jurisdictions are commonly credited with creating the concept of the independent director and exporting it around the world.

In the first half of the twentieth century, a managerialist model of corporate governance dominated in the US. Inside directors, chosen and controlled by the CEO, dominated corporate boards. The concept of the independent director and the related model of the 'monitoring board' appeared only in the 1970s. Two watershed events sparked this dramatic change: First, the sudden collapse of the major railway company Penn Central in 1970; and second, Eisenberg's influential book 'The Structure of the Corporation', published in 1976. According to Eisenberg, the board's essential function was to monitor the company's management by being independent from it. Today the reliance on independent directors as a panacea for various corporate governance ills has reached its zenith in the US.

As in the US, the typical British board of the 1950s was an advisory board dominated by insiders. It was only in the 1990s, with the beginning of the British corporate governance movement subsequent to the publication of the Cadbury Report, that the concept of independent directors was embraced in the UK. Since the early 2000s independent directors have dominated on the boards of listed companies. From the UK, the concept of the independent director started to conquer the European Union as a fundamental corporate governance principle. The European Model Company Act of 2015 and, on the supra-national level, the OECD Principles of Corporate Governance of 2015 recommend assigning important tasks to independent board members.

The empirical support for staffing boards with independent directors, however, remains surprisingly shaky given the ubiquitous reliance on independent directors. The global financial crisis of 2008 has added further doubts.

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The Rise of the Independent Director: A Historical and Comparative Perspective

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I. Introduction

1. Independence as a Magic Cure ?

Independent directors as a corporate governance tool have precipitously risen from obscurity to ubiquity in the West as well as in most other parts of the world, namely in Asia recently. Essentially – and allowing for some simplification – the concept of independent directors and the related model of a 'monitoring board of directors' originated in the US in the 1970s and underwent some modifications thereafter. Today, in their place of origin, in the US, the reliance on independent directors as a panacea for various corporate governance ills has reached its zenith. In 2013, in US public companies, 85% of directors were independent and 60% of boards had only one non-independent director—the Chief Executive Officer (CEO).[1] Over the last decades, the primary legislative and judicial response to almost every major corporate scandal in the US has been to increase reliance on independent directors.

Around 25 years ago, the concept of independent directors was adopted and refined in the UK. During the 2000s, the UK situation came to mirror that in the US as about 90% of directors in UK public companies were independent.[2] From there, the concept of the independent director began its conquest of the European Union as a fundamental corporate governance principle and a 'must have' governance tool. The final draft in 2015 of the European Model Company Act provides in Section 5 that 'the board [of a traded company] should comprise an appropriate balance of independent non-executive directors'.[3]

On the supranational level, the Organisation for Economic Co-operation and Development (OECD) recommends that important tasks should be assigned to independent board members who 'can contribute significantly to the decision-making of the board' in its G20/OECD Principles of Corporate Governance of 2015.[4] Similarly, the 2013 OECD report 'Better Policies for Board Nomination in Asia' emphasises the importance of independent directors in nomination (and other) committees in Asian companies.[5] In a similar vein, a 2010 report compiled by the Asian Corporate Governance Association (ACGA) recommends the nomination of a sufficient number of independent directors to Asian boards.[6] And, as of 2016, virtually all major Asian jursidctions have rules for appointing independent directors to their companies' boards.

1 U. Velikonja, 'The Political Economy of Board Independence', *North Carolina Law Review,* 92 (2014), 855, 857 f. with further references. See *infra* Part III.5.

2 Heidrick and Struggles, *Corporate Governance Report 2009. Boards in turbulent times* (2009), 45; the number has somewhat decreased since then. See *infra* Part IV.1.

3 European Model Company Act Group, *The European Model Company Act (EMCA) Draft 2015,* available at *http://law.au.dk.*

4 The G20/OECD Principles of Corporate Governance (OECD Publishing 2015), available at *http://dx.doi.org/10.1787/9789264236882-en,* 50.

5 Better Policies for Board Nomination in Asia (OECD Publishing 2013), available at *http://dx.doi.org/10.1787/9789264204386-en.*

6 ACGA, Rules & Recommendations on the Number of Independent Directors in Asia, available at *http://www.acga-asia.org*.

The regulatory basis for this obligation is found either in the pertinent company laws, the listings rules and/or the corporate governance codes.[7]

Independent directors obviously have become global players. However, it should be noted that independent directors are markedly different from jurisdiction to jurisdiction. This is because the role that independent directors play is influenced significantly by each jurisdiction's unique shareholder structure, functional substitutes, institutions, regulators, courts, history and culture.[8]

At least until very recently, independent directors seemed to be regarded as some kind of largely unquestioned prescription for a panoply of corporate governance problems. In the US, the faith in independent directors appears to have achieved an almost cult-like status as a magic cure for a variety of corporate governance ills.[9] This observation may come as a surprise because there is only scant empirical evidence that independent directors actually do improve the performance of the companies whose boards they fill.[10] The Global Financial Crisis, however, appears more recently to have produced some disenchantment in Europe with taking independence to US extremes. Part of the discussion is now focussed on the critical role of auditors as external gate keepers rather than on independent directors. This being said, even post-Crisis, the faith that Europe has in independent directors has persisted, as UK boards remain reliant on having a majority of independent directors to make decisions, and in the rest of Europe independent directors remain an entrenched feature on boards of public companies. The same is true for most Asian jurisdictions.[11]

2. Who is Independent?

Before proceeding any further, there is a critical concept that must be clarified: who qualifies as an 'independent director'? At first blush, the answer to this question appears intuitively simple: a director on a company's board who is not dependent on *someone* or *something* that is related to the company is independent. In the abstract, this definition sounds compelling. In practice, however, this abstract definition is vexed with uncertainty: precisely *who* or *what* is the *someone* or *something* which an independent director must be independent from?

7 For an overview see the various reports on Asia's major jurisdictions in H. Baum, S. Kozuka, L. R. Nottage and D. W. Puchniak (eds.), *Independent Directors in Asia: A Historical, Contextual and Comparative Approach* (forthcoming, Cambridge University Press 2017).

8 For a discussion of the importance of the given social and cultural context see A. N. Licht, 'Culture and Law in Corporate Governance', in P. Richman, J. Gordon and W.-G. Ringe (eds.), *The Oxford Handbook of Corporate Law and Governance* (forthcoming, Oxford University Press 2017).

9 See the telling title of a critical article by U. Rodrigues, 'The Fetishization of Independence', *Journal of Corporation Law* 33 (2008), 447. See *infra* Part III.4.

10 See *infra* Part V.

11 See D. W. Puchniak, 'The Independent Director in Asia: A Taxonomy', in H. Baum, S. Kozuka, L. R. Nottage and D. W. Puchniak (eds.), *Independent Directors in Asia: A Historical, Contextual and Comparative Approach* (forthcoming, Cambridge University Press 2017).

– The CEO of the company (or even his or her immediate family, extended family and/or friends)?
– Other board members or the entire senior management of the company (or their family)?
– The company itself (or even its parent company, subsidiary companies or companies that are part of its corporate group)?
– The controlling shareholder (or even a de facto controlling shareholder or a significant shareholder)?
– Other corporate stakeholders (such as creditors, suppliers or employees)?
– A specific corporate transaction in which the director has an interest (and, thus making the director the one to be monitored and not the one to be monitoring).

Obviously, the definition of ‘independence’ depends on the context or, more precisely, on the *function* that the director is supposed to fulfill. Independence is not an end in itself but is constructed to serve a pre-defined goal. If the main task assigned to the independent directors is to monitor management as a means to solve the classic agency conflict between managers and dispersed shareholders (owners), independence from the entrenched CEO of the stereotypical US Berle-Means corporation seems to be the most important criterion. If, on the other hand, the directors’ task is defined predominantly as protecting minority shareholders against a controlling block holder as found in an archetypical Continental European company or in many Asian companies, independence from the latter will be the decisive characteristic. Even if directors qualify *ex ante* as formally independent based on both of these parameters, they may actually not be in a position to provide a substantially objective judgment of a related party transaction involving a conflict of interest if they have a personal interest of their own in that business transaction, and thus are conflicted themselves.

Accordingly, there is no universal definition of ‘independence’. Regulatory standards across countries generally employ various definitions using different combinations of the criteria mentioned above according to what the jurisdiction’s legislature or other governing body regarded as imperative in the given context.[12] Independence is mostly defined *ex ante* in a somewhat formalistic way with reference to the *status* of the directors in relation to various criteria, often formulated in negative terms that describe the absence of certain relationships as a prerequisite for assuming independence. In some cases, however, only positive examples of independence are provided. Courts are sometimes more flexible and focus instead on the *transaction* in question, considering whether the director involved was a substantially disinterested one

12 For an overview, see P. L. Davies and K. J. Hopt, ‘Boards in Europe: Accountability and Convergence,’ *American Journal of Comparative Law,* 61 (2013) 301, 317 ff.; P. L. Davies, K. J. Hopt, R. Nowak and G. van Solinge, ‘Boards in Law and Practice: A Cross-Country Analysis in Europe’ in P. L. Davies, K. J. Hopt, R. Nowak and G. van Solinge (eds.), *Boards in Law and Practice* (Oxford University Press 2013), 28 ff.; see also D. Ferreira and T. Kirchmaier, ‘Corporate boards in Europe: size, independence and gender diversity’, in M. Belcredi and G. Ferrarini (eds.), Boards and Shareholders in European Listed Companies. Facts, Context and Post-crisis Reforms (Cambridge University Press 2013) 191 ff.

as an alternative to the question whether he or she was formally independent of the parties involved in the transaction.

This lack of a shared understanding comes as no surprise if one considers the fact that independent directors exist within boards that have a multiplicity and diversity of functions. This suggests that independent directors are likely to play a variety of roles depending on the primary functions of the board,[13] which may themselves vary depending on the particular agency problems that are most acute in a given jurisdiction's unique corporate governance environment.

In other words, the context in which independent directors operate in each jurisdiction is highly path-dependent.[14] The only common denominator in all of the various conceptions of the *independent director* seems to be the fact that the directors in question have to be *non-executive* ones, meaning that they are not part of a company's management team.[15] However, it goes without saying that being a non-executive director is not equivalent to being an independent one. Even an *outside director,* someone who is not an employee of the company or retained by it (other than in his or her capacity as director), is by no means an independent one *per se*. The prototypical member of a German supervisory board,[16] for example, is an outside director not involved in managing the company who, however, usually has a financial or business affiliation with the company or a major shareholder, or who represents one of these entities.

The theoretical and practical discussions do not always consider these nuances when analysing the concept of the independent director, nor do they look at the conditions which may support independence.[17] Given the ubiquity of the concept in statutes, listing rules, and corporate governance codes, it is surprising how little theoretical consideration has been given to the nature of 'independence'.[18] A

13 See, for example*,* R. B. Adams, B. E. Hermalin and M. S. Weisbach, 'The role of directors in corporate governance: a conceptual framework and survey', *Journal of Economic Literature,* 48 (2010), 58.

14 For an up-to-date overview of different corporate governance arrangements in major economies, see, for example, K. J. Hopt, 'Comparative Corporate Governance: The State of the Art and International Regulation', *American Journal of Comparative Law,* 59 (2011), 1; and the various contributions in A. M. Fleckner and K. J. Hopt (eds.), *Comparative Corporate Governance. A Functional and International Analysis* (Cambridge University Press, 2013); for a general discussion regarding the complexity of a meaningful comparison of corporate law, see also D. C. Clarke, ''Nothing but Wind'? The Past and Future of Comparative Corporate Governance', *American Journal of Comparative Law,* 59 (2011), 75.

15 D. C. Clarke, 'Three Concepts of the Independent Director', *Delaware Journal of Corporate Law,* 32(2007), 73, 79; see also L. M. Fairfax, 'The Uneasy Case for the Inside Director', *Iowa Law Review,* 96 (2010), 127 ff.

16 Germany adheres to the two-tier board system. See *infra* Part IV. 3.

17 Clarke, 'Three Concepts of the Independent Director', (note 15, above), 73.

18 Notable exceptions are S. Le Mire and G. Gilligan, 'Independence and Independent Company Directors', *Journal of Corporate Law Studies,* 13 (2013), 443; and Clarke, 'Three Concepts of the Independent Director', (note 15, above); one of the extremely rare discussions of the concept of independence as such and regarding all of its aspects was written by Swiss company law expert J. N. Druey, 'Unabhängigkeit als Gebot des allgemeinen Unternehmensrechts', in S. Kalss,

fundamental, although often ignored, paradox is that 'independence actually creates dependence', as the independent director has to rely on company insiders for information.[19] Notwithstanding this fact, the role of independent directors is most often *assumed* to be monolithic, fixed and even universal—with the addition of more independent directors often being deemed to axiomatically improve corporate governance. How these improvements occur is rarely scrutinised and is rather, as it seems, accepted on blind faith alone. From this flawed perspective, the discussion surrounding independent directors is often reduced to a myopic consideration of the appropriate proportion of independent directors that should be on boards.[20] Only fairly recently, in the wake of the Global Financial Crisis of 2008, has the concept of the independent director come slowly under closer and critical scrutiny in Europe.[21] In America, however, aside from a small but growing number of corporate governance 'heretics',[22] independent directors still seem to be regularly accepted as the panacea for all kinds of corporate governance shortcomings.

With a clearer understanding now of what an 'independent director' is, or perhaps more accurately, what an independent director can be, we can now delve into the rich history that forms the foundation of the rise of the independent director. Inevitably, the start of such an inquiry must begin with a brief historical examination of the origins of the board of directors itself, which is explored in Part II. Thereafter, a detailed consideration of the historical rise of the independent director in the US, the birthplace of the concept itself, will be undertaken in Part III. Then, the focus of our historical inquiry will shift to the UK in Part IV, which has played a role in refining and, especially, exporting the concept of the independent director around the world. In addition, the migration of independent directors from the UK to Continental Europe will

C. Nowotny and M. Schauer (eds.), *Festschrift Peter Doralt* (Vienna: Manz, 2004) 151 ff.; a fundamental comprehensive analysis of the concept can be found in a recent German publication by C. Kumpan, *Der Interessenkonflikt im deutschen Privatrecht* (Tübingen: Mohr Siebeck, 2014), 138 ff., 158 ff.

19 Druey, 'Unabhängigkeit', (note 18, above), 163, 169; see also see also J. Winter, 'The Financial Crisis: Does Good Corporate Governance Matter and How to Achieve it?' in E. Wymeersch, K. J. Hopt and G. Ferrarini (eds.), *Financial Regulation and Supervision: A Post-Crisis Analysis* (Oxford University Press, 2012), 368, 376.

20 Davies and Hopt, 'Boards in Europe', (note 12, above), 317 f.

21 See G. Ringe, 'Independent Directors: A Theoretical Framework', in H. Baum, S. Kozuka, L. R. Nottage and D. W. Puchniak (eds.), *Independent Directors in Asia: A Historical, Contextual and Comparative Approach* (forthcoming, Cambridge University Press 2017), Part II, for a detailed discussion of the growing skepticism; see further M. Gutiérrez and M. Sáez, 'Deconstructing Independent Directors', *Journal of Corporate Law Studies,* 13 (2013), 63.

22 See, for example, Rodrigues, 'The Fetishization of Independence', (note 9, above); Fairfax, 'The Uneasy Case for the Inside Director', (note 15, above); E. J. Pan, 'Rethinking the Board's Duty to Monitor: A Critical Assessment of the Delaware Doctrine', *Florida State University Law Review* 38 (2011) 209, 225; R. S. Karmel, 'Is the Independent Director Model Broken?', *Brooklyn Law School Legal Studies Research Papers*; Accepted Paper Series; Research Paper No. 348 July 2013, available at *http://ssrn.com/abstract=1972057;* J. R. Brown, Jr., 'The Demystification of the Board of Directors', *University of Denver Sturm College of Law,* Legal Research Paper Series, Working Paper No. 14-37 (2014), available at *http://ssrn.com/abstract= 2474394.*

be considered briefly, with a particular focus on the transplantation of independent directors to civil law jurisdictions. To streamline the European analysis, the focus in Continental Europe will be on the recent developments in European Community law, and Germany will be used as a case study to illustrate European Community law in a member state. Indeed, the German example is a fascinating one as it has a long history of rigid separation between executive and non-executive directors, this having been introduced as early as 1861.

II. Historical Origins of the Board of Directors

1. Medieval Guilds and Chartered Companies

Today in almost every jurisdiction, regulation demands or assumes that public companies are managed by a board, or are at least under the direction of a board of directors. This is quite remarkable because the worldwide spread of the board system is a comparatively new development, replacing other successful models such as the merchant house in pre-Meiji Japan. It is even more remarkable because complaints about the ineffectiveness of boards have been universally voiced for as long as company boards have existed.[23] Creating a caricature of the very concept of the corporate board, companies with dispersed ownership typically seem to be run in practice by the executive management team or the CEO, and companies with concentrated ownership are often actually run by the dominant shareholder, with the board playing only a peripheral role in both cases. So how did the idea that a board of directors should play a central role in corporate management achieve widespread popularity, and from where did it originate?

The use of a body of representatives as a tool for collective governance can be traced back to the medieval guilds and political institutions in the late Middle Ages in Western Europe.[24] Some guilds developed into regulated companies, such as the British Company of Merchant Adventurers in the sixteenth century,[25] which had by charter a governor and an elected board of 'assistants' taking care of the company's governance.[26] Though these governing boards were familiar with the practice of

23 F. A. Gevurtz, 'The European Origins and the Spread of the Corporate Board of Directors', *Stetson Law Review,* 33 (2004), 925, 926 f.

24 *Ibid.*, 946 ff.

25 For the evolution of the stock company in general, see M. Schmitthoff, 'The Origin of the Joint-Stock Company', 3 *The University of Toronto Law Journal,* 3 (1939), 74 (discussing the competing theories); for an institutional perspective, see P. Lipton, 'The Evolution of the Joint Stock Company to 1800: A Study of Institutional Change', *Monash University, Department of Business Law and Taxation,* Working Paper No. 19 (2009), available at *http://ssrn.com/abstract=1413502*; for the historical developments in the UK, see in general P. L. Davies, *Gower's Principles of Modern Company Law,* 6th edn., (London: Sweet & Maxwell, 1997) 18 ff.

26 Gevurtz, 'The European Origins', (note 23), 945 f.; for an overview of the historical antecedents of corporate directors and officers, see C. O'Donnell, 'Origins of the Corporate Executive', *Bulletin of the Business Historical Society,* 26 (1952), 55, 60 f.

collective governance, they did not have much else in common with modern boards.[27] Its members were active merchants trading on their own accounts, and not passive investors like the modern private shareholder. The board's main tasks were to resolve disputes among the members and to set up rules regulating the members' behaviour.[28]

2. The First Joint-Stock Companies

Though the British trading companies, like the East India Company, had started as chartered companies, they were subsequently structured with features similar to the modern joint-stock company during the seventeenth century:[29] members were no longer allowed to trade on their own under the company's franchise, and voting rights increasingly depended on the amount invested by a member in the company's permanent joint stock.[30] Such companies started to trade on their own accounts, and boards, elected by members, began to manage the affairs of companies and to take business decisions in their best interests, acting as members' representatives. This marked the birth of the corporate board as a management organ in the modern sense.[31] With benefits in the form of economic returns and voting rights dependent on the capital paid into the company's common fund, the former 'confederation of merchants' was transformed into a 'vehicle for passive investment by the general public.'[32]

In these early days, the monitoring capacities of the board did not yet play a significant role in their own right, and a modern understanding of the different roles of management and the board of directors had yet to be developed.[33] Most members of the board were heavily invested in the company and thus, in effect, managed the company in their own interest. They were elected because other investors assumed that they were trying their best for the company in enlightened self-interest, thus making a monitoring board unnecessary.[34]

27 Y. Zhao, *Corporate Governance and Directors' Independence* (Alphen aan den Rijn 2011) 11, which provides an excellent concise historical overview of the evolution of the board of directors and the independence of directors at 9-36.

28 Gevurtz, 'The European Origins', (note 23, above), 946.

29 Schmitthoff, 'The Origin of the Joint-Stock Company', (note 25, above), 90 f.; for a historical overview of the legal developments regarding the East India Company see R. Harris, 'The English East India Company and the History of Company Law', in E. Gepken-Jager, G. van Solinge and L. Timmerman (eds.), *VOC 1602–2002: 400 Years of Company Law,* (Kluwer Legal Publ., Deventer 2005) 217 ff.

30 Gevurtz, 'The European Origins', (note 23, above), 944; some claim that by the mid-seventeenth century these companies already had developed most of the main characteristics of a modern company; see Lipton, 'The Evolution of the Joint Stock Company', (note 25, above), 16 with further references.

31 Zhao, *Corporate Governance and Directors' Independence,* (note 27, above), 11.

32 Gevurtz, 'The European Origins', (note 23, above), 944; see also Harris, 'The English East India Company', (note 29, above), 234 ff.

33 Zhao, *Corporate Governance and Directors' Independence,* (note 27, above), 12.

34 *Ibid.*; O'Donnell, 'Origins of the Corporate Executive', (note 26, above), 70.

A parallel development of joint-stock companies and accordingly corporate boards took place in Continental Europe.[35] A famous example is the Dutch East India Company founded two years after its English counterpart.[36] Other examples include the corporate boards that developed as tools of governance for Hanseatic merchant societies. In the US, the operation of boards of directors in early American corporations was unsurprisingly rooted in the English tradition. A prominent example is the 1791 charter of the first Bank of the United States that was modelled in parts on the Bank of England's 1694 charter.[37] In general, former European colonies usually adopted their mother countries' institutions to a large degree. In accordance with this custom, the board of directors as a corporate organ and governance tool spread to a multitude of jurisdictions.[38] Even a country like Japan, which was never colonized, regarded the modern joint-stock corporation with its board as a superior form of enterprise for establishing and conducting business. Immediately after the Meiji Restoration of 1868, the Japanese government began to promote the introduction of a company system, and the first Japanese banks had to be organized as joint-stock companies by decree in 1876.[39]

3. The Rise of the Executive Director and the Split of the Board

During the eighteenth and nineteenth centuries, joint-stock companies flourished as a business model in Britain.[40] They constituted the successful British 'landmark of the early capitalist society'.[41] The separate legal personality of the company—and the accompanying creation of limited liability providing a financial shelter for its shareholders[42]—made this form of enterprise highly attractive for an ever-increasing number of average citizens. The attraction persisted, notwithstanding recurrent scandals such as the South Sea Bubble in 1720 and others. In his famous treatise on the wealth of nations published in 1776, Adam Smith complained that one could not expect directors of a joint-stock company, '… being the managers rather of other people's money than

35 For a brief overview, see F. A. Gevurtz, 'The Historical and Political Origins of the Corporate Board of Directors', available at *http://ssrn.com/abstract=546296,* 30 ff.

36 Schmitthoff, 'The Origin of the Joint-Stock Company', (note 25, above), 93 ff.; for a historical overview of the legal developments regarding the Dutch East India Company, see Paul Marie Louis Frentrop, *A History of Corporate Governance 1602 – 2002* (Amsterdam: Deminor 2003) 49 ff..

37 Gevurtz, 'The Historical and Political Origins', (note 35, above), 16 ff.

38 Gevurtz, 'The European Origins', (note 23, above), 935 f.

39 H. Baum and E. Takahashi, 'Commercial Law and Corporate Law in Japan: Legal and Economic Developments After 1868', in W. Röhl (ed.), *A History of Law in Japan Since 1868* (Leiden: Brill 2005), 330, 341 ff.

40 Lipton, 'The Evolution of the Joint Stock Company to 1800', (note 25, above), 16; Davies, (note 25, above), 22 ff.

41 Zhao, *Corporate Governance and Directors' Independence,* (note 27, above), 13.

42 This was fully acknowledged in Britain by the Limited Liability Act of 1855; see R. R. Formoy, *The Historical Foundations of Modern Company Law* (London: Sweet and Maxwell, 1923), 114 ff; Davies, (note 20, above), 40 ff.

their own… [to] watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own'.[43]

The broader the investing circle of shareholders became, the wider the gap between the shareholders and the companies' directors, with the latter taking charge of managing the companies' affairs.[44] With this, the separation of ownership and control became apparent. Lawmakers and courts acknowledged, or at least assumed, that the board of directors would manage companies. In reality, however, managerial power had started to shift gradually from the boards in their entirety to professional managers acting as executive directors. This shift was caused by the growth and diversification of the joint-stock companies. This delegation of power increasingly deprived the boards of directors of their managerial role, and the boards became segmented between those running the company and those 'invited to sit on the board for non-managing purposes'.[45] In Britain, it became customary to hire members of the nobility as non-executive directors to create a veneer of respectability and to use their name as bait for the investing public;[46] in the US, retired generals and film stars were later preferred instead as board members to entice investors.[47]

The German regulation of stock companies in the Commercial Code of 1861 *(Allgemeines Deutsches Handeslgesetzbuch)* was probably the first law to acknowledge these developments legally.[48] The split between a supervisory board and a management board became mandatory. Members of the management board were not—and still are not— allowed to simultaneously act as members of the supervisory board. Thus, at least in principle, a clear separation between executive and non-executive functions was introduced although the law allowed more powers to be assigned to the supervisory board in the articles of incorporation beyond what was required to perform its mandatory supervisory functions. Thus, in practice, the distinction was somewhat blurred. A strict exclusion of the supervisory board from the management of the company came with the Stock Corporation Act of 1937.[49]

43 Adam Smith, *An Inquiry into the Nature and Courses of the Wealth of Nations,* (Edwin Cannan (ed.), New York, 1937), 700; for a discussion of Smith's general skepticism towards joint stock companies see A. M. Fleckner, 'Adam Smith on the Joint Stock Company', *Max Planck Institute for Tax Law and Public Finance Working Paper 2016 – 01,* available at *http://www.tax.mpg.de.*

44 Zhao, *Corporate Governance and Directors' Independence,* (note 27, above), 15 f.

45 Ibid*.,* 17 f.

46 A vivid critical analysis of this practice can be found in H. B. Samuel, *Shareholders' Money,* (London: Pitman, 1933), 111 ff.

47 Zhao, *Corporate Governance and Directors' Independence,* (note 27, above), 18 f.

48 M. Roth, 'Corporate Boards in Germany' in P. L. Davies, K. J. Hopt, R. Nowak and G. van Solinge (eds.), *Boards in Law and Practice* (Oxford University Press, 2013), 253, 276 f.; R. Wiethölter, *Interessen und Organisation der Aktiengesellschaft im amerikanischen und deutschen Recht,* (Frankfurt: C.F. Müller, 1961), 271.

49 Roth, 'Corporate Boards in Germany', (note 48, above), 277; for a comprehensive historical overview see, for example, M. Lutter, 'Der Aufsichtsrat im Wandel der Zeit: von seinen Anfängen bis heute' in W. Bayer and M. Habersack (eds.), *Aktienrecht im Wandel,* Vol. 2: *Grundsatzfragen des Aktienrechts,* (Tübingen: Mohr Siebeck, 2007), 389 ff.; for developments in Germany see *infra* at Part IV.3.

III. From 'Shirtsleeve' Directors to Independent Directors: Developments in the US

1. The Area of Inside Directors

A famous article published in 1934 in the Harvard Law Review had the telling title *Directors Who Do Not Direct*.[50] The author, William O. Douglas, criticized the widespread corporate scandals in the US in the 1920s and 1930s that were made possible by, among other factors, the almost complete passivity of directors. He especially warned that a board staffed with 'shirtsleeve'directors who are close to management would prove to be an illusory form of protection in companies with a wide diffusion of stock ownership, where the boards are the only means of protecting shareholders against management.[51] In this way, managers 'came to be their own supervisors, and the stockholders were moved into a position of effective subservience to those who by tradition and law were their servants'.[52] This is an early—if dramatic—description of the classic agency conflict between managers and shareholders as owners of widely held public companies. Douglas was one of the first to discuss the different tasks directors should fulfill and to propose some rudimentary version of a monitoring board where directors who were independent from management should play a prominent role.[53] An early legislative attempt to install a certain portion of independent directors on the boards of special corporations—in this case, funds—can be found in the Investment Company Act of 1940. This type of regulation, however, remained an outlier for several decades.

In reality, inside directors—from within the company's rank and file and employed by it full time—dominated the corporate boards for the first half of the twentieth century. And even outside directors on the boards—those non-executive directors who were not employees of the company—who increasingly started to outnumber inside directors during the second half of the twentieth century were, until fairly recently, not independent but rather affiliated with the company and its management by interlocking directorships or on the basis of financial or other business relationships.[54] A managerialist model of corporate governance dominated the mid-twentieth century and especially the 1950s.[55] Boards played a passive role; their members were chosen and

50 W. O. Douglas, 'Directors Who Do Not Direct', *Harvard Law Review,* 47 (1934), 1305; the heading was also used a year earlier for a chapter in Samuel, *Shareholders' Money,* (note 46, above), at 111.

51 *Ibid.*, 1307.

52 *Ibid.*, 1308.

53 L. E. Mitchell, 'The Trouble with Boards', in F. C. Kieff and T. A. Paredes (eds.), *Perspectives on Corporate Governance* (Cambridge University Press, 2010) 17, 25.

54 An analysis of the different types of outside directors in US corporations in the 1960s can be found with M. L. Mace, *Directors: Myth and Reality* (Boston: Division of Research, Graduate School of Business Administration, Harvard Univ., 1971), 86 ff.

55 For detailed description see A. D. Chandler, *The Visible Hand: The Managerial Revolution in America,* 16th edn., (Cambridge, Mass: Belknap Press of Harvard Univ. Press, 2002).

dominated by the CEO and had little incentive to challenge him.[56] In short, the CEO got 'exactly the kind of boards he want[ed].'[57] The CEO regularly also held the post of the chairman of the board of directors. In this model, public corporations resembled some kind of bureaucratic hierarchy controlled by professional managers, while boards of directors acted as mere figureheads, and shareholders were mostly ignored.[58] From a comparative perspective, it is surprising how weak the position of the shareholder in US joint-stock companies was then and is still now.[59] Responsibility for the company lies squarely with the board and, as a rule, shareholders traditionally cannot even propose directors to be elected to the board.

The 1950s were a time of stakeholder capitalism in the US: management's objective was not focused exclusively on profit-making but also on balancing the different stakeholder interests while assuming a role as a central planner of the large corporations.[60] A 1961 survey among executive managers of large corporations showed that over 80% of these regarded it as their task not to act in the interest of shareholders alone, but also in the interest of employees and consumers.[61] This understanding of the senior management team allocating the firm's rents among its various stakeholders fits the role of the board of directors as an *advisory* board staffed with insiders and affiliated outsiders, such as bankers, suppliers and lawyers.[62] At their best, these boards served as sources of advice and counsel to the CEO without providing any monitoring; thus the famous study titled *Directors: Myth and Reality* published in 1971 observed that they 'were found *not* to perform the classical and generally accepted roles that are attributed to them.'[63] A monitoring board would have been simply an irritant in such a setting.

2. The Battle of the 1970s

Two watershed events sparked a dramatic change in the 1970s.[64] The first event was a pair of corporate scandals, which is unsurprising as corporate scandals have a storied history of sparking corporate law reform. The second event was an academic publication, which is somewhat surprising as, depressingly, academic publications rarely drive reforms. The initial corporate scandal was the sudden and completely

56 J. N. Gordon, 'The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices', *Stanford Law Review,* 59 (2007), 1465, 1511; Mace, *Directors: Myth and Reality,* (note 54, above), 86.

57 Mace, *Directors: Myth and Reality,* (note 54, above), 78.

58 S. M. Bainbridge, 'Director Versus Shareholder Primacy in New Zealand Company Law as Compared to U.S.A. Corporate Law' (2014), available at *http://ssrn.com/abstract_id=2416449.*

59 M. Roth, 'Unabhängige Aufsichtsratsmitglieder', *Zeitschrift für das gesamte Handels- und Wirtschaftsrecht,* 175 (2011), 605, 611.

60 Gordon, 'The Rise of Independent Directors', (note 56, above), 1511.

61 *Ibid.*, 1512 with further references.

62 *Ibid.*, 1513.

63 Mace, *Directors: Myth and Reality,* (note 54, above), 86.

64 For a detailed historical analysis see B. Cheffins, 'Corporate Governance Since the Managerial Capitalism Era', *Business History Review* (forthcoming), University of Cambridge Faculty of Law Research Paper No. 39/2015, available at *http://ssrn.com/abstract=2618480.*

unexpected financial collapse of Penn Central, a major railway company, in 1970. As it turned out, the company's directors did not have the slightest idea about the firm's financial troubles before its implosion; even worse, they had obviously not even tried to gather any relevant information about the financial state of the company.[65]

A second corporate scandal came when it was revealed in the course of the Watergate hearings that hundreds of companies had made 'questionable payments', namely illegal campaign contributions, as well as outright bribes in and outside of the US.[66] This scandal swept the issue of the role of the corporation as an institution into the highly controversial political debate of the day.[67] The movement for corporate social responsibility was spearheaded by (among others) the consumer rights activist Ralph Nader, co-author of the then-famous book *Taming the Giant Corporation,*[68] which made the corporation and, particularly, the unrestrained powers of its management responsible for various social ills.[69] This created additional pressure for company law reform as Nader put part of the blame on the dysfunctional boards of directors. However, Nader's proposal to create a cadre of full-time professional directors whose members should be exclusively allowed to sit on boards went nowhere.[70]

Nevertheless, these pressures led to a profound re-conceptualization of the board's role and structure.[71] The academic publication that presented the 'monitoring model' of the board of directors and paved the way for its gradual rise was Melvin Eisenberg's influential book *The Structure of the Corporation,* published in 1976.[72] According to Eisenberg, the board's essential function was to monitor senior management—more precisely, to select, monitor, and remove the members of the chief executive's office.[73] This was exactly what had *not* happened in the past. Eisenberg regarded all other functions of the board, such as advising the CEO or authorizing major corporate decisions, as being of minor importance or as being merely pro forma.[74] In his view, the board needed to be truly independent from the executives it was supposed to monitor to

65 An investigation by the SEC unearthed these and other troubling findings. *SEC Staff Study of the Financial Collapse of the Penn Central Co.: Summary* (1972-73 Transfer Binder), Fed. Se. L. Rep. (CCH) ¶ 78,931 (1972).
66 Gordon, 'The Rise of Independent Directors', (note 56, above), 1516 f.
67 S. M. Bainbridge, *Corporate Governance After the Financial Crisis* (Oxford University Press, 2012), 51.
68 R. Nader, M. (J.) Green and J. Seligman, *Taming the Giant Corporation* (New York: Norton, 1976).
69 *Ibid.*, 62 ff.
70 Bainbridge, *Corporate Governance,* (note 67, above), 52. But, interestingly, a comparative idea with respect to professionalism was promoted in 2014: permitting firms to provide board services as professional ''board service providers'', see S. M. Bainbridge and M. T. Henderson, 'Boards-R-Us: Reconceptualizing Corporate Boards', *Stanford Law Review,* 66 (2014), 1051.
71 Gordon, 'The Rise of Independent Directors', (note 56, above), 1518 ff.
72 M. A. Eisenberg, *The Structure of the Corporation: A Legal Analysis* (Boston: Little, Brown & Co., 1976).
73 *Ibid.*,162 ff.
74 *Ibid.*, 157 ff.

fulfill its monitoring task, and it needed to be in a position to obtain all information necessary for this task.[75]

By the end of the 1970s, after a prolonged, intense, and sometimes vicious discussion, business circles finally accepted the inevitability of a monitoring board at least partly staffed with independent directors.[76] The Securities and Exchange Commission (SEC) had endorsed the model from the start and requested in 1976 that the New York Stock Exchange (NYSE) amend its listing requirements to include an audit committee composed of independent directors, which it did in 1977. The controversy about the role of independent directors in corporate governance flamed up again with all its intensity in 1982 when the American Law Institute published the first tentative draft of its planned *Principles of Corporate Governance*. Eisenberg was the reporter for the first sections of the Proposals that, among other ideas, envisioned an extended role for independent directors.[77] In the end, the final Principles retained the basic division between the monitoring and the managing functions of the board though under different terminology, whereas the initially proposed mandatory rules for the composition of the boards were changed into mere recommendations.[78] Nevertheless, the Principles became highly influential, and the monitoring board model evolved into being part of best corporate practice.

The outcome of the corporate governance reforms of the 1970s was mixed: managerial elites made significant concessions, but at the same time they were able to hold onto the important managerial prerogative over the composition and actual functioning of the board.[79] While the new rhetoric of monitoring independent directors was widely accepted, real change in the habits and practices of the board had just begun.[80] There is also another, somewhat darker interpretation of the changes. In this reading, from the beginning of the discussion, business circles were interested only in making use of the monitoring board as a shield to protect directors from serious threats of legal liability, a plan that ultimately succeeded.[81]

3. Success of the Monitoring Model

When a wave of hostile takeovers re-shaped the corporate landscape in the US in the 1980s by making use of the market for corporate control, the Delaware courts, where most of the takeover-related court proceedings took place, were quick to make use of the fact that the majority of large companies by then had embraced the monitoring

75 *Ibid.*, 170; Eisenberg discussed the two-tier board system as an alternative governance structure (177 ff.).
76 For an excellent and concise analysis of the political debate surrounding Eisenberg's proposals, see Mitchell, 'The Trouble with Boards', (note 53, above), 34–53.
77 Bainbridge, *Corporate Governance,* (note 67, above), 54 f. with further references.
78 *Ibid.*, 57 with further references.
79 Gordon, 'The Rise of Independent Directors', (note 56, above), 1519.
80 *Ibid.*
81 Mitchell, 'The Trouble with Boards', (note 53, above), 34 f., 44 f., 52 f., 59.

model with outsider-staffed boards.[82] Now the protective side effect of the model became clear. In a string of decisions throughout the 1980s, Delaware courts established the practice of looking *only* at the process of decision-making in the target company but *not* into the substance of the deal. Thus, a properly composed board that behaved in accordance with the model and exercised at least a formally independent judgment was allowed to 'just say no' to a hostile bid that would favor the target's shareholders without having to fear any liability.[83] This is an outcome that would be unthinkable in the corporate governance world of the UK, where the target's board is supposed to be neutral and not frustrate the decision of the shareholders in any way.[84] The hostile takeover movement in the US focused attention on shareholder value as the ultimate management objective. The managerial elite that was previously critical of independent directors started to welcome them as an essential part of shareholder capitalism.[85]

4. Scandals, Crises, and Reforms after 2000

The focus on the maximization of shareholder value and the independent board became characteristic of the corporate world of the 1990s. The time of stakeholder capitalism and insider-dominated boards was gone for good. By 2000, 78% of the directors of US public companies were independent and 23% of the companies had a non-executive chairman.[86] The monitoring model obviously had taken root in the corporate world, but it was far from being a cure-all at a time when the collapse of Enron, WorldCom, and other corporate failures came to the awareness of a shocked public at the beginning of the new millennium. A cynical observer might be tempted to note that the circumstances leading to the implosion of these firms eerily resembled those of the collapse of Penn Central some 30 years earlier, but this time the board of directors, which again obviously had no idea what was going on in the companies they were expected to monitor, was composed not of a mix of inside and some affiliated outside directors but

82 For a detailed analysis of the role the Delaware courts played in promoting the role of independent directors see B. R. Cheffins, 'Delaware and the Transformation of Corporate Governance', *The University of Cambridge Faculty of Law Legal Studies Research Paper Series,* Paper No. 64/2014, November 2014, available at *http://ssrn.com/abstract=2531640,* 39 ff..

83 Mitchell, 'The Trouble with Boards', (note 53, above), 55 with further references; another critical analysis can be found with Pan, 'Rethinking the Board's Duty to Monitor', (note 22, above).

84 Cf. General Principle 3 of the British Takeover Code: "The board of an offeree company must act in the interests of the company as a whole and must not deny the holders of securities the opportunity to decide on the merits of the bid", and Rule 21.1: "During the course of an offer, or even before the date of the offer if the board of the offeree company has reason to believe that a bona fide offer might be imminent, the board must not, without the approval of the shareholders in general meeting: (a) take any action which may result in any offer or bona fide possible offer being frustrated or in shareholders being denied the opportunity to decide on its merits; …".

85 Gordon, 'The Rise of Independent Directors', (note 56, above), 1526.

86 Velikonja, 'Political Economy of Board Independence' (note 1, above), 857 with further references.

mostly of *independent* directors.[87] Though a major part of the blame for the scandals can be attributed to the failure of the gatekeepers, especially the accountants, the events showed the deficits of the governance system developed in the 1990s featuring the independent monitoring board at its core.[88] The boards involved obviously did not realize the risks and moral hazard problems inherent in stock option-based compensation.

The US lawmaker's answer was more of the same: increasing the level of independence within company boards. The lawmaker in this case was the Congress, and the vehicle was securities regulation. As the authority for company law legislation lies with the states, Congress can only make use of securities regulation that applies for public—and especially listed—companies. In effect, this leads to a creeping federalization of US company law.

Congress can further empower the SEC to set standards and to require the exchanges to implement the corresponding changes in their listing rules. All this happened in the wake of the Sarbanes-Oxley Act of 2002, at the center of which stood the monitoring model, which was thus in effect codified.[89] As a result of the reform, boards of listed companies have to be composed of a majority of independent directors, and the audit committee must be fully independent. Also, the standards of director independence were raised. Later, the Dodd-Frank Act of 2010—which was the legislative reaction to the 2008 Global Financial Crisis (amongst other things)—further enhanced the role of independent directors by demanding that compensation committees be composed entirely of independent directors.

It is important to note that these enhanced standards were made applicable to diffusely held public companies *only,* but *not* to controlled companies where a shareholder (or a coordinated group of shareholders) holds more than 50% of the voting rights.[90] In this sense, the US has clearly made the decision that the primary function of independent directors is to monitor management on behalf of dispersed shareholders who are—unlike a controlling shareholder—prevented from doing so themselves as a result of their own collective action problems. The flip side of the same coin is that the United States has clearly envisaged independent directors to be of limited or no value when there are controlling shareholders (as a controlling shareholder can monitor and, if need be, replace management or manage the company themselves).

5. Super-Majority Boards

Interestingly though, by the time the legal changes came into force, most companies had already adapted to these standards. Furthermore, without being forced to do so by law, regulations, or listing rules, by the early 2010s a multitude of companies had installed

87 The head of Enron's audit committee was a professor of accounting at Stanford University whom one might regard as highly qualified for the job; *cf.* Bainbridge, *Corporate Governance,* (note 67, above), at 92.

88 Gordon, 'The Rise of Independent Directors', (note 56, above), 1535, 1538.

89 Bainbridge, *Corporate Governance,* (note 67, above), 59 f.

90 Section § 303 A, NYSE Listed Company Manual 2016, available at *http://nysemanual.nyse.com/lcm.*

so-called ‘super-majority boards’ with only one remaining inside director who was not independent, normally the CEO. In 2013, approximately 60% of the public companies had such super-majority boards and, in general, 85% of all directors were independent.[91]

This comes as a surprise given the decade-long apprehension on the side of management surrounding independent boards. At first blush, the fact that business circles seem to have embraced and to have gained faith in independent boards appears to be shareholder friendly. The true reasons, however, may be less so. Adopting independent nominating committees helps to avoid regulation that would empower shareholders—anathema to corporate management—in the nomination process.[92] Adopting super-majority boards actually helps the CEO, who in US corporations usually serves as chair, to steer the flow of information about the company. Independent directors lack a material relationship with the company. Accordingly, they do not have independent access to information about the company’s internal matters. Once there are no inside directors left on the board, the independent directors have no real alternative other than to rely more or less exclusively on information supplied by the CEO.[93] In this way, independency creates dependency.[94]

6. The Arrival of Agency Capitalism

This leads us to the observation that the discussion in the US about the benefits and detriments of independent boards is framed by the wider and more general discourse about the balance of power between boards and shareholders as a group.[95] While some propose to empower shareholders and increase their role in corporate governance,[96] others object and insist on (continuing) director primacy.[97] This discourse, in turn, has to be seen in the context of a major change in the shareholder structure of US corporations. Whereas unsophisticated observers often still associate the US stock market with widely dispersed individual (household) ownership matching the pattern described by Berle and Means in the 1930s,[98] the current reality shows a different picture: an increasing re-concentration of institutional ownership. Over the last three decades, a shift of shareholdings from individual owners to concentrated institutional

91 Velikonja, ‘Political Economy of Board Independence’ (note 1, above), 857 f. with further references.

92 Gordon, ‘The Rise of Independent Directors’, (note 56, above), 1539; Velikonja, ‘Political Economy of Board Independence’ (note 1, above), 860.

93 Brown, ‘The Demystification of the Board of Directors’, (note 22, above), 35 ff.

94 Druey, ‘Unabhängigkeit’, (note 18, above), 163, 169.

95 K. Greenfeld, ‘The Third Way: Beyond Shareholder or Board Primacy’, *Seattle University Law Review,* 37 (2014), 749.

96 One of the leading proponents of shareholder empowerment is L. Bebchuck. See, for example, L. Bebchuck, ‘The Case for Increasing Shareholder Power’, *Harvard Law Review,* 118 (2005), 833.

97 The leading advocate for director primacy is S. M. Bainbridge. See, for example, S. M. Bainbridge, ‘Director Primacy and Shareholder Disempowerment’, *Harvard Law Review,* 119 (2006), 1735.

98 A. A. Berle and G. C. Means, *The Modern Corporation and Private Property* (New York: Commerce Clearing House, 1932).

owners in the form of financial intermediaries could be observed, something that has been aptly described as the 'rise of agency capitalism'.[99]

By 2009, the top 1,000 largest US corporations had an average institutional holding of 73%.[100] A characteristic feature of this particular structure of concentrated institutional ownership, which is claimed to be different from block holdings observed elsewhere,[101] is the passivity of these owners with respect to corporate governance—although they are confronted with much lower collective action costs than individual owners.[102] This behavior is not the common "rational apathy" of individual minority shareholders but rather some kind of "rational reticence" caused by the institutions' underlying business model: as a rule, they will not initiate governance proposals, but they are likely to vote for them if other activist shareholders such as hedge funds bring these to the table.[103] The change in ownership gives rise to a new set of agency costs, the "agency costs of agency capitalism". This new set of agency costs arises out of the additional agency problem existing between the households investing in an investment intermediary—like a mutual fund—as beneficial owners and the fund's management; these costs are in addition to the agency costs between the funds as record owners and the company they are invested in.[104] The main reason for a shift in ownership was a change in the nature of retirement savings in the United States, with a move from government social security to private pension funds. This was in addition to a change in the employer-provided pension plans, their switching from the form of defined benefit pensions to defined contribution plans, thus shifting the investment risk from the employer to the employees.[105] Most of the equity investment is held by mutual funds.[106]

7. Shift to a Shareholder-Centric System?

Some interpret the re-concentration of institutional ownership in the US as a paradigmatic shift away from a manager-centric to a shareholder-centric system.[107] Whereas in a manager-centric environment the major agency conflict is between managers and dispersed shareholders, the prominent agency conflict in a shareholder-

99 R. J. Gilson and J. N. Gordon, 'The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights', *Columbia Law Review,* 113 (2013), 863. One of the first analyses of this change was R. C. Clark, 'The Four Stages of Capitalism: Reflections on Investment Management Treatises', *Harvard Law Review,* 94 (1981), 561.

100 Gilson and Gordon, 'Agency Capitalism', (note 99, above), 875 with further references.

101 *Ibid*., at 876.

102 *Ibid*.

103 Ronald J. Gilson & Jeffrey N. Gordon, 'Agency Capitalism: Further Implications of Equity Intermediation', *ECGI, Law Working Paper N° 239/2014*; available at *http://ssrn.com/abstract=2359690; see* also Paul Edelman, Randall Thomas & Robert Thompson, 'Shareholder Voting in the Age of Intermediary Capitalism', 87 *Southern California Law Review* (2014), 1359.

104 Gilson & Gordon, (note 93, above), at 867.

105 *Ibid.,* at 878 ff.

106 *See ibid.,* at 884 ff. for details.

107 E. B. Rock, 'Adapting to the New Shareholder-Centric Reality', *University of Pennsylvania Law Review,* 161 (2013), 1907.

centric system is between shareholders and creditors.[108] According to this view, the former agency conflict is by and large solved, though less by law than through changes in the market and corporate practices such as shareholder concentration and activism as well as through changes in managerial compensation, board composition, and other things.[109] In this view, managers and directors are now regarded as largely 'think[ing] like shareholders.'[110]

If this is the case, then today's governance problems in the US corporate world are possibly not those that are likely to be solved alone or perhaps even primarily by the independent monitoring board. In this vein, some critics argue that board independence actually only serves the political goal of deflecting substantive regulation that might limit rent-seeking in favor of managers and shareholders alike while putting other stakeholders at a disadvantage.[111] Accordingly, independent boards are seen, at best, as a weak constraint on the ability of managers to impose negative externalities on stakeholders other than shareholders.[112]

8. Too Much of a Good Thing?

Other critics articulate fundamental doubts about whether the board system as an institution, especially in the form of the monitoring board, is and can structurally be more than 'façade corporate governance' providing a 'false sense of security for all those dependent upon the corporation' in the light of the complexity of the modern corporation.[113] Before the establishment of the monitoring board, people at least 'knew that the top corporate officers were the center of corporate power'.[114] One of the possible solutions that arises in the context of this discussion is a 'return to boards with real managerial powers.'[115]

Stephen Bainbridge, a leading proponent of 'director primacy'—as a third alternative to manager primacy and shareholder primacy—[116]criticises the present US practice on similar grounds. Though an ardent supporter of the board system who regards group decision makers as superior to individual decision makers, he is highly

108 The third classical agency conflict is between controlling and non-controlling shareholders, see R. Kraakman, J. Armour, P. Davies, L. Enriques, H. Hansmann, G. Hertig, K. Hopt, H. Kanda and E. Rock, *The Anatomy of Corporate Law. A Comparative and Functional Approach,* 2nd edn., (Oxford University Press, 2009), 36.

109 Rock, 'New Shareholder-Centric Reality', (note 107, above), 1909 f.,1917–1926, showing in great detail how the various corporate ills ranging from empire building and captured boards to the undermining of hostile takeovers by staggered boards are mostly problems of the past.

110 *Ibid.*, 1910.

111 Velikonja, 'Political Economy of Board Independence' (note 1, above), 860 f.

112 *Ibid.*, 862.

113 Mitchell, 'The Trouble with Boards', (note 53, above), 59 f.

114 *Ibid.*, 60.

115 *Ibid.*, 61; others, however, claim that greater board independence leads to more rigorous CEO monitoring, see L. Guo and R. W. Masulis, 'Board Structure and Monitoring: New Evidence from CEO Turnover', *Review of Financial Studies,* 28 (2015), 2770.

116 Bainbridge, 'Director Versus Shareholder Primacy', (note 58, above), 3 ff., with further references.

skeptical of over-emphasizing the board's monitoring function and its mandatory independence.[117] In his view, the monitoring model suffers from a crucial deficit: the erroneous assumption that monitoring and management can be separated in any sensible way that improves performance.[118] In practice both are "inextricably intertwined" as the power to review encompasses the power to decide, and the board's role in affirming strategic corporate decisions, for example, should accordingly be regarded as "an executive and managerial one, rather than one of mere oversight."[119] Managing directors are better informed than outsiders, who inevitably suffer from an information asymmetry lacking informal information networks; these will worsen if relations between an outside board and managers turn adversarial.[120] Seen from the objective of efficient decision-making, independence might not be desirable.[121] As one size does not fit all companies, he believes the creation of overly formalized mandatory independent monitoring boards applicable to all public companies should be abolished in favor of more flexible boards governed by rules that enable.[122]

This criticism challenges essential parts of the corporate revolution that Eisenberg's analysis shaped some 40 years ago. US corporate governance might have arrived at a crossroads regarding independent monitoring. Nevertheless, at least so far, for the majority in the US the independent director appears to still be seen as a panacea which is well-suited to address a panoply of corporate governance ills.

We now turn in a much briefer fashion to Europe and begin with an analysis of the UK, which, in the wake of the recent financial crisis and corporate failures the US, drew somewhat different lessons regarding independent boards from the corporate failures.

IV. The Rise of Independent Directors in Europe

1. The UK: Taking the Lead

Shareholdings in UK listed companies are normally not concentrated; instead they are 'semi-dispersed' with international investors (the majority of which are probably also institutions) by now holding over 50% alongside domestic institutional shareholders

117 Bainbridge, *Corporate Governance,* (note 67, above), 75.

118 Ibid*.,* 63 ff. In the collapse of the once famous Canadian network supplier Nortel in 2009, some blame was given to the fact that its board was stuffed with independent directors with no experience of the company's specific business; see P. M. Vasudev, 'Independent Directors sank Nortel', *Financial Post,* October 22, 2014, available at *http://business.financialpost.com.*

119 *Ibid.,* at 62 f.

120 *Ibid.,* at 63 f.

121 *Ibid.,* at 88; similar skepticism can be found in Europe, *cf.,* e.g., Druey, 'Unabhängigkeit', (note 18, above); Winter, 'The Financial Crisis: Does Good Corporate Governance Matter and How to Achieve it?', (note 19, above), 376.

122 *Ibid.,* at 65; for a more nuanced view see M. M. Blair, 'Boards of directors and corporate performance under a team production model', in J. G. Hill and R. S. Thomas (eds.), *Research Handbook of Shareholder Power* (Edward Elgar 2015) 249 ff.

holding another 40% of the shares.[123] A similar shift from individuals to institutional investors can be observed in the US.[124] The institutional and regulatory setup in both jurisdictions is, however, completely different. First, the balance of power between shareholders and boards of directors tips in favor of the boards in the US.[125] In Britain, shareholders are in a more powerful position as they may, among others things, propose directors for nomination or remove serving directors and install a new board independent of the intentions of the incumbent board.[126] From a US perspective, this balance of power is perceived as 'shareholder-centric'.[127]

Second, whereas the US uses mandatory law to regulate corporate governance via federal securities regulation and the corporation law of the individual states, in the UK rules made by statutory bodies are much more important than legal ones.[128] Accordingly, the Companies Act 2006 provides little mention of the structure, composition, and function of boards; it assumes the existence of a single tier board without even mandating it.[129] The central piece of regulation in the area of corporate governance is the UK Corporate Governance Code, which currently is administered by the Financial Reporting Council.[130] It embraces the independent monitoring board model and provides explicit rules on board composition. However, as the Code adheres to the 'comply-or-explain' principle that had its genesis in an earlier version of the Code, companies may deviate from these rules if they provide an explanation for doing so. The 'comply-or-explain' principle is enforced by the listing rules of the London Stock Exchange.

The UK's adoption of the monitoring board model is fairly recent.[131] As in the US, the typical British board of the 1950s was an advisory board composed of insiders and framed by a managerialist governance system. The dramatic events that shaped

123 For figures for 2012, see P. L. Davies, 'Shareholders in the United Kingdom', ECGI Working Paper No. 280/2015; P. L. Davies, 'Corporate Boards in the United Kingdom' in P. L. Davies, K. J. Hopt, R. Nowak and G. van Solinge (eds.), *Boards in Law and Practice* (Oxford University Press, 2013), 713, 714 f., both with further references.

124 See *supra* text accompanying notes 99 f.

125 See *supra* text accompanying notes 95 ff.

126 P. L. Davies and S. Worthington, *Gower and Davies' Principles of Modern Company Law,* 9th edn., (London: Sweet and Maxwell, 2012), 436; for a comparative overview see K. J. Hopt, 'Directors' Duties and Shareholders' Rights in the European Union: Mandatory and/or Default Rules?', ECGI Law Working Paper 312/2016, available at *http://ssrn.com/abstract=2749237* or *http://dx.doi.org/10.2139/ssrn.2749237.*

127 Rock, 'New Shareholder-Centric Reality', (note 107, above), 1978. A shared problem is that institutional shareholders are rather passive owners. For the US and the UK respectively, see Gilson and Gordon, 'Agency Capitalism', (note 99, above), 876; Davies, 'Shareholders in the United Kingdom', (note 123, above), 14 ff.

128 Davies, 'Corporate Boards in the United Kingdom', (note 123, above), 716.

129 *Ibid.*, 716 f.

130 Financial Reporting Council, *The UK Corporate Governance Code* (September 2014), available at *http://frc.org.uk.*

131 For a detailed historical analysis see B. R. Cheffins, 'The Rise of Corporate Governance in the UK: When and Why', *Current Legal Problems* (2015), available at *http://dx.doi.org/10.1093/clp/cuv006.*

corporate governance in the US during the 1970s and 1980s were largely absent in the UK (as in the rest of Europe). It was industry and not the government that first promoted the concept of monitoring by non-executive (though at first not necessarily independent) directors in the early 1980s.[132] Things started to change with the report of the Committee on Financial Aspects of Corporate Governance in 1992. The Committee was set up by the financial industry in 1991 after a series of corporate scandals became public, and it was chaired by Sir Adrian Cadbury.[133]

The Committee's so-called Cadbury Report soon attracted international attention.[134] It was the beginning of the British corporate governance movement.[135] The Committee had identified the domination of many companies by a single, highly powerful CEO as a central governance problem.[136] Accordingly, the Cadbury Code of Best Practices proposed a board staffed with a sufficient number of non-executive directors. It was suggested that a majority of these be independent. Three non-executive directors were obviously regarded as a minimum requirement.[137] Some core elements of the conception of an independent monitoring board were without doubt 'imported' from the US, the 'first mover' of corporate governance.[138]

The Cadbury Code of Best Practices was reviewed six years later, in 1998, by the Hampel Committee, which ultimately suggested combining the Cadbury recommendations with the 1995 recommendations made by the Greenbury Committee regarding directors' remuneration.[139] The resulting Combined Code was in turn revised in 2006, following the recommendation of the 2003 Higgs Report. The British government had initiated this report in the wake of the Enron and other scandals in the US. The 2006 revision of the Combined Code recommended that now half of the board members of large companies should be independent non-executive directors. In the years between 2001 and 2009 the number of independent directors on the boards of companies listed in the UK oscillated around the high benchmark of 90%.[140]

In 2010, the Combined Code was transformed into the present UK Corporate Governance Code. Interestingly, the strong emphasis on independent non-executive directors as an antidote to an individual or a small group of individuals dominating the board[141] was changed to the recommendation that 'the board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the

132 Zhao, *Corporate Governance and Directors' Independence,* (note 27, above), 30 f.
133 B. R. Cheffins, 'The History of Corporate Governance', *ECGI Law Working Paper No. 184/2012,* available at *http://ssrn.com/abstract=1975404,* 19 f; Cheffins, 'The Rise of Corporate Governance in the UK', (note 131, above).
134 C. Jordan, 'Cadbury Twenty Years on', *Villanova Law Review,* 58 (2013), 1.
135 Davies and Worthington, *Principles of Modern Company Law,* (note 126, above), 424.
136 *Ibid.*, 424 f.
137 Davies, 'Corporate Boards in the United Kingdom', (note 123, above), 738.
138 Cheffins, 'The Rise of Corporate Governance in the UK', (note 131, above), 3.
139 For the history of the various codes see Davies and Worthington, *Principles of Modern Company Law,* (note 126, above), 425 f.; Cheffins, 'The Rise of Corporate Governance in the UK', (note 131, above).
140 Roth, 'Unabhängige Aufsichtsratsmitglieder', (note 59, above), 616 with further references.
141 Main Principle A3, Combined Code 2006.

company to enable them to discharge their respective duties and responsibilities effectively'.[142] It comes as no surprise that by 2011 the number of independent directors on the boards of companies listed in the UK had sunk to 61% in reaction to this change.[143]

The major regulatory change has to be seen in connection with the Walker Review published in 2009 in the wake of the Global Financial Crisis.[144] The Review recommended that financial firms in need of expertise need not be bound to the Code's recommendation of having half their board composed of independent directors. This is an instructive example of how expertise is presently gaining ground in comparison to independence when it comes to board composition.[145]

The post-crisis reform shows a significant discontinuity from the US concept of strict independence that has resulted in the dominance of super-majority independent boards.[146] In general, it has been observed that the average European Union corporate board increasingly resembles the average US board in two aspects: size and gender diversity, two areas where the European companies have being gaining ground.[147] However, regarding board independence, while the gap between the US and the European Union was always visible on average (though until recently less so for the UK), it dramatically increased between 2000 and 2010 from 19% to around 40%.[148]

Three other characteristic features of the UK Corporate Governance Code are: (i) that the positions of CEO and chair of the board should not be exercised by the same individual as both roles are regarded as being distinct;[149] (ii) that the chairman should hold meetings with the independent non-executive directors without executive directors being present;[150] and (iii) that the board should appoint one of the independent non-executive directors as the senior independent director who will be available as a contact person for the chair, the other independent directors, and shareholders who would like to contact the board (i.e., there should be a 'lead independent director').[151] An additional

142 Main Principle B, Corporate Governance Code 2014. The Principle is the same in the 2010, 2012, and 2014 editions of the CGC.
143 Roth, 'Unabhängige Aufsichtsratsmitglieder', (note 59, above), 616.
144 Sir David Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (2009), available at *www.hm-treasury.gov.uk.*
145 Davies, 'Corporate Boards in the United Kingdom', (note 123, above), 739; S. M. Le Mire, 'Independent Directors: Partnering Expertise with Independence', *Journal of Corporate Law Studies,* 16 (2016), 1.
146 G. Ferarini and M. Filippelli, 'Independent directors and controlling shareholders around the world', *ECGI Law Working Paper No. 258/2014,* available at *http://ssrn.com/abstract=2443786, 7.*
147 Ferreira and Kirchmaier, 'Corporate boards in Europe', (note 12, above), 198.
148 *Ibid.*
149 Principle A.2.1., Corporate Governance Code 2014; Davies and Worthington, *Principles of Modern Company Law,* (note 126, above), 428.
150 Principle A.4.2., Corporate Governance Code 2014.
151 Principle A.4.1, Corporate Governance Code 2014; Davies and Worthington, *Principles of Modern Company Law,* (note 126, above), 429; in the US, exchange listing standards require the appointment of an independent lead director if the CEO chairs the board. Bainbridge, (note 60, above), 104 f.

new feature came with a revision of the UK listing rule in 2014. Since then, a proposed independent director voted for by a majority vote needs to be appointed by a second separate vote by minority shareholders only.[152]

The UK Corporate Governance Code puts the decision of whether a director qualifies as independent in the hands of the board.[153] The board should determine whether the director is independent in character and judgment and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgment.[154] Furthermore, the board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination, including if the *director*:

– has been an *employee* of the company or group within the last five years;
– has, or has had within the last three years, a *material business relationship* with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
– has received or receives *additional remuneration* from the company apart from a director's fee, by participating in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
– has close *family ties* with any of the company's advisers, directors or senior employees;
– holds *cross-directorships* or has significant links with other directors through involvement in other companies or bodies;
– represents a *significant shareholder*; or,
– has served on the board for *more than nine years* from the date of his or her first election.[155]

It is noteworthy that, as a rule, being a representative of a significant shareholder excludes independence.[156] Here again, we see a stark contrast to the US regulatory regime of board composition where a relationship with a major shareholder does *not* exclude independence. To the contrary, as explained above, US companies with a majority block shareholder are exempt from the requirement that listed companies must have a majority of independent directors on their board.[157]

The shift from independence to competence and expertise was a quick and pragmatic reaction to the Global Financial Crisis. This reinforces the observation that the pro-active and business oriented stance regarding non-executive directors and subsequently independent non-executive directors in Britain is probably the main reason

152 UK Listing Rule 9.2.2A R and 9.2.2E R.
153 Davies, 'Corporate Boards in the United Kingdom', (note 123, above), 740.
154 Principle B.1.1, Corporate Governance Code 2014.
155 *Ibid.*
156 For a significant critique of this rule, see J. L. Hansen, 'Active Owners and Accountable Directors', in H. S. Birkmose, M. Neville and K. E. Sørensen (eds.), *Boards of Directors in European Companies: Reshaping and Harmonising their Organisation and Duties* (Kluwer Law International, Alphen aan den Rijn, 2013), 241, 250 ff.
157 See *supra* text accompanying note 90.

for the international success of the flexible British model of corporate governance.[158] This contrasts with the rather grudging acceptance of the corporate reforms in the US under public, administrative, and federal pressure. Though the UK was late to embrace the independent monitoring model pioneered by the US, it was able to make considerable refinements to the independent monitoring model.

2. The EU: Building on the UK Experience

For better or worse,[159] the Cadbury Report set corporate governance standards in the European Union. A corporate governance code with its 'comply-or-explain' principle is, with slight variations, now ubiquitous in the Member States.[160] The concept of having at least some independent non-executive directors on the board also became, albeit somewhat hesitantly, a European standard.

The European Commission dealt with the role of non-executive or supervisory directors in general in 2005 in the form of a non-binding Recommendation.[161] The Recommendation closely follows the former UK Combined Code by recommending the adoption of 'an appropriate balance of executive/managing and non-executive/ supervisory directors such that no individual or small group of individuals can dominate decision making'.[162] The number of independent non-executive or supervisory directors elected to the (supervisory) board of companies should be sufficient to ensure that any material conflict of interest involving directors could be properly dealt with.[163] The Recommendation provides a definition of independence:

> [a] director should be considered to be independent only if he is free of any business, family or other relationship, with the company, its controlling shareholder or the management of either, that creates a conflict of interest such as to impair his judgment.[164]

The decision whether a director qualifies as independent is assigned to the board, as in the UK.[165] Annex II to the Recommendation sets out a list of negative criteria that would threaten a director's independence. By and large these are, notwithstanding some minor variations, almost identical with the relationships or circumstances listed in the

158 Zhao, *Corporate Governance and Directors' Independence,* (note 27, above), 35; for a much less benign view of the achievements of the Cadbury Report, see Hansen, 'Active Owners and Accountable Directors', (note 156, above), 249: 'Rather than seeing the Cadbury Report as state-of-the-art regulation, it was in fact a rear guard action to avoid legislative encroachment on the status quo'.
159 Hansen, 'Active Owners and Accountable Directors', (note 156, above).
160 See, e.g., Patrick C. Leyens, ‚Comply or Explain im Europäischen Privatrecht', *ZEuP* 2016, 389.
161 Commission Recommendation (2005/162/EC) of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, OJ L 52/51 [hereinafter 'European Commission Recommendation']
162 Section 3.1, European Commission Recommendation; for the former corresponding British rule, see *supra* text accompanying notes 129 f.
163 Section 4, European Commission Recommendation.
164 Section 13.1, European Commission Recommendation.
165 Section 13.2, European Commission Recommendation.

UK Corporate Governance Code. As noted above, the recommendations are not binding, and they have not, for instance, been adopted by either the German Stock Corporation Act or the German Corporate Governance Code.

As a reaction to the General Financial Crisis, European Union legislation became more stringent. A 2014 Directive makes a majority of independent directors and an independent chair mandatory for audit committees of public-interest companies.[166]

Largely independently of the European Commission, a group of European scholars drafted a European Model Company Act (EMCA). The final draft of the Act was published in 2015.[167] Section 5 of the Act recommends that the board of a traded company should comprise an appropriate balance of independent non-executive directors. The EMCA does not provide its own definition of independence, instead referring to the 2005 Recommendation of the European Commission and thus, in effect, to the Combined Code of the UK.[168]

3. Germany: Quick on Outside Directors, Slow on Independent Ones

As already mentioned, Germany was probably the first jurisdiction to establish a formalized separation between management and supervision in as early as 1861.[169] Since then, the German corporate governance system has been characterized by the two-tier board structure.[170]

The management board is exclusively staffed with executive directors. It has direct responsibility for the management of the company.[171] The board has to serve the ‘interest of the company’ but has wide discretion how to achieve this objective. The interest of the company encompasses actually a plurality of interests: those of

166 Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, [2014] OJ L158/196. This Directive modifies, *inter alia,* Art. 39 of the EU Accounting Directive.

167 European Model Company Act Group, *The European Model Company Act (EMCA) Draft 2015,* (note 3, above). An earlier pan-European project was the *Corporate Governance Principles and Recommendations* published in 2000 by the European Association of Securities Dealers, which recommended that there ‘should be a sufficient number of board members …… who are independent of management, influential shareholders and other conflicting interests’ (Recommendation VI. 1. b.).

168 See *supra* text accompanying note 161 f.

169 See *supra* text accompanying notes 48 f.

170 For a comparative discussion in English see K. J. Hopt, ‘The German Law of and Experience with the Supervisory Board’, *ECGI Working Paper No. 305/2016,* available at *http://ssrn.com/abstract=272270,* 2; Roth, ‘Corporate Boards in Germany’ (note 48, above); J. J. du Plessis, B. Großfeld, I. Saenger and O. Sandrock, ‘An Overview of German Business or Enterprise Law and the One-Tier and Two-Tier Board Systems Contrasted’, in J. J. du Plessis, et al (eds.), *German Corporate Governance in International and European Context,* 2nd edn., (Heidelberg: Springer, 2012) 1 ff. For a comparative analysis of the German and the British board models, see P. C. Leyens, ‘Aufsichtsrat: Terra incognita des englischen Gesellschaftsrechts?’, in S. Grundmann et al (eds.), *Unternehmen, Markt und Verantwortung. Festschrift für Klaus J. Hopt zum 70. Geburtstag am 24. August 2010,* Vol. 2, (Berlin: De Gruyter, 2010), 3135 ff.

171 Section 76, Stock Corporation Act (*Aktiengesetz*).

shareholders, labor, and the public interest (*Gemeinwohl*). The interests of (other) specific stakeholders, such as creditors or suppliers, are not included. Increasing shareholder value is *not* an exclusive objective, though it probably has become the most important as traditional debt financing became less and the capital markets became more important; details are disputed depending on the political preferences of the proponents.[172]

By contrast, from the very beginning the law required the supervisory board to be composed exclusively of outside non-executive directors.[173] The tasks of the supervisory board are usually regarded as twofold: *ex post* monitoring of the management board and *ex ante* advising on business strategy. Arguably, the latter is in substance a form of proactive or preventative monitoring, which makes it impossible to separate the two functions into two distinct watertight compartments.[174]

Being an outside director does not, of course, mean the same thing as being an independent director. Rather, the non-executive directors staffing the supervisory board were—and to some extent still are—typically either affiliated with the company and its management or were constituency directors representing major shareholders. Accordingly, the traditional structure has been aptly described as an 'insider system' of corporate governance.[175] This pattern corresponded with the widespread block-holding structure existing until the partial dissolution of what was dubbed 'Germany Inc.' from the late 1990s onwards.[176] But even today we see a strong and prevailing presence of group affiliation and block-holding families among listed companies. The latter feature is also characteristic of many Asian companies.[177]

Since the introduction of enterprise co-determination in 1976, half of the supervisory board members of large companies are, by law, constituency directors

172 H. Merkt, 'Germany. Internal and External Corporate Governance', in A. M. Fleckner and K. J. Hopt (eds.), *Comparative Corporate Governance: A Functional and International Analysis,* (Cambridge University Press, 2013), 521, 536 f with further references.

173 The regulation is presently found in Section 105, Stock Corporation Act of 1965 (*Aktiengesetz*). For an English overview of the composition and function of the supervisory board, see Hopt, 'The German Law of and Experience with the Supervisory Board', (note 170, above); J. J. du Plessis and I. Saenger, 'The Supervisory Board as Company Organ', in J. J. du Plessis et al, *German Corporate Governance,* (note 170, above), 91 ff.

174 A brief discussion can be found in U. Hüffer and J. Koch, *Aktiengesetz,* 11th edn. (Munich: C.H. Beck, Munich 2014) at § 111 marginal notes 5 ff.; for a detailed analysis see K. J. Hopt and M. Roth, at § 111 marginal notes 52 ff., in K. J. Hopt and H. Wiedemann (eds.), *Großkommentar Aktiengesetz,* 2nd edn. (Berlin: De Gruyter, 2005).

175 K. J. Hopt, 'Law and Corporate Governance: Germany within Europe', *Journal of Applied Finance* 27 (2015), 8. Another (in)famous insider corporate governance system can be found, for example, in Japan, see G. Goto, M. Matsunaka and S. Kozuka, 'Japan's Gradual Reception of Independent Directors: An Empirical and Political-Economic Analysis', in H. Baum, S. Kozuka, L. R. Nottage and D. W. Puchniak (eds.), *Independent Directors in Asia: A Historical, Contextual and Comparative Approach* (forthcoming, Cambridge University Press 2017).

176 G. Ringe, 'Changing Law and Ownership Patterns in Germany: Corporate Governance and the Erosion of Deutschland AG', *University of Oxford, Legal Research Paper Series,* Paper No. XX/2014, available at *http://ssrn.com/abstract=2457431.*

177 Cf. Puchniak, 'The Independent Director in Asia: A Taxonomy', (note 11, above).

representing labor, with a mix of directors coming from the company's workforce as well as from the industrial unions—a rather unusual institutional setting internationally-speaking.[178] Whether these can be regarded as 'independent' continues to be a hotly-debated topic. Usually, the difference between an inside and an outside director is that the latter is *not* employed by the company. Since the beginning of 2016 listed companies subject to co-determination are further legally bound to (gradually) introduce a 30% minimum of female supervisory board members.[179]

Germany still has one of the lowest proportions of independent non-executive (supervisory) directors in Europe. In 2011, only 21% of supervisory directors were independent, 49% were employee representatives, 5% were former executive directors, 8% were shareholder nominees, and 19% were other non-independent supervisory directors.[180] The idea of independent monitoring by outsiders still meets much skepticism that is rooted in the persistently strong presence of family-controlled and dependent companies.[181] Accordingly, the concept of independence only slowly gained ground and was introduced in two distinct steps.[182] The first step came in the form of independence from management in 2002, and the second step came in the form of independence from a significant block-holder in 2012.[183] Germany has been slow in improving the independence of its boards, but the same is true of other European jurisdictions, such as the Scandinavian countries having block-holding structures.[184]

The Stock Corporation Act has no general provision on independence, but it does provide a few mandatory requirements for supervisory directors. As already mentioned, the supervisory board has to be exclusively composed of outside non-executive directors.[185] Furthermore, a member of the supervisory board may not be a legal

178 For an English overview see O. Sandrock and J. J. du Plessis, 'The German System of Supervisory Codetermination by Employees', in J. J. du Plessis et al, *German Corporate Governance,* (note 170, above), 149 ff.

179 For the background to this legislation, see U. Seibert, 'Frauenförderung durch Gesellschaftsrecht – Die Entstehung des Frauenfördergesetzes', *Neue Zeitschrift für Gesellschaftsrecht* 2016, 1.

180 Roth, 'Corporate Boards in Germany' (note 48, above), 303 f. with further references.

181 Hopt, 'Law and Corporate Governance', (note 175, above), 10; for the German discussion on corporate governance see (in English); J. J. du Plessis and I. Saenger, 'An Overview of the Corporate Governance Debate in Germany', in J. J. du Plessis et al, *German Corporate Governance*, (note 170, above), 15 ff.

182 A concise critical overview can be found in M. Hoffmann-Becking, 'Unabhängigkeit im Aufsichtsrat', *Neue Zeitschrift für Gesellschaftsrecht* 2014, 801.

183 See L.L. Lan and D. W. Puchniak, 'Independent Directors in Singapore: A Corporate Governance outlier', in H. Baum, S. Kozuka, L. R. Nottage and D. W. Puchniak (eds.), *Independent Directors in Asia: A Historical, Contextual and Comparative Approach* (forthcoming, Cambridge University Press 2017).

184 Hansen, 'Active Owners and Accountable Directors', (note 156, above); for a general discussion see P. Lekvall (ed.), *The Nordic Corporate Governance Model* (Stockholm: sns förlag, 2014).

185 Section 105, Stock Corporation Act: 'A member of the supervisory board must not simultaneously be a member of the managing board'. For an English overview of the composition and function of the supervisory board see Hopt, 'The German Law of and Experience with the Supervisory Board', (note 170, above); J. J. du Plessis and I. Saenger, 'The Supervisory Board as Company Organ', in J. J. du Plessis et al, *German Corporate Governance*, (note 170, above), 91 ff.

representative of a subsidiary nor may he or she hold an interlocking directorship.[186] Listed companies must have at least one independent director on the supervisory board and, if one is established, on the audit committee.[187] This regulation was triggered by European Union law.[188]

Independence is predominantly dealt with in the German Corporate Governance Code[189] established in 2002.[190] It is based on the ‘‘comply-or-explain’’ principle originating in the British model, thus being a legal transplant into German law. That principle is given legal force by the Stock Corporation Act and not, as in the UK, by listing rules. Listed companies have the statutory duty to publish annually a declaration of compliance with the Code where they have to disclose whether they comply or, if not, explain to what extent and why they are not complying with the Code.[191]

The Code suggests that the ‘Supervisory Board has to be composed in such a way that its members as a group possess the knowledge, ability and expert experience required to properly complete its tasks’.[192] This recommendation obviously reflects the pertinent rule in the UK Corporate Governance Code.[193] Furthermore, the Code recommends that the ‘Supervisory Board shall include what it considers an adequate number of independent members.’[194] Thus, it is up to the supervisory board to decide what composition fits the given company best. The board has wide discretion when deciding on the precise number of independent members that it believes is ‘‘adequate’; there is no objective criterion to rely on.[195] In general, the Code emphasizes expertise rather than independence.[196]

The Code does not define independence. It supplies only an exemplary short catalogue of criteria which may cause a substantial and not merely temporary conflict of in-

186 Section 100 para 2 nos. 2 and 3, Stock Corporation Act (*Aktiengesetz*).
187 Section 100 para 5, Section 107 para 4, Stock Corporation Act (*Aktiengesetz*).
188 Art. 41 para 1 of the European Commission Directive on statutory audits of annual accounts and consolidated accounts, Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006.
189 Government Commission for the German Corporate Governance Code, *German Corporate Governance Code* (as amended on 5 May 2015), available at *http://www.dcgk.de;* for a German commentary on this topic, see H. M. Ringleb et al. (eds.), *Kommentar zum Deutschen Corporate Governance Kodex* 5th edn., (Munich: C. H. Beck, 2014).
190 The history of the Code is discussed in du Plessis and Saenger, ‘An Overview’, (note 170, above).
191 Section 161, Stock Corporation Act; see F. Aoun and L. Nottage, ‘The Rise and Unlikely Demise of Independent Directors in Australia’, in H. Baum, S. Kozuka, L. R. Nottage and D. W. Puchniak (eds.), *Independent Directors in Asia: A Historical, Contextual and Comparative Approach* (forthcoming, Cambridge University Press 2017), at Part III. 2, for a comparable ‘‘if not, why not’’ approach in Australia.
192 No. 5.4.1., German Corporate Governance Code.
193 See text accompanying notes 144 ff.
194 No. 5.4.2. (1), German Corporate Governance Code.
195 Ringleb et al., *Kommentar*, (note 189, above), marginal note 1023.
196 Roth, ‘Corporate Boards in Germany’, (note 48, above), 306.

terest and which thus exclude independence.[197] A supervisory board member is in particular not to be considered independent if he or she has personal or business relations with

– the company,
– its executive bodies,
– a controlling shareholder or an enterprise associated with the latter,

which may cause a substantial and not merely temporary conflict of interest.[198]

The Code's list of negative criteria is less strict than those recommended by the European Commission.[199] Two further negative criteria are that not more than two former members of the management Board shall be members of the Supervisory Board and Supervisory Board members shall not exercise directorships or similar positions or advisory tasks for important competitors of the enterprise.[200]

It was only after a heated discussion that the list of criteria was extended in 2012 to include a relationship with a controlling shareholder (or an enterprise associated with him or her) as excluding independence.[201] Given that the historical legislator of the Stock Corporation Act conceived the Supervisory Board as a representative organ of the *shareholders*—to compensate them for a loss of direct influence on the management—it may indeed appear to be slightly irritating that, today, being a shareholder or having a relationship with a shareholder is a possible indicator for a disqualification to serve as a member of that Board or a committee operating under the Board.[202] Critics have emphasized that representatives of controlling shareholders have the incentives and probably the expertise to monitor the management board efficiently.[203] Reflecting these considerations, the Government Commission for the German Corporate Governance Code issued a critical comment on the 2014 Draft for the OECD Principles of Corporate Governance[204] complaining about a perceived tendency—originating form the Anglo-American world—to assign important tasks in principle exclusively to independent directors instead of taking the more flexible approach of dealing with conflicts of interest on a case-by-case basis.[205]

197 No. 5.4.2. (2), German Corporate Governance Code.
198 GCGC, No. 5.4.2. (2).
199 See *supra* note 163.
200 GCGC, No. 5.4.2. (3).
201 T. Florstedt, 'Die Unabhängigkeit des Aufsichtsratsmitglieds vom kontrollierenden Aktionär', *Zeitschrift für Wirtschaftsrecht,* 337 (2013).
202 Hoffmann-Becking, Unabhängigkeit im Aufsichtsrat', (note 182, above), 806. By contrast, the Swedish Corporate Governance Code takes a positive view of the role the company's major shareholder may play in corporate governance, see Hansen, 'Active Owners and Accountable Directors', (note 156, above), 260 with further references.
203 N. Paschos and S. Goslar, 'Unabhängigkeit von Aufsichtsratsmitgliedern nach den neuesten Änderungen des Deutschen Corporate Governance Kodex', *Neue Zeitschrift für Gesellschaftsrecht,* 2012, 1361, 1362; Hoffmann-Becking, Unabhängigkeit im Aufsichtsrat', (note 182, above), 807.
204 OECD, 'OECD Principles of Corporate Governance, Draft for Public Comment – November 2014', available at *http://www.oecd.org.*
205 Press comment of 26 January 2015 by the Regierungskommission Deutscher Corporate Governance Kodex, available at *http://www.dcgk.de.*

As a concluding remark regarding the German regulation of independent directors, a recent legal change in banking law is worth mentioning. Since January 2014, the reformed Banking Act requires that supervisory (non-executive) directors of financial institutions must not only be independent but must also have sufficient *expertise* and *experience* as well as sufficient time to be able to fulfill their task properly.[206] The change was triggered by the implementation of the Capital Requirements Directive into German banking law. The new emphasis on expertise is surely needed. A recent study showed a systemic underperformance of German state-owned banks—which hold nearly half of all bank assets in the country—during the 2008 Global Financial Crisis in comparison with private banks.[207] This could be traced back to a 'statistically highly significant and qualitatively large' difference in boardroom competence.[208] Independent but financially 'illiterate' supervisory board members, often from a political background, were unable to fully understand the risks of the financial business they were expected to monitor. All German banks that were in financial trouble due to the Global Financial Crisis were publicly owned.[209]

The above findings show that in Germany, the concept of the independent director has become increasingly attractive for policymakers notwithstanding the fact that its regulatory framework (still) puts a great deal of emphasis on the expertise of the members of the supervisory board. Even though Germany has been resistant to independent directors for quite some time, it has now adopted them and they appear to be in Germany for the long-run—for better or worse.

This brings us to the general question of whether empirical studies support this rise in board independence.

V. Dubious Empirical Support for the Independent Monitoring Board

In spite of (i) much faith and fortune in the West, and more recently in Asia, being placed on board independence and (ii) the corresponding enthusiasm of policy makers to promote or enforce it, the empirical support for staffing boards with independent directors remains surprisingly shaky. It is beyond the scope of this paper to provide an in-depth analysis of the litany of empirical studies undertaken over the last 30 years, which employ a wide range of quantitative research methods and statistical analysis. It is, however, important for a better understanding to at least summarize the conclusions of these empirical findings and make a few observations about them.[210]

206 Section 25d of the Banking Act (*Kreditwesengesetz*).

207 H. Hau and M. Thum, 'Sub-prime Crisis and Board (In-)Competence: Private versus Public Banks in Germany', *Economic Policy,* 24 (2009), 701.

208 *Ibid.*, 705.

209 *Ibid.*, 703; this reflects international observations, see Ringe, 'Independent Directors: A Theoretical Framework', (note 21, above), at Part IV. 2.

210 See also the discussion with Ringe, 'Independent Directors: A Theoretical Framework', (note 21, above), Part II., and Blair, 'Boards of directors and corporate performance under a team production model', (note 122, above).

Some studies find no correlation between board independence and performance, others find a negative correlation, especially with regard to super-majority independent boards, and a few, mostly older studies, find a positive correlation.[211] An often-cited meta-analysis of various empirical studies by Bhagat & Black in 1999 found no evidence that companies with a majority of independent directors were more successful than other companies.[212] A more recent meta-study by the same authors showed the same inconclusive results.[213] Similarly, the composition of board committees does not seem to have a significant impact on the company's performance.[214] A new study covering 2,919 stocks traded on major stock exchanges in the United States between 1996 and 2006 summarizes in its findings that "a majority of independent directors on the board has an overall negative effect on stock returns".[215]

A somewhat surprising new piece of research claims to have found that board independence had a positive impact on firm value in the United Kingdom but no significant impact on firm value among US firms.[216] A new (albeit disputed) Australian study states that the introduction of a mandatory requirement in 2003 for companies listed in Australia to install a majority of independent board members destroyed considerable shareholder wealth between 2003 and 2011.[217] By contrast, another recent study found that companies whose boards are staffed with "powerful" independent directors have significantly higher firm valuations.[218] In general, however, there seem to be negative incentives for independent directors when it comes to encouraging companies to investigate possible misbehavior.[219]

211 For a brief discussion see Clarke, 'Three Concepts of the Independent Director', (note 15, above), at 75 ff.; Gutiérrez & Sáez, (note 21, above) at 66 f.; Velikonja, 'Political Economy of Board Independence' (note 1, above), at 858 f., 868 ff.; Bainbridge, (note 49, above) at 90 ff.; all with extensive further references.

212 See Sanjai Bhagat & Bernard Black, 'The Uncertain Relationship Between Board Composition and Firm Performance', 54 *Bus. Law*. 921 (1999).

213 See Sanjai Bhagat & Bernard Black, 'The Non-Correlation Between Board Independence and Long-Term Firm Performance', 27 *J. Corp. L*. 231 (2002).

214 See April Klein, 'Firm Performance and Board Committee Structure', 41 *J.L. & Econ*. 275 (1998); but see Chen Wang, 'Does Independent Board of Directors Really Make a Difference? Evaluating the Treatment Effects of Increased Board Independence Requirements on Corporate Performance' (2014); available at *http://ssrn.com/abstract=2535761,* the study finds some variations for US companies between 2002 and 2005.

215 Sebastien Gay & S. Chris Denning, 'Corporate Governance Principal-Agent Problem: The Equity Cost of Independent Directors'; available at *http://ssrn.com/abstract=2468942*.

216 Maureen I. Mueller-Kahl, Liu Wang & Jun Wu, 'Board Structure: An Empirical Study of Firms in Anglo-American Governance Environments' (2014), abstract available at *http://ssrn.com/abstract=2446242*.

217 Marc-Oliver Fischer & Peter L. Swan, 'Does Board Independence Improve Firm Performance? Outcome of a Quasi-Natural Experiment' (2013), available at *http://ssrn.com/abstract=2312325;* the authors estimate is a whopping AUS $ 69 billion.

218 See Kathy Fogel, Liping Ma & Randall Morck, 'Powerful Independent Directors', *ECGI Finance Working Paper* No. 404/2014; available at *http://ssrn.com/abstract_id=2377106*.

219 Cf. Q. Curtis and J. Hopkins, 'Do Independent Directors Face Incentives to Monitor Executives?' (June 23, 2016), available at *http://ssrn.com/abstract=2800008*.

In sum, the only definitive statement that can be made about these wide-ranging empirical studies is that they are clearly ambiguous. It does seem that the empirical evidence leans towards indicating that there is no obvious benefit to including independent directors on boards. It also suggests that too much independence may be a bad thing. What is surprising, however, is that despite this ambiguity the faith in independent directors has propelled them to the status of a core governance tool, with a uniform recognition that they are a prerequisite (to varying extents) for "good" corporate governance.

VI. Conclusion

Where does this *tour d'horizon* through the Western evolution of the independent director leave us? The ubiquitous repetitive history of corporate calamities and scandals, in spite of a century-long effort to get the function and composition of the board 'right', offers a cautionary lesson. This skepticism is reinforced by the fact that the empirical support for staffing boards with independent directors remains surprisingly shaky. These findings are hard to reconcile with both the faith and fortune internationally placed on board independence as well as the corresponding enthusiasm of policymakers to promote or enforce it. The modus operandi for continuing in this fashion seems based more on a blind faith in independent directors than anything anchored in the type of hard empirical data and rational behavior that we often (perhaps incorrectly) associate with the corporate world.

In reality, however, corporate governance is far more complex and less predictable than assumptions based on raw empirical data and rational actors would suggest. Since the inception of the joint stock corporation, a board of directors with some type of monitoring function has existed, although it has also been obviously flawed. This may suggest that the concept of the monitoring board may, like democracy, only be a second-best option—but yet better than any alternative. All troubles notwithstanding, the collective decision-making and some kind control, however imperfect, seem to have been proven over time to be more useful than other institutional arrangements. This being said, it seems equally clear, as our journey has shown, that the process of improving and adapting the concept of the independent director and monitoring board to an ever-changing corporate reality has been far from perfect.

Certainly, we see no 'end of history'[220] for the model and function of the board of directors in the West. Rather, we have observed a dynamic development from an *insider dominated* board with some non-executive affiliated directors fulfilling mostly advisory and networking functions to a *super-majority independent monitoring* board, composed almost exclusively of non-executive independent directors who are focused on monitoring management.

In sum, there seems to be a need for further thought and a healthy skepticism toward the concept of the independent director, at least if taken to the extreme. In this spirit, two central lessons might be drawn from history.

220 Cf. H. Hansmann and R Kraakman, 'The End of History for Corporate Law', *Georgetown Law Journal*, 89 (2001), 439.

The first and obvious lesson is that policymakers in the US conceived the independent board as a corporate governance tool with the aim of addressing the classical agency conflict between managers and owners in a Berle-Means corporation with dispersed ownership. It was *not,* however, designed to solve the agency problems between minority shareholders and a controlling shareholder in a corporation with concentrated ownership. Whether independent directors *can* actually fulfill a meaningful monitoring role in such a setting is an entirely open question.[221] The heated discussion in Continental Europe—where concentrated ownership is commonplace[222] —is telling. As far as we can see, there are practically no empirical studies that deal with this question. In Asia, we frequently find corporate structures with controlling shareholders, whether family members or sovereign wealth funds. The question of conceptual suitability and the possible need for institutional adaptation seem to be of foremost importance.

The second lesson became clear in the aftermath of the 2008 Global Financial Crisis: independence as such is *not* sufficient to guarantee good monitoring. This explains the recent shift in the UK from a more or less exclusive focus on independence to a more nuanced concept including competence and experience.[223] In Germany, the emphasis has traditionally been placed on competence rather than independence. Future developments will probably bring a more flexible[224] and *competence oriented* board composed of a 'competent'mix of directors with *ex post* and *ex ante* monitoring functions. 'Competence' will include sufficient independence from key players involved in the company (however defined), material disinterest (no conflict of interest),[225] expertise and experience as well as motivation and, optimal personal authority.[226]

In comparison, the *super-majority independent monitoring* board that we can presently observe in the US may be a dead end. This kind of excessive independence actually creates a new dependence on corporate insiders, namely the CEO, with respect to the all-important issue of gaining the necessary information for a sound monitoring. Policy makers should be aware of this pitfall.

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221 Gutiérrez and Sáez, 'Deconstructing Independent Directors', (note 21, above), 63 (skeptically observing that directors lack the mandate, the incentives, and the ability to properly monitor insiders under such circumstances); see also Hansen, 'Active Owners and Accountable Directors', (note 156, above), 250 ff.; Hoffmann-Becking, Unabhängigkeit im Aufsichtsrat', (note 182, above), 807.

222 F. Barca and M. Becht, *The Control of Corporate Europe* (Oxford University Press, 2001).

223 For a general discussion and the proposal of a new concept see Ringe, 'Independent Directors: A Theoretical Framework', (note 21, above), at Part V.

224 The optimal balance of board composition for a given company depends on a number of exogenous factors and will possibly differ during the firm's lifespan; for the specific problems boards are supposed to solve within small and medium sized companies (SMEs) see M. Neville, 'The Many Roles of Boards in SMEs', in H. S. Birkmose et al. (eds.), *Boards of Directors*, (note 146, above), 241.

225 Some claim that rather than being formally independent, the directors' impartiality, trustworthiness, and disinterestedness should be secured; see Gutiérrez and Sáez, 'Deconstructing Independent Directors', (note 21, above), 83 f.

226 For the latter, see Le Mire and Gilligan, 'Independence and Independent Company Directors', (note 18, above).