ЮРИДИЧНІ НАУКИ

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Murad Jafarli
Vytautas Magnus University

PERSONAL CHARACTERISTICS OF INDEPENDENT DIRECTORS AFFECTING THE QUALITY OF THEIR PERFORMANCE

Summary. The present research examines the main individual characteristics of independent directors in resolving conflicts of interest between shareholders and managers in public companies with dispersed ownership structure. In the modern corporate governance system, independent outside directors have become an integral part of boards of directors. The addition of independent directors to boards of directors aims to protect the interests of shareholders and is considered an ef-fective mechanism to counterbalance the excessive influence and authority of top executives. How-ever, the mere presence of these directors on the boards of directors of publicly traded companies should not be considered as providing full protection for the interests of shareholders. The quality of the performance of their basic monitoring and advising responsibilities are seriously affected by a number of personal characteristics of independent directors, such as incentives, a propensity to dis-tractions, and a low risk of personal responsibility.

Keywords: independent directors, board of directors, management, incentives, distractions, personal liability.

Problem statement. An overwhelming majority of contemporary public companies have dispersed ownership structure where shareholders inevitably have to cope with challenges in the organizing cooperation and collective actions. As a result, shareholders, who are actually the main investors of the company, do not have access to company management, which makes it possible for the top management team to run the company at their own discretion without taking into account the views of shareholders. In this context, the role of the board of directors as the supervisory body of the company becomes extremely important, since it is the directors who can exercise control over the activities of managers and promote the interests of shareholders. Currently, corporate governance standards require independent outside directors on boards of directors who are not employees of the company, therefore, unlike insider directors, they do not risk becoming dependent on top-level management members (in particular, CEOs) of the company. Nevertheless, the status of independent directors is not perfect and involves a number of difficulties that can significantly affect the level of performance of these directors as representatives of the interests of shareholders.

Recent research and publications. The personal features of independent directors have been the focus of research by various authors. For example, Masulis and Mobbs (2014) examine the impact of reputational concerns on the quality of performance of independent directors. Moreover, the authors examine the performance of directors with multiple board positions and find that independent board members often unequally distribute their limited time and efforts among all directorships.

Among other things, various researchers identified various distractions as factors that considerably affect the level of involvement of independent directors in company management (Falato et al., 2014; Masulis and Zhang, 2019). Interestingly, in the vast majority of previous studies, the authors have focused on the distraction events of independent directors with several board positions. However, distractions, in particular professional ones, may be faced not only by directors with more than one directorship but also those who occupy senior management positions in other companies.

The purpose of this article is to analyze the principal personal characteristics of independent outside directors affecting the effectiveness of their performance as impartial shareholder interest protectors. In the research, the focus is on publicly held companies with a dispersed ownership structure where no single individual or group has a sufficient percentage of shares to gain control over the governance of the company.

Presentation of the main material. Boards of directors play a huge role in stabilizing relations between managers and shareholders, acting as a bridge for these parties, whose interests may fundamentally differ. At the present time, a majority of jurisdictions, as well as stock exchanges, require or recommend publicly held companies to include independent members on boards and committees [15, p. 117]. Director independence implies an absence of any considerable material relationships with the company that could undermine a bias-free judgment. This independence status is associated with the desire to ensure a balance in corporate governance through strengthening the role of independent boards of directors, providing effective monitoring and advising aimed at protecting shareholders. However, sometimes such independence is purely formal in nature, precluding independent directors from properly fulfilling the full range of powers established by corporate law. In other words, the existing legal status of an independent director may not be reflected in the quality of services provided by these directors and, accordingly, may not affect the shielding of shareholders from abuse by senior management. In such circumstances, the study of the personal characteristics of individuals working as independent directors in a publicly traded company can help to reveal the full picture and identify factors reducing the efficacy of independent board members.

1. Incentives. What incentives drive independent directors to monitor man-agement properly? If independent directors are expected to be effective monitoring providers, it is necessary for them to have strong incentives to do so. The vast majority of independent directors have regular jobs in other companies, often these directors hold multiple directorships thus they have to distribute their limited time and energy among all these companies. If they lack motivation, then the quality of monitoring they provide will perceptibly deteriorate.

As Kraakman et al. (2016) emphasize, in corporate law, high-powered incentives include reward measures, aimed at alignment interests of managers and directors with those of shareholders. However, in contrast with the senior management, independent directors do not enjoy high compensation packages. Not having the status of an employee of the company, they are paid only a modest retainer fee for attending board meetings (Adams and Ferreira, 2008). Independent directors with full-time jobs commitments elsewhere do not consider this activity as the primary source of income since in most cases this fee is only a small fraction of the outsiders' total earnings.

The expectation of effective monitoring from independent directors is mainly based on the reputation incentives of these directors. Reputation concerns are deemed to be extremely strong incentives for independent outsiders, since the effective fulfillment of obligations to protect the shareholder interests is a significant investment in the human capital of these directors. In particular, reputation incentives of independent board members considerably influence their attendance at regular board meetings, active participation in committees' activities, as well as the probability of remaining on the board in cases of poor company performance [13, pp. 426–427].

According to Masulis and Mobbs (2014), the presence of a developed external labor market for directors also acts as an important aspect of motivating outsiders. Acting as a vigilant protector of shareholders does not provide independent directors with a substantial profit, however, this is a significant investment in the human capital of directors, and, consequently, in their future career success. The quality of the services provided determines the position of an independent director in the external labor market. This aspect may motivate independent directors to better perform their functions since the possibility of obtaining new more prestigious directorships highly depends on their image in the market. In other words, the better they monitor executives, the higher the likelihood of obtaining new board positions.

All of the above indicates that maintaining a high level of reputation contributes to the obtainment of new directorships by independent outsiders. Talented independent directors with multiple directorships are seen as high-demand professionals who ensure companies diligent monitoring and protection of shareholder wealth. At the present time, independent directors with multiple directorships are a fairly common phenomenon. For example, as stated in 2018 Spencer Stuart Board Index, 62.5% of independent directors of S&P 500 hold two or more public board positions. However, these directors' reputation incentives may differ across directorships they hold. An increase in the number of directorships indicates the director's skills and experience, however, this may lead to a decrease in the quality of services provided. As a matter of fact, the distribution of these directors' time and energy among companies is based on the prestige of each directorship (Masulis and Mobbs, 2014). The selective attitude of busy directors to their board membership leads to the reduction of the time they devote to less prestigious firms. As a result, they cease to supply the proper monitoring and advising services, respectively, the level of shareholder protection decreases.

The question of efficacy of busy independent directors (i.e. with three and more directorships) has been raised earlier. Fich and Shivdasani (2006) posit that presence of a majority of busy independent on the boards of directors leads to a lowering of market-to-book ratios, weak profitability, and a decrease in the CEO turnover sensitivity to firm performance. All these factors are reflections of weak and ineffective monitoring system. However, as it is known, the role of independent directors includes not only monitoring, but also advising. Field et al. (2011) focus on young IPO firms and find that experienced busy independent directors may be a rather useful source of market-based information for firms at the earlier stages of their life circle when they need advising rather than monitoring. Thereby, the heterogeneity of the problem stems from the heterogeneity of the expected services in newly public and seasoned companies. In this situation, the elaboration of one all-purpose system with compulsory requirements for companies with different needs seems extremely complicated.

Reputation is one of the most valuable assets of independent directors, which the career success of these directors depends on. However, it is not always a catalyst for the effective performance of these directors. Reputation concerns of independent directors may encourage them to relinquish the directorship at a time when their services are most needed. Independent directors often prefer to depart the board when the company is anticipated to face financial or legal calamity so as not be associated with the troubled company [6, p. 2351]. Fahlenbrach et al. (2010) note that unexpected outsider departures is a bad signal and is usually followed by events such as restatement, poor stock performance, low accounting performance, extreme negative return, shareholder class action lawsuits etc.

2. Distractions. The level of independent director involvement in company governance, among other things, is adversely affected by external distraction events. Masulis and Zhang (2019) list a wide range of factors that could cause distraction of independent directors: from health problems and receiving various awards (personal distractions) to significant events taking place in other companies where these directors also hold positions on the board (professional distractions). The more responsibilities an independent director has, the greater the likelihood of distractions, in particular professional ones. These preoccupations frequently lead to deteriorated operating performance and efficacy, poor M&A activity and lowered firm value [14, p. 227], as well as to the CEO entrenchment and low earnings quality [9, p. 406].

It worth noting that in most prior studies, authors have focused predominantly on distraction factors of independent directors holding multiple directorships [14, p. 232]. Nevertheless, not only the presence of multiple directorships may increase the likelihood of distraction. Professional distractions may be associated with other companies, where directors can have positions not only of independent outsiders but also of senior managers. The appointment of C-suit managers as independent directors is quite common practice in the corporate environment since they are considered high-level professionals. Statistics confirm this statement: 19% of the directors appointed to the S&P 500 companies in 2018 were active top managers (in particular, CEOs and COOs) of other companies. Notwithstanding upper management may be regarded as highly effective monitor and advice providers, in practice, they do not contribute to a considerable improvement in key strategic decisions of the board of directors (Fahlenbrach et al., 2010). Thereby, by reason of their highest-ranking executive responsibilities, CEO-directors not only devote less time and effort to outside directorships but also more often face distractions.

3. Independent director liability. All directors holding seats on the board have fiduciary duties, which include the duty of care and the duty of loyalty. In case of breach of these duties, shareholders are entitled to bring lawsuits against board members, including independent outsiders. However, the possibility of personal liability is not indicated as one of the significant parameters of the quality of independent directors' monitoring and advising services. The reason for this may be the fact that there have been very few cases where these directors paid compensation to the plaintiffs from their own pockets. In other words, the risk of out-of-pocket liability for independent outsiders is rather low. For example, Black et al. (2006) reveal only thirteen cases of out-of-pocket payments by outside directors in the US from 1980 to 2005.

The question of outsider liability in cases of managerial fraud was raised in the early 2000s, in the midst of WorldCom and Enron trials. In these cases, outside directors agreed to pay $24.75 and $13 million, respectively, out of their own pockets to settle claims by lead plaintiffs [4, p. 1058]. However, it is important to note that one of the plaintiffs' goals in receiving compensation payments from the directors themselves was the desire to "send a message" to the boards of directors of other companies and show what consequences they might have if they neglect their monitoring obligations (Black et al., 2006).

The rarity of personal payments by independent outsiders is caused by three principal factors. First, the business judgment rule applied in different jurisdictions, in particular in common law countries [3, p. 1423], allows directors to avoid unwarranted legal allegations. This rule restricts the ability of shareholders to sue directors and, accordingly, reduces the risk of personal liability of independent directors. Second, corporate indemnifications and directors and officers liability insurance (D&O insurance) shield in most cases outside directors against legal costs, settlement payments, and damage compensations. Finally, out-of-pocket expenses may take place mostly in case of a "perfect storm" scenario which requires insolvency of the company, strong proofs of directors' culpability and availability of sufficient assets of directors [4, pp. 1107–1108]. Indeed, the out-of-pocket liability of outsiders is an infrequent trend not only in the US but also in other countries with different board and ownership structures (Black et al., 2006). The prevalence of company indemnification and D&O insurance, as well as the status of independent directors, act as protection layers in different jurisdictions. Despite the huge monetary losses in the early 2000s, the probability of increasing the risk of independent directors' out-of-pocket liability is currently not observed and is unlikely to be in the immediate future. WorldCom and Enron cases with large personal payments of outsiders are exceptional, where not only all the signs of "perfect storm" were observed, but also the desire of the plaintiffs to send a message to other boards.

On the face of it, an exceedingly low probability of personal monetary losses can be considered as a rather negative factor. Independent directors in this situation may show an extremely low level of interest in proper monitoring of senior management decisions. However, the tightening of the current outsider liability system should not be seen as a necessary amendment to enhance the corporate governance mechanism. Such reforms can lead to the unwillingness of individuals to take independent directorships and complication of the relationship between board and management. Possible menace of legal responsibility and subsequent huge out-of-pocket payments are difficult to justify, given that independent directors do not make managerial decisions and are only paid modest compensations. Black et al. (2006) emphasize that such a change in outsider liability standards may ultimately turn independent directors into quite attractive and accessible targets for shareholder claims. Under such circumstances, talented and experienced individuals will be reluctant to hold the independent director posts, since the small payments received for this activity does not outweigh the potentially high risk of large financial loss and reputation damage. Thus, the establishment of extremely onerous liabilities may have a scarecrow effect and reduce the attractiveness of outside directorships.

Undeniably, independent directors are required to have a proper degree of commitment and vigilance when monitoring the actions of managers, especially transactions that could potentially lead to a conflict of interest. Nonetheless, as Bainbridge (2002) suggests, establishing a high risk of personal liability can make independent directors excessively cautious and distrustful of all management decisions, including ordinary business transactions. Boards of directors burdened with a great risk of out-of-pocket liability, among other things, would also be more prone to intensive monitoring of all elaborated and proposed projects. As it is known, intensive monitoring does not find favor among top managers and may ultimately undermine the trusting relationship between the company's board and management.

In addition, it should be taken into account that appearing in court proceedings as a defendant is fraught not only with monetary losses but also with significant damage to the career prospects of independent directors. Fear of reputational damage may prompt these directors to be careful, even if the threat of out-of-pocket sanctions remains extremely low (Zhao, 2011).

Conclusion. The findings of this research suggest that that the nature and quality of the functions performed by independent outsiders are highly dependent on incentives and individual characteristics of these individuals. Since the status of independent directors itself implies exemption from high-powered (i.e. monetary) incentives and risks of out-of-pocket liability, the principal incentive alignment strategy applied to these directors is the reputation in the director labor market. Directors ensuring proper protection of the interests of shareholders make a considerable investment in their human capital since an impeccable reputation contributes to the acquisition of new, more prestigious board positions. For this reason, directors with multiple directorships in the labor market may be considered as the highly demanded and most reliable. Nevertheless, having a large number of board positions can make it difficult for directors to allocate sufficient time and effort to each directorship, and, accordingly, have a detrimental effect on the quality of monitoring and advising. Moreover, busy independent directors, in particular, those who hold upper management positions, are more predisposed to external distractions due to responsibilities inherent of their permanent place of employment.

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