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The role of independent directors in ensuring good corporate governance

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Abstract: Independent directors are considered an important role in corporate governance under the unitary model. The independence, professionalism and supervisory role of independent directors can provide professional advice to the company, which is conducive to preventing the abuse of power by the management, safeguarding the interests of shareholders and ensuring the compliant operation of the company. However, independent directors are not 100% effective. The fact that independent directors are not involved in the day-to-day operations of the company means that they do not have access to accurate and effective information. In practice, the influence of independent directors is limited and their impartiality cannot be guaranteed.

1. Introduction

Uber's co-founder Travis Cordell Kalanick's tenure as CEO was marked by a pervasive unethical workplace culture and management scandals. In 2017, the scandal-ridden Kalanick was forced to step down as CEO at the behest of numerous shareholders and board members. In October of the same year, Uber's board voted to reform corporate governance and to hire an independent chair and three independent directors. The following year, Ronald Sugar was elected as independent chairman and led Uber to an IPO in 2019, and the appointment of an independent chairman was seen as a critical part of the Uber fiasco.

It is not difficult to see the value of the existence of independent directors in the Uber affair. In response to the scandal, Uber hired Covington & Burling, the legal firm set up by former US Attorney General Holder, to review Uber's policies and make recommendations for improvement. The decision to appoint Wan Ling Martello to the board was prompted by Covington & Burling's recommendation that Uber should appoint more independent directors.

A company with good corporate governance and an effective board can attract investors and secure investment. The board's independence is essential to ensure that it performs its duties objectively and holds management accountable to the company. The practice has shown that the presence of independent directors helps to achieve this goal.[1] Under the "unitary" model, the establishment of independent directors can indeed improve corporate governance, enhance oversight function, reduce agency costs, and maximize corporate social value and shareholder interests.

In the following section, I will explain the concept of corporate governance and independent directors, analyze how the legal and regulatory framework of corporate governance in the UK

judicial context supports or limits the role of independent directors in ensuring good corporate governance, then critically discuss the contribution and challenges of independent directors in corporate governance, and explain the position and the need or otherwise of senior independent directors in this context. Finally, a case study is presented to illustrate the need for good corporate governance by independent directors.

2. Background

2.1 Corporate Governance and Independent Directors

As the system of rules, practices, and processes that guide and control a company's operations, there is no single accepted definition of corporate governance. The Cadbury committee's description of corporate governance in the first edition of the UK Corporate Governance Code is considered more authoritative, "the system that guides and controls the company. The board of directors is responsible for the governance of the company. The role of shareholders in governance is to appoint directors and auditors and to satisfy themselves that a proper governance structure is in place."[2] The purpose of corporate governance is "to reconcile, as far as possible, the interests of the individual, the company, and society."[3] Specifically, its mission is to effectively protect shareholders' interests, realize shareholder value and maximize long-term returns on shareholders' investments and enhance investor confidence by facilitating collaboration between shareholders, management, and creditors, protecting shareholders' interests, achieving win-win outcomes for all stakeholders in the company and other related objectives.

Although many factors are involved in corporate governance, the core issue is resolving the agent problem between shareholders and the operator.[4] The emergence of the corporate system has led to the separation of ownership and control of companies. As capital markets and the globalized economy continue to develop, shareholdings are gradually decentralized, which leaves investors, i.e., company shareholders, with insufficient time and energy to keep an eye on the situation of each company they invest in, increasing the gap between ownership and management of the company, so that the actual control of the company is in the hands of the company's management and board of directors.[5] In this chain of authority, the board of directors is both a decision-making and a supervisory body. However, the interests of shareholders and directors are not always aligned. When conflicts of interest arise, the lack of a proper monitoring mechanism may result in directors undermining the interests of the company and shareholders. Corporate insider control is a severe problem, and abuse of power and operational corruption is rising. The management's self-profit-making phenomenon has attracted controversy and dissatisfaction from the company and the community at large. Corporate governance problems are becoming increasingly severe, and the search for solutions to these problems has directly contributed to the emergence and development of the independent director system.

Robert Hamilton, a leading American corporate law expert and law professor, defines an independent director as "a director who is not an officer of a publicly held company and who has no direct or indirect material relationship with the company in its business dealings."[6] This concept distinguishes the executive director. However, as with corporate governance, there is also no single authoritative standard for independent directors. The interpretations of national institutions and scholars can be summarized broadly as follows: as a member of the board of directors or a committee under the company, an independent director does not hold a management position, is not a member of the company's executive team, and does not take part in the day-to-day operations of the company. In addition to the crucial legal characteristics of a director in general, the key attribute of an independent director is independence.

2.2 Duties and obligations of independent directors in the UK judicial context

2006 The Companies Act imposes various duties and responsibilities on directors, such as the duty to act in the best interests of the company, the duty to exercise independent judgment and the duty to avoid conflicts of interest. These provisions relate to the role of independent directors in ensuring good corporate governance.[7]

The UK Corporate Governance Code includes provisions relating to the composition of the board of directors, the role of independent directors and various aspects of board operations, such as audit, remuneration and nomination committees. Although the Corporate Governance Code 2018 is not as legally binding as the Companies Act 2006, companies listed on the London Stock Exchange are required to report on their compliance with the Code in their annual reports. Companies must comply with the provisions of the Code or explain any deviations from it.

3. Critically Analysis

3.1 Senior Independent Director

In the UK, one of the critical roles independent directors play is that of Senior Independent Director (SID). In some cases, significant shareholders may disagree with a company's board of directors but cannot express their views through the chairperson and chief executive officer. The Higgs Review, published in 2003, recommended that boards of listed companies appoint a senior independent director from among their independent non-executive directors. Higgs believes that the senior independent director is an essential link between significant shareholders and the board and that "shareholders should have access to the senior independent director if they have reason to be concerned that the normal channels of contact through the chairman or chief executive have not been resolved."[8]

As a highly flexible intermediary, the SID's role is indispensable in a well-functioning board. The SID becomes extremely important when "the board or company is going through a period of stress," such as a dispute between the chairman and the CEO or a disagreement between board members.[2] The SID serves as the Chairman's sounding board and stands between other Directors and shareholders. At least once a year, the Non-Executive Directors, chaired by the SID, are anticipated to gather without the Chairman to debate and evaluate all facets of governance and performance.

3.2 Benefits of appointing independent directors for good corporate governance

(1) Professional knowledge and extensive experience

In general, independent directors take on an advisory role in a company. They usually have financial, management, and legal knowledge and extensive industry experience to provide valuable insights and advice to help companies optimize their decisions, navigate complex business environments and manage risk effectively.

The quality and effectiveness of the board are a product of the combined rate of individual directors. To enable the best teams to be formed, independent directors must contribute various skills to the board. These skills, as well as the accumulation of expertise, bring added value to the work of the board.[5] This specialisation is clearly defined in the UK Governance Code. First, non-executive or independent directors are required to provide constructive questioning, strategic guidance and expert advice and to be accountable to management; secondly, independent directors are able to exercise independent judgement on significant corporate matters; and, finally, at least one member of an audit committee comprising independent directors has relevant financial

experience.[9]

The professionalism of independent directors is not only reflected in having specialist knowledge. As independent directors come from different industries and have different backgrounds, when solving problems for the company, they often take an outside perspective and bring in additional third-party advice. In addition, independent directors may be professionals who have worked in industries very different from the company's, and their extensive experience in other sectors may bring new ideas to corporate governance.

(2) Enhancing credibility

The presence of an independent director on a company's board can enhance the company's reputation with investors, shareholders, and other stakeholders. It will signal to the market that the company is committed to good corporate governance practices, which can build trust and potentially increase access to capital.

For a long time, independent directors' presence was considered a criterion of good or bad corporate governance due to the strict control of the board of directors and, therefore, the company by top management that occurred in companies in the UK and the US before the 1960s. With a high degree of separation between ownership and control, the problem of "insider control" was detrimental to the interests of shareholders, and the role of independent directors in monitoring and checking the board of directors of companies was an effective solution to this problem. As a result, the separate director system has become popular and an essential creation in exploring corporate governance models.

The governance standards for companies listed on the New York Stock Exchange in the United States require that independent directors must constitute a majority of the board of directors of a listed company. This is also the case in the UK, where at least half of the board, in addition to the chairman, should be independent non-executive directors recognized by the board.[9] To this day, the role of independent directors remains prominent and is still chosen by many investors for its credibility. In the case of Uber, as mentioned in the introduction, Uber unanimously passed a series of resolutions at its board meeting to improve its corporate governance structure to bring in a US$1-1.25 billion investment from a consortium led by SoftBank Group, the most crucial measure of which was the selection of an independent chairman and independent directors.

(3) Supervision

Independent directors play an essential role in overseeing executive management. They manage the performance of the Chief Executive Officer and other executive directors, which helps to prevent mismanagement and protect the interests of shareholders. They also oversee the financial reporting and audit functions, which help to ensure financial transparency and accountability. The UK's corporate governance structure is manifested by establishing committees under the Board to support the Board in exercising its responsibilities. The role of the independent directors relies on the collective functioning of several specialist committees of the Board, including the Nomination Committee, the Audit Committee, and the Remuneration Committee.

The role of the independent director goes beyond oversight, but oversight remains the primary and substantive role of the independent director. The percentage of independent directors on the board is one of the most crucial aspects since it represents the board's independence and is seen as an objective and professional mechanism.[10] The purpose of supervision is primarily to protect shareholders' legitimate interests and prevent and limit insider control. Insider control is a side effect of the "Agency problem" and system costs. Because managers have the drive and tools to increase their influence, insider control can spiral out of control swiftly. This lack of control may prevent the business and, ultimately, the stockholders from losing interest. Therefore, there is an apparent necessity to keep an eye on insider management managers' professional behavior. Firstly, the appointment of independent directors has changed the proportion of board members, thereby

decentralizing the decision-making and management powers of the company and thus enhancing the board's oversight function. The independent directors are external, on par with the executive directors, and rarely in dispute with them, so the executive directors hardly influence them. Furthermore, they are not involved in the day-to-day running of the company. Therefore, they can make an objective assessment of the conduct and results of business decisions.[11] Secondly, instead of making specific business decisions, the independent director's job is to oversee insiders' work and, in particular, to assess the choices made by motivated insiders who frequently act and think in stereotypical ways. On the other hand, an outsider might provide a fresh perspective on the business that is essential to avoid making the same mistakes.[12]

The oversight function of independent directors facilitates information disclosure, which has long been an essential part of the work of corporate boards, and the 2012 edition of the UK Corporate Governance Code added, among other things, the main principle that the board must provide an objective and understandable assessment of the company's current situation and prospects. The caliber and thoroughness of corporate disclosure have been progressively rising under UK corporate governance. The board effectively communicates with shareholders about the company's risks and operations through high-quality revelation, which is crucial for businesses looking to promote transparency and lessen information asymmetry with investors.

(1) Potential disadvantages of appointing independent directors

1) Information asymmetry

The information that independent directors rely on to create opinions primarily comes from the firm's management because they are not involved in the company's day-to-day operations and only learn about it via management presentations or financial reports. However, any insufficient or skewed disclosure of material by the company's management, particularly intentional coercion or deliberate efforts to obscure or confuse it, is sufficient to sway the independent directors' ability to develop an unbiased opinion. The information given to outside directors is one method the CEO can use to influence the board.[13]

There is a correlation between the level of information barriers in a company and the effectiveness of independent directors.[14] An increase in the proportion of independent directors in companies with high information access costs will not improve the effectiveness of independent directors' oversight, nor will it enhance the company's performance, but rather reduce it. For companies with low information cost access, more independent directors will generate efficiency and effective oversight and improve corporate operations. The inability of independent directors to monitor effectively because of their disadvantaged position in terms of information is already a headache in corporate governance. Increasing the proportion of independent directors may be just a quack corporate governance model.[15]

2) Independence in practice

Although independent directors are impartial in theory, their independence may be questioned in practice. For example, their impartiality may be compromised if a significant shareholder nominates them or has been on the board for a long time.

Independent directors are mainly recommended by executive directors, some of whom are or have been executive directors of other companies. In some cases, the exercise of the independent directors' powers may be influenced by the executive directors based on common interests. And in practice, most independent directors are elected through personal relationships with companies or friendships with directors. It is not uncommon for executive directors or shareholders to recommend independent directors.

An independent director can never be a reliable watchdog over those who elect him. Any perceived strong criticism of the executive team could endanger the independent director's employment if the company's management is directly or indirectly involved in the selection process

and can gain favor on several committees.[9]

3) Limited influence

Despite their crucial role, independent directors may have limited influence over a company's operations, mainly where there is a dominant chief executive or a group of controlling shareholders.

Controlling shareholders tend to choose as independent directors within the company those individuals who are more closely related and can quickly develop control and mastery over them. In this situation, the controlling shareholder will vigorously strengthen its control over the company's board of directors and independent directors to facilitate the protection of its interests. Professional managers and senior management personnel such as the CEO become the main decision-makers and key executives in the actual internal operations of the company, with substantial control over the company's primary internal processes and development. In practice, senior managers within the company often adopt restrictions and weakening of independent directors mainly for the following motives: seeking higher benefits and remuneration rewards; wishing to hold the supreme power and rule-making power of the company to take the initiative in internal management; and being pressured by investors to commit illegal acts such as fraud and reduce monitoring pressure. At the same time, to maintain their power and position within the company, to take the initiative in setting the rules of the company's internal game, and to cover up their violations, the influential executives within the company have the same interests as the controlling shareholders, and to reduce the same supervisory pressure on them, they often choose to conspire together to weaken the independence of the company's independent directors to ensure their interests.

4. Case Law

4.1 Independent director in a Unitary Model

Guardian investigation found a range of disturbing working practices at Sports Direct, including health and safety measures breaches, a 'six strikes and you're fired' policy, and staff earning less than the minimum wage. The 37-page report examined the treatment of employees in detail and urged Sports Direct to rectify the situation. After months of criticism from investors, MPs, and employees, Sports Direct bowed to pressure, committed to an independent review of working practices and corporate governance, and hired ground floor employees as independent directors to provide input and oversight.

Although the treatment of employees has not been radically improved, Sports Direct has made changes. It is believed that the advice of the independent directors from the bottom perspective will help the employees to get out of the situation as soon as possible.

4.2 Independent director under the dualist model

In China, there is a landmark case concerning independent directors. Ltd. for securities misrepresentation, five of the thirteen persons held jointly and severally liable were former or serving independent directors of Kangmei Pharmaceuticals. In this case, the company's independent directors argued that they "had no knowledge of, let alone benefit from, the various violations by Kangmei Pharmaceutical before and after the fact;" and that "Kangmei Pharmaceutical's violations were relatively hidden and difficult to detect."

With the introduction of the system in some countries and regions with dualistic corporate governance in the civil law system, the independent director system has tended to "become the common orientation of different corporate governance models." However, the system of independent directors in China is often labeled as "vase directors" and "humane directors" because it does not play any functional role. There are two reasons for this: on the one hand, many

independent directors wish to play a role in corporate governance, but due to barriers in access to information and institutional obstacles, it is difficult for independent directors to understand the situation of the company truly, and they lack adequate working mechanisms and rights protection to perform their duties. In addition, there are no institutional safeguards for independent directors in terms of their personality, financial interests, procedures for their creation, and the exercise of their rights, making it challenging to guarantee their independence in performing their duties. On the other hand, as an imported system, independent directors have been expected to perform a variety of advisory, advisory, and decision-making roles and have been subjected to high expectations, which have led to questions and accusations when the reality has deviated from the original vision.

As it turns out, for developing countries and countries with a dualistic corporate governance system, there is still a lot of work to be done to improve the role of independent directors in good corporate governance.

5. Conclusion

The system of independent directors was created and developed based on corporate governance theory and issues arising in practice. The existence of independent directors ensures the independence of the board of directors, which in turn provides the board's effectiveness, the ability to perform its duties objectively, and the achievement of good corporate governance.

In the UK, one of the key roles played by independent directors is that of Senior Independent Director. The benefits of appointing independent directors are clear: independent directors come from diverse backgrounds and therefore bring a wealth of expertise and industry experience to the company; the presence of independent directors in the company acts as a signal to investors, shareholders, and other stakeholders that the company is committed to good corporate governance practices; and as the primary and substantive responsibility of independent directors -monitoring, the presence of independent directors facilitates corporate transparency and the quality of information disclosure. However, it is undeniable that independent directors are not 100% effective. In situations of information asymmetry, independent directors may lack detailed knowledge of a company's operations, which may prevent them from making informed decisions and providing effective oversight; and, in practice, the independence of independent directors is often questioned, notably when major shareholders nominate them or have been on the board for a long time; in addition to this, the influence that independent directors can have effect may be limited, mainly where there is a dominant CEO or a group of controlling shareholders.

Further case studies reveal that independent directors still play a significant role in good corporate governance in a monolithic system. In contrast, in countries with a dualist corporate governance system, independent directors face an awkward situation and often need to play a better role in enhancing the quality of corporate governance.

In general, independent directors are essential to ensure good corporate governance. However, in practice, there are still shortcomings to be overcome, which require the cooperation of the board of directors, executive directors, and shareholders.

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