

# MISLEADING OUTSIDE DIRECTORS IN PUBLIC COMPANIES – THE ISRAELI CASE

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## Abstract

The external directors, who serve by law on the board of directors, are responsible for ensuring that, in addition to protecting the interests of stakeholders, the company will take the public interest into consideration. In this research we critically assess this system of corporate governance, and examine whether the external directors can actually succeed in looking out for the public's interest. The research is based on in-depth interviews with external directors of leading public companies in Israel, representing different sectors. The issue at stake is both conceptual and practical: Conceptually there is an issue of how the notion of "the public interest" is understood and whether the legal construct of "outside directors" is capable of manifesting the public interest. Practically the issue at stake has to do with organisational sociology and how the relations within the Board are set and who are the outside directors.

**Keywords:** outside directors, stakeholders, corporate governance, board of directors

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## 1. Introduction

In order to somewhat close the gap between principles of corporate governance and principles of Corporate Social Responsibility (CSR), a company's Board of Directors includes what are called Outside Directors. Outside directors play an important role in guarding the public interest and guiding the board of directors, and by extension the company as a whole, towards ethical behaviour. How effective is this method? This paper aims to look into this question by assessing a specific system of corporate governance, the new Israeli company law, which came into effect in 2000, and ascertain as to whether such a legal and organisational structure of corporate governance is an effective means to protect the public interest and promote Corporate Social Responsibility (CSR). More specifically, can outside directors succeed in guarding the public interest, as they are formally obliged to do? Our research is structured around three main themes; a theoretical section that aims to highlight certain conceptual difficulties with the notion of an outside director; a sociological discussion of organisational factors that may inhibit outside directors from doing their job and finally; empirical data based upon extensive interviews with the outside directors of several leading companies in Israel representing many different sectors. The companies that partook in this research are relatively large public companies within the food,

telecommunications, and banking industries. We come to the conclusion that outside directors are lead astray and are unable or unwilling to fulfil their responsibilities. Hence, we offer some practical recommendations on how to make outside directors more effective.

## 2. Corporate Governance

In a previous study (see endnote 1) we argued that a corporation should be viewed as analogous to a political body. In this case, in order to protect the corporation from corruption and the abuse of its powers, the government of the corporation must be based upon a clear separation of powers between the executive, legislative and judicial branches. Just as civic government exists for the well being of society; corporate governance exists for the well being of the corporation. As such, we suggested looking at management as the executive branch, the board of directors as the legislative branch (in the sense of a policy making branch) and, possibly, the auditor, internal comptroller and supervisory committee as the judicial branch. The idea behind corporate governance is that just as the People in a democratic country periodically elect their legislatures, the general meeting appoints the board of directors and the board thereafter serves as the company's legislative branch.

As such, the Board of Directors is responsible not for overseeing the everyday running of the company but for prescribing policy, strategy, and overseeing finances. The Board of Directors is the legislative branch; it is the policy maker and is responsible for the supervision of the executive branch, or management. The powers and responsibilities of the Board of Directors include the determination of the company's plans of activity, the principles for financing them and the order of priority among them. In addition, they must also examine the company's financial situation, make decisions on the distribution of dividends and the issuing of series of debentures, and report to the annual general meeting of the state of the company's affairs and its business results. Consequently, the general manager, or CEO (Chief Executive Officer) is appointed by the board of directors, to whom in turn he is directly accountable.

Our concern in this issue is with "public companies", that is companies whose shares are listed for trading on a stock exchange, or which were offered to the public by prospectus and are held by the public (see endnote 2). In this sense, a "public company" is a company in which everyone, i.e., the public, has an implicit interest and therefore, the outside directors should be responsible for representing the public interest and protecting existing and potential shareholders, in addition to other stakeholders. A public company in Israel is required by law to nominate at least two outside directors to serve on the board of directors, but it has the right to prescribe the total number, without any limit, of Directors on its Board. Until 2005 the law required to nominate only two outside directors. It may be assumed that despite the change in the law, which took place in 2005, most companies will not nominate more than two outside directors. Outside directors are the officers of a company. Regular directors are usually appointed by the general meeting, unless there is a special provision in the company's by-laws that states otherwise. However, only the general meeting may appoint the outside directors. They are "outside" in the sense that they should not be employed by the company and should not receive a salary from the company. The outside directors are responsible for ensuring that the company takes the public interest, in addition to the interests of shareholders, into consideration.

Against this backdrop, we undertook to research whether the outside directors can actually do their job or whether there are not implicit structural problems that prevent them from fulfilling their responsibility and guiding the company towards CSR. There is both a conceptual and a practical issue at stake. Conceptually the question pertains to how the notion of "the public interest" is understood, and whether the legal construct of "outside directors" is in fact capable of manifesting the public interest. The practical considerations are related to organisational psychology and how the relations within the Board are set and who the outside directors are: Are they

neutral and not influenced either directly or indirectly by any vested interests in the company? Do they have the proper qualifications and abilities to supervise the specific company on whose board they serve? Do outside directors care enough to attend meetings and complete their tasks responsibly? Is there any limit on the number of companies at which the same person may serve as an outside director?

### **3. Conceptual Factors**

Outside directors are supposed to represent the "public interest" on the board of the directors. But what exactly is the "public interest"? According to the traditional legal definitions, "Public interest" is something in which the public, the community at large, has some pecuniary interest, or an interest by which their legal rights or liabilities are affected. Nevertheless, the "Public Interest" is a difficult concept to pin down. It is usually contrasted both with conflicting group-interests, who represent particular political and economic agendas, as well as with the individual's self interests, which are also likely to be in conflict.

To be more specific, let us ask: is the outside director representing the "public interest" supposed to be a voice for: [1] the entire global human community; [2] the local political community directly affected by the corporation; [3] potential participant investors, for example the stock market; or [4] only the people directly involved with the corporation, its stakeholders? In other words, there is a lack of clarity between three pre-conceptions of the responsibility of the outside director: [1] because the general meeting nominates the outside director, it may seem that the public interest that outside directors is obligated to represent is that of the company shareholders; however, [2] the outside director is required to be a member of the audit or supervising committees and in this respect has a semi-judicial role in the company and seems to be a representative of the stock exchange; finally, [3] the precise wording of the law—calling the corporation a "public company" and the juxtaposition of the outside directors against the regular directors—would suggest that the outside director should remain neutral and unbiased in representing the public.

Those who have a more utopian conception of the public interest claim that it refers to some notion of the common good or the welfare of the entire community. Several decades ago Walter Lippmann articulated this idea by defining Public Interest as "what men would choose if they saw clearly, thought rationally, acted disinterestedly and benevolently" (see endnote 3). In contrast, those who are more cynical of the notion of "public interest", particularly *New Intuitionist* economists like Gary Becker, object in principle to the term "public interest" arguing that by appealing to the public interest politicians try to universalise what are merely personal beliefs and values (or the interests of a

section of the community) that may not in fact find common assent.

In trying to clarify this issue we must ask: are there actually any common interests, which the outside directors on the board of directors represent, that are all inclusive in that they offer equal benefits to all? One can draw upon Rousseau's distinction between the "will of all" (the sum of particular wills, i.e., majority rule) as opposed to the "general will" (a single policy which is equally in the interests of all the members of a group) in spelling out this notion. If the outside directors have two votes on a board where decision is based on majority rules, then they are ineffective-- when the board consists of many members. If, however, there were some deeper notions of 'general will' that have to be revealed, then possibly they have a role to serve on the board.

A good example for such an all-inclusive interpretation of "public interest" was suggested by Brian Barry (see endnote 4). Barry appeals to the notion of social 'roles', which helps to understand the functioning of the board of directors in which different individuals represent different group interests. Barry suggests that it is the common interests of all members of society in their roles as citizens, which comprises the realm of the public. Apparent conflicts are merely a result of a conflict between the public interest and the individual's particular interest in terms of their social role. Thus, it might occasionally occur that the interest associated with one's role as a citizen does not coincide with one's particular interest within their capacity as a particular social role (such as, the position of a spouse, parent or businessperson). Moreover, it may occur that the interests of this particular person are more immediate or important to the individual than their public interests. These are situations in which individuals believe that they have more to gain from their personal interests.

One necessary precondition that can give the outside director a stronger incentive not to serve only the narrow interest of the company's shareholder (even if he or she are not capable of serving the public interest as such), is that the outside directors should not have any vested interest in the company. "Interest" is, however, defined very narrowly by the Israeli Company Law as: "an employment relationship, commercial or professional ties in general or control, as well as service as an officer, other than service as an officer for a period of not more than three months, during which the company first offered shares to the public". "Interest" does not include investments in the company such as shares and debentures. The decision on distributions of dividends rests in the hands of the board of directors. The participation of the outside directors who may have shares entitling them to receive dividends at the decision taken by the board may therefore, raise some questions. We believe that, in principle, outside directors should not be allowed to possess, directly or

indirectly, securities in the company on whose board they are serving.

In addition, although outside directors are not allowed to receive a salary from the company, they are entitled to very reasonable remunerations and the refund of expenses, as prescribed by regulations issued by the Minister of Justice. These regulations entitle each outside director to two classes of remunerations: yearly and per meeting. The remunerations may amount to the following: yearly remuneration between sum equivalent to US \$ 4,000-US \$ 10,000 (depending on its self capital), and US \$ 400 per meeting of the Board or any committee appointed by the board. The outside director is entitled to remuneration per meeting even if he or she attended only part of the meeting. The Boards of Directors of some companies, such as banks, convene twice a week and in addition, scheduled meetings for committees take place. All outside directors should be on audit or supervising committees, and may be members of other committees as well, the membership of which entitles them to per meeting remunerations as well. To highlight this point, the average monthly salary in Israel amounts to US \$ 1600. The regulations allow the company to decide on giving the outside directors additional remuneration by shares or options to be shares. The outside director is entitled also to hire advisers in order to fulfil his duties, at the expense of the company.

The Companies Law in Israel does not limit the number of companies on which one person can serve as director. This includes outside directors. It seems however, that if someone serves as a director on more than three public companies simultaneously, his participation becomes inefficient. Moreover, since the Israeli Companies Law does not prohibit appointing the same person as outside director in a company and in its subsidiary companies, an outside director may find similar attractive positions in its subsidiaries as well. Until 2005 the Israeli law did not mention any qualifications, education or professional background as necessary to becoming an outside director. It required only that an outside director be an Israeli resident of full age, that he not be convicted of certain offences and not declared bankrupt. The amendment to the Israel Company Law enacted in 2005 states that outside directors should have "professional qualification" or have "accountancy and financial specialty". The Minister of Justice still has to stipulate the conditions and tests for such a specialty or for "professional qualification". The 2005 amendment will not come into effect as long as such regulations have not been enacted by the Minister. However, while "accountancy and financial specialty" may be more or less understood, the term "professional qualifications" is still blurred, as it may include qualification in any profession.

The fear is that outside directorship may turn into a form of main occupation and that we may soon

herald the arrival of “professional outside directors”. The term “professional” in this context means somebody doing something *not* as an amateur, not as a part-time activity and not out of sheer interest. It is not clear how the moral integrity of this kind of a “professional outside director” would be guaranteed for he differs from the more familiar notion of professional, whereby he is considered as not being a layman. The former has to do with time invested in an activity and monetary remuneration. The latter has to do with being an expert or a specialist rather than a layperson. Therefore, a problem is caused by outside directors who turn altruistic public service into their main form of occupation and then rely upon it for a significant source of income. It is suspect because they are not akin to the traditional professions whose moral integrity is grounded in occupational membership. In the traditional professions, professionals as specialists—physicians, lawyers, and clergymen—the goals of serving the public, moral integrity and autonomy are guaranteed by a form of professional specialization and socialization. A professional’s moral integrity is derived from the fact that being a professional involves the learning of a skill that is based around a certain body of knowledge, training and education and eventually with his admittance into a professional organization. In contrast, outside directors lack the occupational membership and expertise that could help ensure this moral ‘integrity’.

An outside director may serve for the term of three years, but the company may re-appoint the same outside director to one additional term of three years. It is unlikely that the outside director would be reappointed if he had proved to be a problematic appointment or was in constant minority at the board’s meetings. Moreover, due to the fact that the directors of different companies are often of each other’s acquaintance and come from a common socio-economic background, it is also unlikely that an outside director who had proved ‘problematic’ would ever be appointed as an outside director in other companies. In a study published in the *Harvard Business Review on Corporate Governance* (see *endnote 5*), Conger, Finegold and Lawler raise the question of appraising and evaluating the board of directors. In addition, an especially controversial issue is the appraisal of individual members of the board. It is not common for a company to review the performance of the board of directors or its individual members often. According to Conger, Finegold and Lawler, such an appraisal, if carried out correctly can clarify the individual and collective roles and responsibilities of its directors, and provide better knowledge of what is expected of them. This in turn can help boards to become more effective. An efficient appraisal may improve the relationship between the company’s board and its management, it may translate into better corporate governance, the members of the board’s acquisition of greater influence, more attention being paid to long-term

corporate strategy and less friction at meetings. The appraisal of outside directors is a must. They are added to the board not only in order to safeguard the public interest, but also to contribute to the board’s work by offering different competencies and to balance the regular directors and serve on the audit or supervising committees. Their appraisal should take into consideration five parameters: Knowledge, information, power, motivation, and time. These five parameters are listed by Conger et al as the main factors needed for a board of an organization in order to do its job effectively (*ibid*, 111-118).

We propose to use the same terms for the evaluation of the outside directors but using slightly different definitions. Under “knowledge” we include the knowledge of the targets of the company and the strategic demands facing the company. “Information” for that purpose means enough data and information regarding the general condition and situation of the company, and that such data should come also from external resources such as outside stakeholders, customers, and employees. “Power” is the possibility of following up the board’s decisions as carried out by the management (CEO), and the opportunity to control the agenda of the board’s meetings. “Motivation” refers here to the wish to improve the company’s work and further its goals, regardless of any personal reward. “Time”, means that the work is well organized and that the outside director is spending the time necessary in order to fulfil all his functions without interruption or disturbance.

#### **4. Organisational Factors Affecting Director Impact**

The effectiveness of an outside director is in many respects a practical issue that relates to factors (organisational sociology) and how the particular relations within the Board at meetings, are set. The members of the Board of Directors hold regular meetings and come to function as a group in making decisions that affect the firm. Consequently, the internal dynamics within the group, which are related to different sociological factors, affect the quality of the group’s decisions and the actual contribution made by the outside directors. There are many factors that can prevent a group from effectively utilizing all available information and achieving its full potential. The literature describes several factors such as [1] group size; [2] status differentials; [3] cohesiveness; [4] diversity of membership; [5] physical environment; [6] communication and technology and; [7] the emotional maturity of members, which can all influence the group decision and thinking process.

By applying these factors to outside directors it is evident that outside directors can become ineffective. We must focus on three central issues: Firstly, the size of the board makes a big difference with regard to the effectiveness of the outside directors. Suffice it to say, the two outside directors will have more effect

in a group of five than a group of twenty. Secondly, the status difference between the different members of a group is significant. Thus, the chairman or director of the meetings has the formal ability to manoeuvre the discussion. He does this by setting the agenda and deciding how much information to reveal to the other members of the group, as well as by having the authority to dictate what issues will be put to a vote and what issues will be delegated to committees. Informally certain members of the group, such as the legal expert, the accountant, a founding member or elderly member, might come to have a more dominant role in the decision process by dint of their special informal status. Outside directors, on the contrary are provided neither a formal status on the board, which would allow their role greater effectiveness, nor can they come to have an informal status such as professionals who are the members of boards. A central factor that has an especially dominant influence on how the Board of Directors functions is the Chairman of the Board and his individual style of leadership. A task-oriented Chairmen might well endorse the development of agendas for meetings, present issues to the group and ask members for specific information or ideas, while making sure to keep the discussion on track, suggesting procedures for making a decision, assigning responsibility for follow up and ending the meeting. Within this tight framework it may be more difficult for outside directors to have an impact than in meetings conducted by process-oriented chairmen.

## **5. Empirical Data**

In our research, 17 outside directors agreed to be interviewed. We have found out that these 17 serve in 64 different companies (two are serving in the same company). One outside director serves on 11 boards, three are serving on 6 boards, three are serving on 5 boards, four serve on 4 boards, one serves on 4 boards, three are serving on 3 boards, and only 2 serve on one board. One outside director serves as an outside director of two public companies, one of which is a subsidiary of the other. It is worth adding that some of the outside directors serve also as regular directors of other companies.

However, if we work with the basic analogy suggested above, according to which the board of directors serves as the company's legislative branch, then members of the legislating branch in a democratic system need not have any formal education, though they are often required or expected to be of certain age with a clean record, to ensure a level of maturity and sufficient experience in life. The idea is that they should be able to represent the interests of the public who elected them and not only to serve their own personal interests. Only two of the outside directors had any relevant knowledge in, or a background directly relating to, the business of their respective companies, and the others lacked any specific knowledge (particularly in technological

fields). As professionals, they bring with them their personal input for example, lawyers concentrate on the legal aspect of the management, and those in marketing concentrate on marketing strategies, former bankers concentrate on the economic aspects, and so forth. Only one outside director was of the opinion that an outside director should have a combination of economic-managerial-legal background. We can ascertain from the responses that the main two models are extreme ones: over-involvement or no involvement at all. Over-involvement is found mainly in companies traded also on other stock exchanges, mainly USA, where legislation demands over-involvement. Nevertheless, none of the outside directors interviewed used their right to hire independent external advisers in order to learn or assist in preparation toward any subject dealt with in the board meetings. In order to receive the financial support of the company for hiring experts, the outside directors have to disclose the identities of the people whose expertise is sought. In order to hide the identity of the advisers, the outside directors do not obtain any professional advice or, in the case that they do, they may not apply for the financial remuneration from the company for their consultations.

When asked about their role on the board and their qualifications, most of the outside directors confess that they do not initiate any new subjects or items onto the agenda. The most that they seem to do is to prepare for the next meeting by reading over the documents provided. Most of the outside directors believe in a "straight mind" and claim that they do not need any special qualifications or assistance.

Three of the outside directors did not see any difference in the tasks and commitments between the regular director and the outside director. They believe that the personality of the outside director is of main importance. Four outside directors were of the opinion that they, like the regular directors, owe their loyalty above all to those who have control of the company, that is, the majority shareholders, because they indirectly appoint the directors. Where there is more than one person in control of the company, there seems to be a conflict of loyalties. What would happen if, during the term of the outside director, the control of the company changes? Would the outside directors change their loyalty? Would they prefer to take care of themselves than care for the company or its stakeholders?

Most of the outside directors suggested that other than meetings at the audit or supervising committees, the contact between outside directors is similar to that with the other directors. One outside director stated explicitly that all directors, including the external ones, should comply with the requests of the chairman of the board of directors. This statement is very interesting, as at the same company, the term of the other outside director was not renewed. The one whose term was not renewed admitted he held a minority opinion many times, mainly in matters

where the general management of the company was involved. The same outside director was also against converting outside directorship into a “profession”, alleging that one person cannot be loyal to many organizations simultaneously.

As regards attending meetings, it is felt that because of the high remuneration an external receives for attending meetings, it is not worthwhile being absent. Outside directors prefer to serve on as many committees as possible, in addition to the audit or supervising committee, dependant only on their free time. It is worthwhile to come to a meeting unprepared, or to attend part of it, than not to come at all. Unsurprisingly, twelve of the directors interviewed refused to reveal how they were appointed. However, five were willing to talk on the subject, and from these responses we can ascertain that the primary consideration leading to their appointments were their personal acquaintances and assertiveness. It would be an understatement to say that a history in the civil service (in positions such as the Director General of government ministries); service in large organizations such as banks and; a personal acquaintance with the legal advisers or accountants of particular Boards, aided the chances of an appointment significantly. The first two are focused on connections that may improve or advance. Appointment of personal acquaintances of the legal advisers or accountants may appear to be dangerous as the board of directors is expected to supervise their work, and the outside directors are there in order to represent the public.

## 6. Conclusions

There should be a limit on the number of companies at which one person can serve as an outside director. We believe that if a person serves as an outside director in more than three companies, or in more than two companies in the case that he also serves as regular director in other companies, his participation will be insufficient, specifically regarding his obligation to protect the interests of the public. Outside directorship should not become a “profession”.

There should be an explicit duty to attend all or most meetings of the board of directors and of the committees at which the outside director is a member.

Outside directors or their close relatives or corporations where they have control, should not possess securities of the companies at which they serve as outside directors.

The qualifications needed in order to be able to act as outside directors should be specified and prescribed in the law.

The appointment of an outside director should be made by or with, the approval of an independent committee that may consist of members representing bodies such as Securities Authorities.

An appraisal of the outside director should be done at least twice by the end of the first 18 months of term, and again towards the end of the term.

One should remember that the main obligation of the outside directors is to protect the interests of the public and not only the company. The responsibility upon the outside director is greater than that upon the regular director. Misleading outside directors could lead to the crash of large companies, including multinationals as well as nationals, a phenomenon that we have witnessed during the last few years.

## Endnotes

<sup>1</sup> Lurie, Y. and Frenkel, D.A., “Corporate Governance: Separation of Powers and Checks and Balances in Israeli Corporate Law”, 2003, *Business Ethics: A European Review*, Vol. 12, pp. 275-283.

<sup>2</sup> On outside directors on SME boards, see Gabrielsson J. and Huse M., “Outside Directors in SME Boards: A Call for Theoretical Reflections”, 2005, *Corporate Board: role, duties and composition*, Vol 1. pp. 28-37.

<sup>3</sup> Lippmann, W. (1955) *The Public Philosophy* (NY: Mentor books, 2002) p.40.

<sup>4</sup> Barry, B., “The Public Interest”, 1967, in Quinton, A. (ed.) *Political Philosophy*. (Oxford University Press), p.123

<sup>5</sup> Conger, J.A., Finegold D., and Lawler III, E.E., “Appraising Boardroom Performances”, 2000, in *Harvard Business Review on Corporate Governance*, pp. 105-134