Independent Directors: Neither Tigers nor Pussy Cats

The independent directors of Isetan, PacNet and Robinsons were recently put in the spotlight as a result of certain corporate disputes. The controversy generated much hand-wringing in the press over the role of independent directors. The debate ultimately led to some declaring that independent directors were put on the board to protect minority shareholders, while others pointed out that under the law the duty of directors was to act in the company's best interests and not simply the interests of a select group of shareholders. While much heat was generated by this debate, it was also less than illuminating.

By Annabelle YIP, Partner. For more information on this topic or on any other issues relating to corporate governance, please contact Annabelle (direct: +65 6416 8249) or Joy TAN (direct: +65 6416 8138).

Duty of Directors a Useful Guide?

As a preliminary to the discussion, it is worth noting that the concept of independent directors is one that appears primarily in the Code of Corporate Governance ("Code"). Under the Companies Act, there is no mention of independent directors except in section 201B, which relates to the constitution of audit committees of listed companies. This section provides that the majority of the audit committee shall not be:

- executive directors of the company or any of its related corpra-tions; nor
- immediate relatives of any such person; nor
- any person having a relationship which, in the opinion of the board of directors, would interfere with the exercise of independent judgment in carrying out the functions of an audit committee.

The Listing Manual of the Singapore Exchange has a sole reference to independent directors: This is set out in the context of the requirement for the immediate announcement of changes to the constitution of the audit committee (rule 704(8)).

Independence is hence a corporate governance concept, not a legal one. It is unsurprising therefore that the law itself draws no such distinction. As noted above, under the law, a director's general duty is to act in the company's best interests. This duty is one that falls upon all the directors of a company, whether executive, non-executive, or independent non-executive. It underlies the specific common law and statutory duties of directors, such as the duty to avoid conflicts of interest, or the duty under the Companies Act to act honestly and use reasonable diligence. Indeed, not only must a director act in the company's best interests, it may well be a breach of his duty to promote the interests of one group of shareholders over another (the thorny issues surrounding nominee directors warrants a separate discussion of its own). To the extent that this duty is also reiterated in the Code—which states that all directors must objectively take decisions in the interests of the company (guideline 1.2)—the reference is merely a reminder of the basic duty at law.

To focus therefore on the duty of a director under the law is therefore not particularly helpful in understanding the role of an independent director. After all, if the simple application of the law were all that was needed, there would be no need for independent directors, as all directors—executive directors included—are required to act in a company's best interests. However, recent corporate scandals have shown that independent directors do indeed have a role to play in proper corporate governance. It may be useful therefore to take a step back to consider why independent directors were, in the first place, introduced as a cornerstone of the Code.

The Role of Independent Directors

In its report of 21 March 2001, the Corporate Governance Committee stated, "Boards must have some degree of independence from Management in order to effectively fulfil their responsibilities." It further noted that:

"...independent board members play an important role in areas where the interests of Management, the company and shareholders may diverge, such as executive remuneration, succession planning, changes of corporate control and the audit function. Further, they are able to bring an objective view to the evaluation of the performance of the Board and Management."

In the United Kingdom, the Review of the Role and Effectiveness of Non-executive Directors by Derek Higgs ("Higgs Report") made in January 2003 to the Chancellor of the Exchequer and the Secretary of State for Trade and Industry of Great Britain, noted that the functions of non-executive directors included:

- constructively challenging and contributing to the development of strategy;
- scrutinising the performance of management in meeting agre goals and objectives; and
- monitoring the reporting of performance.

The Higgs Report further stated, "Executive and non-executive directors have the same general legal duties to the company. However, as the non-executive directors do not

report to the chief executive and are not involved in the day-to-day running of the business, they can bring fresh perspective and contribute more objectively in supporting, as well as constructively challenging and monitoring, the management team."

In the United States, the Report of the New York Stock Exchange Corporate Accountability and Listing Standards Committee in June 2002 ("NYSE Report") recommended, amongst other things, empowering non-executive directors to serve as a more effective check on management.

While the Higgs Report and the NYSE Report referred to non-executive directors, the same recommendations would apply equally (if not with more force) to independent non-executive directors. It is clear therefore that independent directors are not simply there to act as checks against management wrongdoing, but to provide a measure of internal scrutiny to ensure that the management's decisions are sound and defensible from an objective legal, commercial and business point of view.

Go Beyond "Either-Ors"

Unfortunately for independent directors, management's decisions cannot be simply divided into those that are in the company's interests and those that are against it. Such a dichotomy fails to adequately capture the realities of business. At the very least, any decision can be considered against a backdrop of alternatives, some of which will be against the company's interest, some of which will be either neutral or only somewhat beneficial to the company (but possibly favoured by some of the shareholders), and some of which will be beneficial to the company (but possibly against the interests of some of the shareholders). How should an independent director react? In a scenario akin to that faced by the independent directors of Isetan, might they not argue that to favour the interests of the majority shareholder was also to benefit the company as the company would need the support of its holding company in the long run?

As that situation highlights, there are often no easy answers. However, what is clear is that independent directors must, like Caesar's wife, be above suspicion. This is recognised in the Code's definition of an independent director as excluding someone who had a relationship which might reasonably be perceived as interfering with his independent business judgment, i.e., actual interference is not necessary if the reasonable perception of interference is present. It is therefore necessary that any decisions made by independent directors should themselves be able to bear scrutiny.

In this respect, it is important that independent directors should ensure that they diligently follow a sound decision-making process when bringing to bear their particular expertise and their commercial and business acumen to their roles. In particular, they should ensure the following:

- They should arm themselves with a detailed understanding of their legal duties and responsibilities as directors, and of their role as independent directors.

- They should dedicate sufficient time toward reaching a decision. In particular, they should not allow themselves to be stampeded by management. Where management foists a thick information report on them just minutes before a meeting, it is essential that independent directors insist on being given sufficient time to digest the material. Ideally, they should work to ensure that management understands the need to provide information in good time for them to come to grips with it. On their part, when provided with information, independent directors should take the time to read and thoroughly understand it.

- It follows from the above that independent directors should ensure that they keep themselves fully informed of the company and its business. This does not mean that they should go down to the factory floor to investigate the company's performance. Indeed, they should avoid interfering in day-to-day management. However, as noted in the Higgs Report, they should be prepared to learn about the business, the environment in which it operates, and the issues it faces. This requires a knowledge of the markets in which the company operates as well as a full understanding of the company itself. They should also be prepared to question directors if they are not satisfied with the information that they are receiving.

- Once prepared with an understanding of the company and its business, independent directors should carefully deliberate issues with management and the other directors. They should drill down with management on any loose ends or unreasoned conclusions in the information provided before making a decision on the matter. Here, independent directors should be aware that their strength lies in influencing decisions rather than giving orders. It does not help the company for independent directors and management to be constantly in conflict. Where possible, practical solutions should be found. The objective behind questioning management is not to interrogate them or to deride their plans, but simply to ensure that a particular course of action is a considered one and in line with the broad strategic direction for the group that the board, working with management, has endorsed. For example, if the company wishes to start a new business in, for example, Europe, an independent director with experience of doing business in Europe may query management whether it is fully aware of and has weighed the differences in worker-management relations between Europe and Asia, and how management intends for the company to operate in the new foreign environment. The board may also ask whether and how expansion into the new business and/or into Europe fits in with the group's long-term business strategy.

- If, after having gone through this process, the independent directors are still not convinced of the course of action proposed, they should be prepared to exercise their independent business judgment and to say "no" to management. They should not act as a rubber stamp to management's wishes. On the other hand, neither should they oppose management simply because they may have different views on the details of a particular course of action. Ultimately, there will be risks in every business venture, and they simply need to be sure that the risks have been carefully considered and addressed, and also that the venture fits into the strategic direction of the company set by the board.

- Finally, independent directors should ensure that board minutes adequately reflect that these steps were taken. While it is not necessary for the minutes to record in minutiae the debate between the directors, at least the broad outlines of the debate and the considerations that went into the decision should be recorded. ■