DEFINING AND SELECTING INDEPENDENT DIRECTORS

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Abstract

Drawing from the Enlightened Shareholder Theory that the author first developed in 2011, this theoretical paper with practical and normative ambitions achieves a better definition of independent director, while improving the understanding of the roles he fulfills on boards of directors. The first part defines constructs like firms, Governance system and Corporate governance, offering a clear distinction between the latter two concepts before explaining the four main missions of a board. The second part defines the ideal independent director by outlining the objective qualities that are necessary and adding those subjective aspects that have turned this into a veritable profession. The third part defines the ideal process for selecting independent directors, based on nominating committees that should themselves be independent. It also includes ways of assessing directors who are currently in function, as well as modalities for renewing their mandates. The paper’s conclusion presents the Paradox of the Independent Director.

Keywords: Company Performance, Corporate Governance, Corporate Governance Principles, Board Members, Board of Directors, Nominating Committee, Enlightened Shareholder Theory

1. INTRODUCTION

“Freedom in its practical sense means a will that is independent from the constraints of inclinations and sensitivities” Kant, Critique of pure reason, I, 1781

This theoretical academic research paper has practical ambitions. It is situated in the field of corporate governance - a management discipline that is essentially transdisciplinary in nature, integrating concepts and theories derived from other management sciences (strategy, accounting, management control, but also marketing and human resources) and other human and social sciences, including law, economics, political science and psychology (notably group psychology) and sociology.

This paper takes a normative approach to a figure who has assumed mythical proportions over the past 30 years in contemporary visions of corporate governance – the independent director. All main theories of governance, whether shareholder or stakeholder-focused,1 portray boards of directors as cornerstones of good governance. They also assert independent directors' special status as leading protagonists on these boards, despite research failing to detect any correlation between the proportion of independent directors on a company’s board and its performance. If Beasley (1996) suggests a clear and unequivocal correlation between external directors (different from independent directors in the strict sense of the term, and demonstrating, if need be, why the expression requires conceptual clarification) and a lesser risk of fraud. Similarly, Abbott et al. (2004) and Chitourou et al. (2001) showed the connection between the presence of an outside director (who they assimilated with independent directors) and the quality of the accounting information being produced; and above all, a moderation in executive pay. Then there are studies exclusively focused on the correlation between the proportion of independent directors on a board and company performance, such as P. McAvoy et al. (1983) and Hermalin and Weisbach (2003); Klein (1998) and above all S. Bhagat and B. Blick (2002), all of which led to negative and even counter intuitive findings. We consider that these findings must be significantly relativised, mainly because of their misconception of what an independent director is and does.2 In fact, these studies must be viewed with caution for several reasons. They are based on an


2 Limitations that were very apparent to Chitourou et al. (2001) who specified on page 6 that, “A major shortcoming of this criterion is that non-executives may not be effectively independent from management”.


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unreliable definition of the concept of independent director (and for multinational companies the definition is frequently different from country to country); they are too recent in terms of when the notion of independence was first defined (and given the evolving nature of this definition); they therefore rely on too short a time period; the empirical studies focused essentially on listed companies, and the biggest among them, due to the easy access to data; due to endogeneity the methods of analysis have different bias. What is certain, on the other hand, is that improving a company’s image and transparency corresponds with the arrival of a significant number of independent directors as board members - witnessed by the countless scandals that have shocked the world of governance over the past 30 years, first and foremost being the Enron case.

The theoretical framework of this paper is based on our Enlightened Shareholder Theory which is grounded in shareholder reasoning but integrating useful elements from stakeholder theories as well as more recent contributions from cognitive theory. “A good image would be to say that Enlightened shareholder theory has been doubly enlightened by stakeholder theory and by cognitive and behavioural theory”. In the paper’s first part we give a definition that should be as comprehensive as possible of independent directors. This will be based on a re-specification of notions such as the firm (section 1.1), corporate governance (1.2) and the role of a board of directors (1.3). The second part defines the concept of independent directors by outlining traditional criteria, pointing out their limitations (section 2.1) and adding subjective criteria (2.2) that help to improve understanding of the main role that a board of directors fulfills when defined in this way (2.3). The third part deals with the selection of independent directors by demonstrating the need for an appointment committee that is itself independent (section 3.1) and by suggesting both an ideal selection procedure for new independent directors (3.2) plus ways of renewing existing independent directors’ mandates (3.3). The conclusion focuses on the Paradox of the Independent Director and suggests the best way to manage this.

2. FROM THE FIRM TO THE BOARD OF DIRECTORS

2.1 Defining Firms In The Year 2017

“The purpose of business is to create and keep a customer.” Peter Drucker

We consider that a firm is more than a mere nexus of contracts 1 - i.e. not just a simple legal mechanism but a living entity that is a unique combination of material and human. Indeed one of cognitive theories’ most important contributions is the role played by human capital and employee competencies, where these are specific to a firm in its creation of value added (Blair 1999; Rajan & Zingales 2000) and intangible assets comprising a reservoir of competencies and a repertoire of knowledge (cognitive theories of governance, a category including Enlightened Shareholder Theory, pertinently differentiates between the information that a firm receives and the knowledge that it creates) enabling a continuous learning process. Then we agree with Charreaux (2000) that the firm “creates value when the combination of its resources produces an organisational rent that is equal to the difference between the value of the products and services offered by the organisation, the price customers are willing to pay and its resources’ opportunity cost”. As explained by Charreaux: “In the cognitive theories of the firm devised by C.K. Prahalad and G. Hamel (1990) and Teese et al. (1997) focused on the construction of competencies, the firm’s ability to innovate to create investment opportunities and modify its environment - the key to performance - tends to reside in management’s aptitude for imagining and perceiving new opportunities (in C.K. Prahalad, 1994) as well as in its ability to restructure current processes or reconfigure the principle of activities in response to changes in the environment” 2.

2.2. Modern Corporate Governance

“Long-term results cannot be achieved by piling short-term results.” Peter Drucker

Corporate governance is generally understood as “the sum total of organisational mechanisms whose purpose is to limit managers’ powers and influence their decisions (notably funding and investment-related), in other words, [the mechanisms that] govern their conduct and define their discretionary space” 3. Given the definition of the firm provided above, we can specify, in agreement with Lazonick and O’Sullivan’s (1998) thinking on innovative firms, that the governance system must encourage strategies for developing organisational learning.

At least one conceptual clarification is indispensable at this level. The French language has two words referring to corporate governance problems: la gouvernance (governance) and le gouvernemment d’entreprise (corporate governance). The English word “governance” is different from gouvernement, in part for some very fundamental reasons. Governance relates to a system that simultaneously covers institutions, relationships, rules and behaviours, i.e. it is much more than corporate government, which refers to the structure itself. “The distinction presented here at the company level is particularly valid on a national

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2 For a definition of the firm set within a contractual theoretical framework, it is worth re-reading the founders of seminal literature in this discipline: A. Achian, H.Demsetz (1972); M. Jensen and W.Meckling. (1976); as well as G.Baker et al. (2001).
4 Charreaux, 1997, p. 29.
5 In a more dynamic conception, governance should help firms to construct strategies enabling a sustainable creation of value. This is a proactive perspective that draws from the cognitive theories of the firm, notably grouping behavioural theories of the firm inspired from the work of H.A. Simon (1947); Cyert R.M. and March J.G (1963); Nelson and Swint (1982) not to forget resource and competency-based theories derived from the work of Perrouze, E. (1959).
6 Borrowed from the French word meaning to direct or lead, personal conduct should be understood in the original sense of the term: “Love does not warrant any pasture other than sweet and loyal governance. This is its peace and substance, and I swear, all that is good in it”, Chartier Alain (1385-1433).
7 Poètes”, in Duchesne André, Les oeuvres de Maître Alain Chartier, 1617, page 770.
plane: public governance is bigger than government, even if it is legitimate to think that the latter constitutes an essential part of the former. This intimates a need to distinguish between the concept of a governance system comprised of the sum total of both external mechanisms (the institutional and legal environment that is external to the firm and which is forced upon it from the outside, plus external actions like takeovers; more generally, all financial-market-related constraints) and internal mechanisms (“internal corporate governance”, or focused on the relationships between shareholders, the board and management) versus. This differs from corporate governance in the strict sense of the word, which only covers internal mechanisms that actors (shareholders, directors, managers, etc.), can impact but only within the framework of external rules that they are forced to adhere to.

In this vision - one that Charreaux develops in greater detail - the board is attributed a role in producing new opportunities, hence contributing to the innovation process. Compared to the definition offered by Peter Drucker, our vision of corporate governance adds explicitly what he considered implicitly, namely a long-term vision. We therefore suggest the following detailed definition: “Within the governance system, corporate governance (or a firm’s internal corporate governance) is a system based on three principles, materialising in all of the internal mechanisms that allow shareholders to: 1) receive non-confidential information showing whether the company is functioning properly (principle of limited transparency); 2) control the company and its managers through the general meetings and through the boards’ delegated powers (principle of legitimate control); 3) give the board responsibility for a corporate strategy furthering the company’s long-term interests (principle of long-term corporate interest).”

**2.3 Board Missions**

“Directors generally do not use board meetings to ask question.”

Ambroise Roux (1921-1999), leading French establishment figure of the 1970s and 80s, quoted in Le Monde newspaper, 3 August 2004

Like a firm, a board is a living organism whose success depends on an alchemy shaped by processes relating to its external organisation (number of members, composition, etc.) along with a number of internal factors (organisation of deliberations, members’ culture, collaborative interactions, etc.). Within this framework, the independent director - like other directors - must always act with integrity, competency, proactivity and implication in the corporate interest and represent all shareholders rather than any one shareholder in particular. A superficial simplification would be to categorise the respective role that each plays in the firm as follows: “Employees and managers do things; executives (senior management) get things done; and directors (at board meetings) control the way executives get things (i.e. they manage managers).” In line with the vision of the firm offered above, we agree with the analysis of Charreaux according to whom, “In this offensive and proactive perspective that borrows from cognitive theories of the firm, the board receives a role in the production of new opportunities and contributes to the innovation process”. What gets an original response here is the composition of the board. Where financial performance depends on the board’s control over management - meaning that the board should be largely comprised of independent members - from a cognitive strategic perspective, the board should be mainly composed of directors who can contribute as much as possible to the creation of dynamic competencies and help management to come up with a vision facilitating organisational learning. Here, board members’ requisite qualities are no longer be envisioned in terms of their independence or control expertise - as per the distinction between the world inside and outside - but depend on which cognitive contributions can be integrated into the group project. At this level, the board’s level of diversity is more important than its independence.

At the same time, it is important to highlight the limitations of Charreaux’s reasoning, based on the implicit but necessary dichotomy between competency and independence.**2** Therefore, it is important to select a selection of directors who are independent and competent - though Charreaux’s study dates from an era (2000) when there was a manifest shortage of independent directors.

Against this backdrop, boards have four distinct missions. Firstly in finalising the annual accounts to submit to the general shareholders meeting (its oldest legal and historical mission). Secondly in selecting and controlling managers on how they run the firm (this monitoring mission is important in terms of director’s civil and penal liability: The idea here is to verify whether management complies with previous board decisions and corporate interests - if only to ensure that they do not abuse their powers for self-serving purposes (notably but not only by paying themselves too much) to the detriment of the corporate interest. Thirdly in identifying and controlling risks: Think about legal risks and non-compliance with regulations. Of course, financial risks (notably treasury-related one) top this list, as do image risks that are directly related to Enlightened Shareholder Theory’s cognitive dimension. Lastly in working

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9 Pérec Roland. 2003, p. 5.
10 Charreaux G. 2000, p.12.
11 “Corporate governance consists of establishing and adhering to rules that guide and limit the behavior of those who act in the name of the company”. P. Drucker (1973).
12 It is in this sense that our Enlightened Shareholder Theory is fundamentally shareholders and not stakeholders oriented. Whereas shareholder interest can differ from those of the company in the short run, in the long term the two must converge.
13 Within the Enron corpus, when the company went bankrupt in 2002, four of its directors had also been personally bankrupt since 1985, including the Chair of the Audit Committee, and directors sitting on its Audit and Compliance Committee, Subcommittee on Investigations Report, page 55.
15 Like the old French joke about Americans. They are usually capitalists, intelligent and honest but unfortunately never all three at once. The same applies to independent directors. It is always possible (and probably increasingly so given the ongoing growth in the reservoir of directors) to find ones who are independent, competent and honest.
17 The 1992 Cadbury Report features a very British euphemism (page 21): “Recognition that the specific interests of the executive management and the wider interest of the company may at times diverge”.
18 Enlightened shareholder Theory does not elucidate all disciplinary issues and features one aspect that should not be hidden. The theory is based on a lucid diagnostic of human nature, according to which “People tend to go as far as they can” (Thucydides).
together with senior management to elaborate and validate the firm’s long-term strategy, notably by analysing and understanding monthly or semester scorecards, a process facilitated by the rhythm of board meetings (between four and eight annually) (as per our definition of the director’s main role of supporting a firm’s corporate interest) – indeed Enlightened shareholder theory is particularly useful because it avoids creating an opposition between the interests of the firm and shareholder interests. Emphasizing the corporate interest means that in situations of fraud or abuse (i.e. where a majority shareholder wants too much in dividends, thereby weakening and even endangering the company’s existence), the directors and the board must provide an opposition, even if over the long run, it is clear that the interests of the firm and the long-term interests of the shareholders converge. This implies that the board has a real vision of the firm and its future.

3. THE CONCEPT OF INDEPENDENT DIRECTOR

The benchmark governance code in France (drawn up by AFEP-MEDEF) defines independent directors in the following terms: “Directors are independent when they do not entertain any relationship whatsoever with a company, its group or management, that might compromise their freedom to exercise their own judgment”. This definition is clear and relevant but quite conceptual, hence of little practical utility. Clearly this is one reason why the code’s following paragraph sets out a more common dependency situation: “Thus, an independent director does not only mean an non-executive director, i.e. one who does not exercise any management functions in the company or group, but also someone who does not have any direct interest (significant shareholdings, employee status, etc.) in these entities”. Analysis of codes of good practice have demonstrated that almost everywhere, independent directors comprise a concept that is almost always defined in negative terms.

3.1. Exclusionary Criteria

Codes try to list in a more or less detailed fashion those dependency situations that arise out of a conflict of interest, i.e. each and every time that directors might be tempted to influence a decision benefiting a party other than the company towards which they have fiduciary duties. It means that for the different codes and by default, independent directors can best be described as individuals who fit this kind of box ticking process.

Returning to the principal situations where directors face a conflict of interest and can therefore not be described as independent – and given that people are always looking out for number one - the greatest conflicts tend to involve top managers using their powers to pursue personal interests to the detriment of the company they lead. This is followed by situations involving employee directors whose duty is to obey managers’ orders limited only by the instructions’ legality. In principle, employees obeying a superior’s order don’t have to be concerned with corporate interest, except when the order is clearly against the legal regulations, in which case they can engage in whistleblowing. This is the reason why no manager or employee can ever be described as independent. For the same reasons, a director who has a business relationship with a company cannot be independent. This should classically include consultants, customers, suppliers, and people representing those geographic territories where the company operates. It should also includes bankers: notwithstanding resource dependency theory, which holds that even if a company’s bankers can help it to better control its risks and stabilise the environment (something that is true), it is always preferable not to have them join the board (one counter-example being the way that Société Générale’s CEO sat on Arcelor’s board from 2002 to 2004, something that did not prevent him from funding Mittal’s takeover of Arcelor in 2006). It is still possible, however, to appoint ex-bankers without any previous business relationship to the company, to take advantage of their expertise (note the caricature of the CEO of a large French bank who is also director of a leading CAC-40 company and criticises its CEO for only investing in treasury bills and not in bank savings products...). We also estimate that like most codes, independence must imply the absence of any previous work or business connection with the company. It also means that the person has not been (or represented) a shareholder with a big equity stake in the company. Lastly, the imperative of independence necessarily excludes being a board member of a company that is connected via cross-shareholdings.

These obvious conflicts of interest are easy to identify. Other forms are more subtle. One example is the “gray outsider” or “gray director” when people have worked together for many years and quite naturally create a kind of connection that can cloud their judgment. This is why it is reasonable to establish a maximum total duration for a board’s cumulative mandates, turning this into the threshold beyond which a presumption of dependency exists. What is harder to analyse is a privileged relationship with an important shareholder or director who is also a company executive. It is easy to identify this when relatives are involved but much harder in case of friendships or where people are connected through common networks. Indeed, it is almost

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22 Indeed, this is one foundation of The Agency Theory (see Jensen and Meckling 1976), which views a board’s prime mission as controlling a company’s management.
23 Read the Subcommittee Report on Investigations (page 55) where it says that in 2000, Enron paid $490,000 in consulting fees to one of its allegedly independent directors.
24 As a practical rule, most codes require a break of five years without any contractual ties to the company before the person in question might be deemed independent.
25 Meaning that a company’s former auditors cannot be classified as independent.
26 In practice, a 5% threshold - often mentioned by stockmarket regulators or in literature – could be used.
27 The so-called “scratch my back” technique where an executive at company A is director at company B and vice versa.
28 France’s AFEP-MEDEF Code (2016, p. 8) puts this at 12 years.
impossible to count all of the situations where a conflict of interest exists, given the vagueness of constructs like “friends of the CEO”: the question here is how, in a list of prohibitive defects that excludes “independence”, it might be possible to account for the fact that a director has, for instance, gone to school (or even something more intimate) with the CEO. The fear here is that this dilemma may never be resolved satisfactorily. One other kind of dependency is financial in nature, raising questions in turn as to the degree of independence enjoyed by directors who have satisfied all the criteria of independence defined above yet for financial reasons cannot afford to resign. Directors who need the income they receive during a particular term of office are anything but independent and become, ipso facto, subcontractors. It is not at all desirable for directors to receive for one directorship a significant part of his total remuneration. Being balanced is central to a director’s work since this criterion logically contrasts with another one that is written in stone in all kinds of codes of good practice - one to which all directors must subscribe whether or not they are independent - relating to directors’ ability to fulfill their mission correctly (for instance, directors cannot serve more than 3 mandates in listed companies since 2015). This is one illustration of the Paradox of the Independent Director presented in the conclusion to the present paper but it is also unclear whether absolute or relative thresholds should be set to limit potential directors’ income. What we suggest for less straightforward criteria of this kind is a simple presumption of dependency that the company may choose to neglect (as long as it justifies its decision) in application of the famous Comply or Explain principle. The difficulty here is ensuring satisfactory remuneration in a way that attracts talents to a function that is becoming increasingly professional, while ensuring that the pay does not amount to a disproportionate share of directors’ income (i.e. 20%), since beyond this point it is hard to argue that they can remain independent.

3.2. Criteria that are Positive but Also Subjective

“I generally consider anything that is voluntary to be free.”

Descartes, Letter to Mesland, 1644

Some of these criteria may be hard to measure but they are in fact part of a tangible reality. Of course, other more subjective (basically potestative) criteria also exist, insofar as a director’s independence is much more than a simple catalogue of parameters. Although catalogues of this kind may be necessary, they are never sufficient and directors could fully satisfy all the criteria defined above without ever having to behave independently29. Indeed, independent directors will accumulate a number of other qualities over time, the most fundamental being the ability (and especially the desire) to say no to certain things and oppose decisions considered incompatible with the corporate interest. To exercise this capacity appropriately, independent directors must possess the qualities of a “marginal-sécant” (influential outsider) as per Crozier and Friedberg’s definition30. In fact the usual English translation of “marginal-sécant” into “influential outsider” misses the point on the most important characteristic: a “marginal-sécant” is not an outsider, he is an insider, that’s the reason why we will keep the French denomination in this paper. A marginal-sécant is an actor working within the system (i.e. directors who, unlike consultants, are in the company and not outside31) and whose concomitant position as a stakeholder in other systems that have a relationship to the first one means that they can serve as an intermediary, interpreting different and even contradictory logics of action. To fulfill this role (and like “marginaux-sécants”), independent directors must possess real competency enabling them to understand the logics of action in question. They must also be in a strong position and feel free to act, something translating into specific room to maneuver and to experiment (particularly when directors fear being excluded from the organisation, specifically because of their financial freedom as aforementioned). There is also people’s willingness to fulfill this role, and not just as part of some embeddedness and/or institutional rent capturing strategy, as is far too often the case in practice. Assertively opposing decisions because this benefits the company, being capable of providing constructive opposition to ideas with which the director does not agree - all this also implies independent judgment enabling the person in question to forge their own opinions. In turn, this requires a real ability to listen, to express oneself clearly and to fully participate in board discussions. A passive director will not have the same attitude as an independent one.

Clearly, defining independent directors is a real Gordian knot. As always, however, an approximate definition is better than none at all32, explaining why stock market regulators in France - in their infinite wisdom - generally require listed companies to take part in such exercises.33 The definition then becomes a de facto question that must be studied on a case-by-case basis for all of the directors claiming an independent status, in each company, year in year out, following some real debate. Each board must engage in a reflective exercise and develop, after deliberation, its own definition based on current codes and regulations. We also consider it good practice that the definition updated annually. Once the doctrine of independence has been defined, it is up to the board of (upon proposal from the nominating committee, where one exists) to face the consequences by examining year in year out, on a case-by-case basis, the situation of each of its members in light of the independence criteria that it has defined34. This annual checkup is particularly

29 As André Malraux used to say, people are judged on their acts, not what they do. Les noyers d’Altenburg, 1943.

30 Crozier and Friedberg, 1977, p.73.

31 Another fundamental difference between director and consultant is that the latter generally provides the company with one or several services on an ad hoc or limited time basis, whereas the activity of the former is an ongoing process that takes time to unfold.

32 Keynes was right to say that he always preferred being vague and right rather than specific and wrong.

33 In France, “The AMF (The French Market Regulator) reminds companies that providing information about directors’ independence means that they must specify which definition of independence they are using”. AMF (2016), page 33. The AFEP MEDEF Code (2016) correctly specifies on page 7 that, “The board might determine that directors, even when the criterion of independence has been satisfied, cannot be deemed independent solely due to their...
justified given that good independent directors must work hard to remain independent throughout their terms of office. As a practical rule, each company must define categories of board members: inside directors connected to the company by a work contract; affiliated or gray directors who (without being insiders) do not satisfy formal independence criteria; and independent directors who satisfy these criteria and whose real independence can only be appreciated in practical terms. This is why boards must consider that directors who satisfy independence criteria formally cannot be deemed independent solely on the basis of their or the company’s particular circumstances.

3.3. The Role of Independent Directors and the Contributions They Make

“There is no freedom outside of action.”
G. Debord, La société du spectacle, 1967, p.1

Like their fellow board members, independent directors are first and foremost fully fledged directors who participate as equals in the board’s collegial proceedings and must therefore possess all of the qualities required for a function that has undergone rapid professionalisation over the past 30 years. In other words, directors must behave with integrity as if they represent all of the shareholders who appoint them and focus on the company’s corporate interest and nothing else. They must be competent in the sector of activity where the company is active or else provide an expertise that is useful to the board, even as they manifest good judgment, see the big picture and possess a real experience of business life, implying an ability to identify weak signals that announce significant upheavals in the corporate environment or are symptomatic of bad operational management by the company or of tensions within the board. They must deliver relevant analyses while applying mindset that should be more summative than analytical in nature and offer a real vision of the company and its future, implying good understanding of the sector even of global macroeconomics where, for instance, financial institutions or global players are concerned. Of course, directors must respect board deliberations’ confidentiality, fulfill a fiduciary duty of loyalty and indeed an absolute loyalty to the company based on full compliance with the three types of texts to which they must adhere (law, regulations and corporate statutes) as the board’s own regulations will tend to dominate quite naturally, but unlike the other three categories, they can be modified by the directors themselves. They must act with responsibility, diligence, and confidentiality. They must be involved in terms of workload, the norm is an average between 20 and 30 days per annum in a listed company. Good directors work non-stop for their company and are constantly seeking anything that can improve performance. Lastly, in their relationships with fellow directors, they must demonstrate - more than others given the essentially oppositional nature of their role - a great sense of devotion as well a perfect courtesy, to encourage real debate. Within the theoretical framework of cognitive governance defined above, directors must ultimately create value for the company. On the other hand, a director’s relational contribution - something that is central to the business network because of the way that this can facilitate or develop business - has long considered a key virtue but is very devalued today, if only because it is increasingly viewed as a potential cause for conflicts of interest that could lead to corruption or illicit agreements, instead of as a real competency.

Asides from these generic qualities, independence means contributing something extra to each of the four board missions defined above. There is the vigilance mission, reinforced to ensure that risks are identified and monitored, as well as the the need to study boards’ ideal composition and different modus operandi for selecting new directors or renewing the mandates of existing ones.
4.1. The Need for a Nominating Committee and the Composition Thereof

Many new director recruitment processes are opaque and superficial, with far too many individuals today still being “Friends of the CEO” or, in the best case, adopting an informal approach where they are simply co-opted into the current directors network35. Improving upon such processes36 starts with the creation of a nominating committee within the board, a practice that has expanded rapidly in recent years37. This committee must identify what it considers to be a more or less ideal board38, notably defining an optimal size as well as desirable profiles ensuring the board’s equilibrium and complementarity while respecting the constraints weighing on the company39 - a task to which the present paper contributes.

The nominating committee should ideally be exclusively comprised of independent directors (and no executive managers). As A. Shivdasani & D. Yermarck (1999) demonstrate there is evidence consistent with the proposition that firms select directors less likely to monitor aggressively when CEOs are involved in the process of selecting new directors. An independent nominating committee improves a board’s efficiency by keeping executives from directly influencing directors’ nomination process. Limiting senior managers’ ability to choose other managers is not that easy, if only because influence of this kind can be exerted merely by suggesting certain names, applying friendly pressure during the selection process or wielding normal prestige and influence. Hence the need for a formalised appointments process.

4.2. Procedures for choosing new Independent Directors: Fighting the Old Boys Clubs

The nominating committee should start by putting together a precise job description defining needs40 before subcontracting the actual recruitment to executive search specialists (the best solution, in our opinion). Otherwise, it is always possible to ask one existing board member to be in charge of finding a new candidate. In any event, a short list of applicants should be established and processed by the nominating committee. The nominating committee should subsequently draft a formalised selection process41 specifying what due diligence will require the assistance of an outside agency42, a process that not only verifies applicants’ competencies but also their integrity. Lastly, the new director selection process must include an inclusion chapter (suggesting a mentor director, and transmitting useful information sufficiently early enough to allow the newcomer to learn as soon as possible about the company’s workings and any urgent and/or important files).

4.3. Procedures for Renewing the Mandates of Existing Independent Directors

Cases involving the renewal or succession of an existing director are harder, if only because of many board members’ sense that they are part of the furniture (an especially tricky situation when this opinion is shared by their peers). Yet orderly corporate succession planning is one of the nominating committee’s main missions. The same applies to the preparation of continuation plans in case of an emergency or sudden disappearance of a key staff member. Clearly the most crucial task is planning the operational leader’s succession, given how critical this can be for a company’s survival. One good practice at this level consists of writing into the board’s internal regulations a maximum term of office for each director (i.e. 12 years) as well as an assessment grid that can be filled in each and every time that a mandate is renewed. Purely factual data like attendance at board meetings, duration of the term of office, number of terms of office, loss of independence, a company’s strategic development, etc. can be used to ascertain whether a director should be renewed or replaced. Director mandates can be terminated in three kinds of circumstances: forced retirement for legal or statutory reasons; resignations; or departures from the company. A reasonable retirement age should also be set, if only because renewing directors generally helps to revitalise a board43. The duration of directors’ term of office, the conditions in which their cessation of service should be announced and the nature of any severance pay they may receive at the end of their mandate – all of this information will have to be published. In addition, there should also be some indication whether there are any particular arrangements for paying directors severance pay following a corporate takeover44.

5. CONCLUSION: THE PARADOX OF THE INDEPENDENT DIRECTOR

“When people think about free thinking or free will, they do not ask whether it is possible to do something they want to but whether their will is itself independent enough.”

Leibnitz, New essays on human understanding, 1705, II, XXI

Built on the foundation of our Enlightened Shareholder Theory, what we have devised is a definition of the modern firm, the distinction between the governance system and the corporate

35 A substantial empirical corpus largely confirms this vision of professional practice, one shared by practitioners and observers alike. See The Working Group on Corporate Governance (1995).
36 Recent literature on appointments has focused especially on the recruitment of women, c.f. J. Claringbould & A. Knopper, (2007).
37 The nominating committee must be small (3 to 4 persons) with most members being independent. At least one should be competent in human resource development.
38 It is customary for teacher-researchers to pretend, quite ridiculously, that they have discovered the secret recipe for the ideal board…Practitioners don’t have the same immediate ambitions.
39 Thus, the banking sector or any other regulated sector is subject to specific legal or regulatory constraints that it must take into account.
40 On this point, see Daily and Dalton (2004), pp 8-9. The idea here is that it is possible to create a matrix of competencies specifying on one axis which ones are being sought and on the other which ones the existing board already provides.
41 See the rule changes that the SEC adopted at yearend 2003.
42 Like Kroll’s International Business Research, IPSA International Business.
43 Which does not mean that there is any need to deprive oneself of the competencies of an exceptional director due to some guillotine retirement age (for the greater glory of management studies, Peter Drucker was still teaching and consulting when he died in November 2005 at the age of 95). French law setting an age limit for two-thirds of all board members seems a good compromise at this level.
governance stricto sensu, and the missions of a board of directors. Within this theoretical action framework, a director’s definition can first be stated in negative terms by listing all of the criteria that prevent us from considering a director independent. This can then be followed by a much more positive definition. Even if we cannot account for all situations, simply recognising the de facto existence of independent directors means that each board should be free to set up its own doctrine and to deal with (infrequent) exceptional situations on a case-by-case basis. As a practical rule, we also suggest few principles relating to appointments committees and their independence. These should make it possible to recruit new independent directors and decide whether or not to renew the mandates of ones who are already in place.

The practice of an independent director implies to find the right balance between opposite forces⁴⁵. Exercising an activity that has undergone rapid professionalisation over the past 30 years, he will generally try to maintain his status and value on the market for board members. This being the case, it is in his interest to present to executives from the companies that are likely to call upon him the image of a director who is capable of working in a team to further the company’s interest, behaving towards senior management in a conciliatory and flexible manner⁴⁶. Reconciling the ability to work in a team with the core idea of independence (i.e. with the power to oppose things and to say no)⁴⁷ probably constitutes the Gordian knot of the Paradox of the independent director. The only way to overcome this dilemma is by transcending the customary definitions characterising it. After all, as we learned from Leibnitz, independence is not a question of circumstances but fundamentally of spirit and will.

REFERENCES

24. McAvoy, P. et al. (1983). Proposals for increased control of the corporation by the board of directors: An economic analysis in Business Roudtable on the American Law’s Institute’s Proposed Principles of Corporate Governance and

⁴⁵ See supra the opposition between the financial independence necessary to be able to say no and the ceiling of directorship to maintain the ability of the independent director to fulfill correctly his mission.
⁴⁷ Independence is a totally distinct concept and in many ways the opposite of constructive behaviour. Yet this is what all directors must show, namely a collaborative and constructive mindset. A good independent director must always oppose anything that is contrary to the corporate interest while remaining helpful and instructive.
Structure: Restatement and recommendation (Business Roundtable, New York).


