Independent directors and corporate governance

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The paper examines the reliance placed in the United Kingdom and Australia on the concept of 'independent directors' as a mechanism to ensure better (less crisis prone) corporate governance. The article suggests that there is an over emphasis placed on some rather limited psychological evidence that independence in the boardroom produces more critical thinking and informed discussion thus leading to higher quality decision-making. The article offers others evidence, drawn from the material on the psychology of group formation and group discussion, which suggests that this confidence in 'independence' is misplaced. The article exposes a misunderstanding between independence as a character trait and independence as a structural concern which goes to the heart of the corporate governance discourse around the benefits of independence.

Introduction

In the world of corporate governance there are two families of regulation; rules, of which the United States would be the paradigm example, and principles, of which the United Kingdom and Australia would be the paradigm examples.[1] Both systems have come to rely upon the office of independent director as a legitimising presence and both house this concept in soft law. The hard law systems that support both families have in common their concern with eliminating director interest from decisions and transactions rather than in securing director disinterest. The leading US exchanges (NYSE,[2] NASDAQ,[3] and Amex) nest their requirements for independent directors in their listing rules which sit alongside the federally enacted rules based framework and in the United Kingdom and Australia the requirements are to be found in the codes that set out best practice. Bainbridge describes independent directors as the 'corporate governance success story of the decade'.[4] Their role was endorsed at EU level notwithstanding the different

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1 There is an argument that the two systems are not as distinct as this dichotomy might suggest, see, eg, L Cunningham, 'A Prescription to Retire the Rhetoric of "Principles-Based Systems" in Corporate Law, Securities Regulation and Accounting' (2007) 60 *Vand L Rev* 1411. Indeed a glance at the NYSE Listed Company Manual reveals that the board committee structure it mandates is identical to the ones found in the UK and Australian codes. Differences between the systems emerge much more strongly when the relationship between shareholders and managers in the two jurisdictions is compared, see C Williams and J Conley, 'An Emerging Third Way — The Erosion of the Anglo-American Shareholder Value Construct' (2005) 38 *Cornell Int LJ* 493 at 530f.

2 New York Stock Exchange, *Listed Company Manual*, s 303A.01.

3 NASDAQ, *NASD Rules*, r 4350(c).

4 S Bainbridge *Corporate Governance After the Financial Crisis*, OUP, New York, 2012, see also U Rodrigues, 'The Fetishization of Independence' (2007–2008) 33 *J Corp Law* 447.

board structures (dual/unitary) that exist across the EU.[5] This article takes as its starting point the importance placed within corporate governance on non-executive directors and their independence.

The article tracks the way in which the independence of directors and now ‘independence plus’, as the push for boardroom diversity is termed here, has been the solution that has been adopted in both the United Kingdom and Australia to bolster corporate governance mechanisms that do not appear to be delivering the desired quality of governance. The article tries to separate the structural tests of independence that are used in corporate governance mechanisms from the behavioural traits that the proponents of structural independence erroneously think are imported into or excluded from boardroom behaviour by the adoption of structural tests. The final section of the article draws on research from the psychology of decision-making and group behaviour to look at the phenomenon of relationship conflict that does not seem to be acknowledged by the proponents of independence plus and at group think which has been rather more influential. Structural tests of independence produce boards of directors that have the required degree of separation from whatever inter-personal or business related ties are prohibited. The resulting independent boards might, through happenstance rather than design, exhibit a mix of different skills but in the context of corporate governance independence is expected to deliver very much more than this. Structural independence as a value for director selection will always be trumped by the needs of collaborative and constructive decision-making in the boardroom setting.[6] Insights from psychology move us beyond rather simplistic ideas of the influence of dominant or charismatic personalities[7] in the boardroom to thinking about group dynamics and the processes involved in-group decision-making.[8]

Section 1 — Independence in context

Both the United Kingdom and Australia enjoy corporate governance codes rooted in a principles rather than a rules culture which are buttressed by the listing requirements of their respective exchanges.[9] The United Kingdom and

5 Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, (2005/162/EC).

6 N Sharpe, ‘Process not Structure: An Organizational Behaviour Approach to Improving Corporate Boards’ (2012) 85 *S Calif L R* 261.

7 For example, one of the enduring fascinations of the failure of Enron has been the personality of Jeff Skilling, the Chief Executive, and the effect that it had on the actions of the other members of the boardroom, see B Sharfman and S Toll, ‘Dysfunctional Deference and Board Composition: Lessons from Enron’ (2008) 103 *Northwestern University Law Review Colloquium* 153 and D Langevoort, ‘Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals About Self-Deception, Deceiving Others and the Design of Internal Controls’ (2004–2005) 93 *Geo LJ* 285 at 302–4.

8 N Kerr, ‘Group Performance and Decision Making’ (2004) 55 *Annual Review of Psychology* 623.

9 In the United Kingdom the relevant rule is LR 9.8.6 of the FSA given statutory authority by the Financial Services and Markets Act 2000. In Australia the link is established by ASX Listing Rule 4.10.3 given statutory authority by the Corporations Act 2001 (Cth) (Commonwealth of Australia 2001).

Australia began their march towards the principles based codes that both now enjoy at around the same point in time — the last decade of the last century — and apart from some differences between 1995 and 2003 when the Australian position was that governance arrangements were to be disclosed but there were no mandated practices — their structures are now very similar.[10] Australia was prompted to look at corporate governance by the financial crash of 1987[11] and by ideas that the Australian corporate sector was underperforming.[12] The United Kingdom experienced a series of high profile corporate collapses that were thought to be due to poor governance rather than market conditions; BCCI, Polly Peck and the Maxwell Empire for example. There was also a perception that outbreak of executive salary increases were 'excessive' particularly as they often seemed to concern the executive leadership of recently privatised utilities. The different background to the adoption of 'comply and explain' in the two jurisdictions underscores the fact that the mechanism is being used in two different ways; to improve corporate performance through creating what are seen as better governance structures and to set up structures that will prevent or at least give early warning of fraudulent conduct by managers. Large scale corporate failure can and does occur in the absence of actual fraud but corporate success is often founded on the use of practises which take compliance with governance regimes to their limit. Changes in governance regimes merely result in new devices being created.[13] Two issues arise from this dual application. One is the definition given to governance performance[14] and the other is the extent to which structures created to guard against fraud might actually inhibit the delivery of improved corporate performance in the absence of fraud.[15]

There is evidence that investors value what we might term 'secure'

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10 J du Plessis et al, *German Corporate Governance in International and EU Context* (2007) Springer Berlin at 452f.

11 The Business Council of Australia, *Corporate Practices and Conduct*, (Bosch Report 1991, 1995) and H Bosch, 'The Changing Face of Corporate Governance' (2002) 25 *UNSWLJ* 270.

12 The Hilmer Report of 1993, *Strictly Boardroom: Improving Governance to Enhance Company Performance*, Australian Print Group, Melbourne makes clear that the Australian approach to corporate governance while clearly influenced by the Cadbury Report in the United Kingdom was designed to tackle poor performance and not fraud or misconduct.

13 Using the example of off-balance sheet financing to explain the concept of creative compliance; the stretching of formal law to its interpretative limits is the subject of a classic article and subsequent book, see D McBarnet and C Whelan, 'The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control' (1991) 54 *MLR* 848 and D McBarnet and C Whelan, *Creative Accounting and the Cross-Eyed Javelin*, Wiley, New York, 1999. The fuel for Enron's huge earnings growth was the use of a form of this sort of accounting where indebtedness was not recorded on Enron's balance sheet but on that of special purpose entities resulting in the over-statement of Enron's earnings, see S Schwarcz, 'Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures' (2001–2002) 70 *University of Cincinnati LRev* 1309.

14 S Bhagat et al, 'The Promise and Peril of Corporate Governance Indices' (2008) 108 *Col L Rev* 1803 conclude that there is no one best measure of corporate governance and that all measures depend on the context the corporation finds itself in.

15 For a discussion and overview of the work of those commentators such as the late Larry Ribstein who believe that formalising governance standards and increasing governance requirements in the wake of fraud is misconceived see J McConvill, 'Reflections on the Regulation of Contemporary Corporate Governance' (2006) 2 *Corporate Gov LR* 1.

governance; unexpected shocks to the business model of a corporation cause stock price fluctuation which affects the return on index tracking products as well as individual stock and creates long term doubts about the security of investment.[16] Surveys of the investor community have suggested that a high proportion of investors not only place importance on secure governance but are also prepared to pay a premium for it.[17] This chimes with other anecdotal comments from the financial press about the share price of some specific corporations being discounted because of concerns about the robustness of their governance arrangements.[18] If we make the assumption that what investors are concerned with is financial performance in terms of share price and profitability ratios[19] then the link between independent directors and improved corporate performance becomes somewhat opaque. We are placing investors in the classic principle and agent paradigm as principals by considering this[20] and given that governance mechanisms constructed through a 'comply or explain' methodology are the very embodiment of principal and agent theory[21] this has a certain attraction. Regulation is enabling, rather than mandatory, and ultimate judgement on the usefulness or quality of the structures adopted is exercised by the financial market. Shareholder value is maximised through the adoption of efficient structures that both police the behaviour of potentially errant managers — errant in the sense that they might indulge in 'shirking' or other 'opportunistic behaviour' at the expense of shareholders[22] — and ensure that accurate and sufficient information is relayed to shareholders so that they can form accurate judgements about corporate performance. Viewed in this way then the value of independent directors to corporate performance is at best equivocal. There are a number of empirical studies[23] none of which find a positive relationship between the presence of independent directors and improved financial performance even

16 *Climate Changes Your Business*, 2008, KPMG International, at <http://www.kpmg.com/global/en/issuesandinsights/articlespublications/pages/climate-changes-your-business.aspx> (accessed 1 August 2012) and H Petersen and H Vredenburg, 'Morals or Economics? Institutional Preferences for Corporate Social Responsibility' (2009) 96 *J Bus Eth* 1 at 5–6.

17 P Coombes and S Wong, *Investor Perspectives on Corporate Governance — a rapidly evolving story*, McKinsey, London, 2004. This combines the results of two earlier surveys.

18 For example, in relation to News Corp see M Bow, 'Hermes EOS to withhold support at News Corp meeting', *Professional Pensions*, 14 October 2011 and in relation to ENRC PLC blog post at <http://ftalphaville.ft.com/blog/2011/10/11/698741/business-as-usual-at-enrc/> (accessed 1 August 2012).

19 See J Gordon, 'The Rise of Independent Directors in the United States 1950–2005: Of Shareholder Value and Stock Market Prices' (2007) 59 *Stan L Rev* 1465. Gordon argues that share price has become the yardstick by which to measure corporate performance because share price is based upon an accumulation of considerable material from a range of sources. This dependence on share price makes the job of independent directors easier as there is no longer the same amount information asymmetry involved in board oversight.

20 S Bhagat and B Bolton, 'Corporate Governance and Firm Performance' (2008) 14 *Jnl of Corporate Finance* 257.

21 For an explanation see the review in A Shleifer and R Vishny, 'A Survey of Corporate Governance' (1997) 52 *J of Finance* 737 and the classic explanations in E Fama, 'Agency Problems and the Theory of the Firm' (1980) 88 *J Pol Econ* 288 and E Fama and M Jensen, 'Separation of Ownership and Control' (1983) 26 *J L and Econ* 301.

22 O Williamson, *The Economic Institutions of Capitalism*, Free Press, New York, 1985.

23 A useful summary of the literature can be found in R Duchin et al, 'When are Outside

when the definition of financial performance is extended to include shareholder litigation and CEO turnover.[24]

On a macro level these findings tell us something about the limitations of using agency theory to explain board behaviour in conjunction with board characteristics.[25] On a more micro level they suggest that the significance that is attached to non-executive directors and independence has only a weak correlation to the empirical world. If we consider the recent concerns that government in the United Kingdom[26] and in Australia[27] has expressed about spiralling executive compensation packages in a time of uncertainty and austerity for many employees caused by the perceived failure of the very corporate executives whose remuneration is increasing and their suggested solutions then we can see the trajectory of governance moving away from the use of independent directors as the monitors of corporate behaviour. Over a period of years governance structures have moved from non-executive directors as monitors accompanied by the gradual introduction of structures for increasing shareholder influence, to the placing of executive remuneration issues in the hands of independent directors and finally, in the case of the United Kingdom, the placing of the brake on excessive executive remuneration in the hands of shareholders. Shareholders, as a result of legislative changes scheduled for the next parliamentary session, will enjoy a binding vote on remuneration policy, exercisable every 3 years or more frequently if that policy changes and an advisory annual vote on the application of that policy.[28] The existing Australian legislation[29] is more

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Directors Effective?' (2010) 96 *J of Fin Econ* 195 and L Drennan et al, 'Effective Corporate Monitoring: Independence, Motivation and Means' (2012) 8 *Int Business Research Papers* 65.

24 D Langevoort, 'The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability' (2000–2001) 89 *Geo LJ* 797.

25 See J Davis et al, 'Towards a Stewardship Theory of Management' (1997) 22 *Academy of Management Review* 20 and C Daily et al, 'Corporate Governance: Decades of Dialogue and Data' (2003) 28 *Academy of Management Review* 371 both of which point out that agency theory can only look at the structural components of board composition and then judge them against its assumptions about what motivates opportunistic behaviour and its rather one dimensional picture of human nature. New ideas for research into the activity of boards is proposed by M Huse et al, 'New perspectives on board research: changing the research agenda' (2011) 15 *J Manag Gov* 5.

26 See *Directors' Remuneration*, July 1995 (the Greenbury Report) and the *Committee on Corporate Governance*, April 1998 (the Hampel Committee) both published by Gee Publishing, London. On 19 September 2011 the United Kingdom Coalition Government published a consultation paper on Executive Remuneration. The consultation closed on 25 November 2011. Compensation has been a perennial concern since the mid-1990s, see J Hill, 'New Trends in the Regulation of Executive Compensation' in R P Austin and A Y Bilski (Eds), *Directors in Troubled Times*, Ross Parsons Centre of Commercial, 2009, Corporate and Taxation Law 100, p n 1.

27 *Executive Remuneration in Australia*, Productivity Commission Inquiry Report, 2009.

28 Oral Statement by the Rt Hon Vince Cable, Secretary of State for Business, 'Innovation and Skills, on Directors' Pay: 20 June 2012', see <http://www.bis.gov.uk/policies/business-law/corporate-governance/executive-pay> (accessed 1 August 2012).

29 See Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act 2011. Two consecutive annual votes that see 25% or more of shareholders reject the remuneration report results in the shareholder meeting voting on the

sophisticated and potentially more empowering of shareholders[30] than the UK proposals, despite stopping short of mandating a binding vote. Notwithstanding the 'shareholder spring' as the current wave of shareholder revolts in the United Kingdom in relation to executive remuneration has been termed, binding votes might not, given the historic passivity of shareholders,[31] prove to be particularly popular. Nevertheless the resort to this level of shareholder involvement would suggest a certain loss of confidence on the part of policy makers that the system of oversight of corporate governance by independent directors can deliver the type of control over corporate power that governments think is necessary to maintain corporate legitimacy.

Section 2 — The development of independence

The importance of the independence of directors as opposed to merely their non-executive status — the difference being the nature of their ties with the company concerned — arrived in the corporate governance systems of the United Kingdom[32] and Australia at similar times; 2003–04. Both systems had highlighted the role of the independent director much earlier in the Cadbury Report[33] and the Bosch Report (1995)[34] respectively. In 1996 ASX introduced Listing Rule 3C(3)(j) which was accompanied by App 4A – a handy aide memoir for companies listing the nine governance issues that they were required to report on. It contained no reference to independent directors despite the Bosch Report of 1995 recommending that a majority of the board should be non-executive directors and that a majority of those should be independent. The Code that emerged from the Cadbury Report contained one mention of independent directors; the majority of non-executive directors

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so-called board spill resolution where if 50% or more of the votes cast demand it the entire board must put themselves forward for re-election at a subsequently convened second general meeting.

30 Key management personnel, a category that extends beyond directors, and those coming within the definition of 'closely related' are prohibited from voting on the remuneration report. This coupled with the regulations on the use of and subsequent attention paid to remuneration consultants points to the potential for a significant shifting of voting outcomes. The threat of this is likely to lead to a more sustained and detailed interaction with shareholders about the issue of remuneration.

31 K Keasey and G Veronesi, 'Lessons from the Northern Rock Affair' (2008) 16 *Jnl of Financial Regulation and Compliance* 8 and P Myners, 'Speech to the Association of Investment Companies', 21 April 2009, at <http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/speech_fsst_210409.htm> (accessed 12 July 2012). This is the Myners speech which famously described institutional investors as 'absentee landlords'. Shareholder protest votes in the United Kingdom are historically much less common in the United Kingdom than Australia, see J Hill, 'Regulatory Show and Tell: Lessons from International Statutory Regimes' (2008) 33 *Delaware Jnl of Corporate Law* 819 at 829f.

32 A role for non-executive directors in the United Kingdom had been suggested prior to the Cadbury Report, see P Collier, 'The Rise of the Audit Committee in UK Quoted Companies: a Curious Phenomenon?' (1996) 6 *Acc, Business and Fin History* 121 at 124f.

33 *The Financial Aspects of Corporate Governance*, December 1992 (the Cadbury Report).

34 For a discussion of the development of corporate governance in Australia from 1991 onwards, see I Ramsey and R Hoad *Disclosure of Corporate Governance Practices by Australian Companies*, Centre for Corporate Law and Securities Regulation, Melbourne, 1997.

should be independent,[35] with independence assessed according to the report by the board of directors.[36] As the report itself had suggested that a minimum of three non-executives was required on the board this did not leave a large role for independent directors. Any perceived problems with the recruitment of suitable persons to be non-executive directors, it asserted, could be solved by appointing known individuals already serving on the boards of other companies.[37]

By the end of 2001 not only had Enron[38] and WorldCom[39] collapsed in the United States but so had a whole series of other large corporations such as One Tel[40] and HIH Insurance in Australia and Marconi in the United Kingdom. Corporate governance systems worldwide came under pressure for their apparent failure to detect the practises that would lead to collapse.[41] The US response was the Sarbanes-Oxley Act of 2002 which focused on accounting standards and the need for auditor independence.[42] The UK government commissioned the Higgs Report[43] in response to the Sarbanes Oxley legislation. A response was required presumably to maintain the competitive attraction to investors of the FTSE as a secure investment base.[44] The brief of

35 Code of Best Practice, provision 2.2. The Code appears as an appendix to the Report.

36 Ibid, at [4.12].

37 Ibid, at [4.17].

38 The demise of Enron is well documented in academic commentary; see for an extensive treatment of what has been seen as one of the key areas of failure, J Coffee, *Gatekeepers: The Role of the Professions in Corporate Governance*, OUP, Oxford, 2006. What is more surprising is that despite the reasons for its failure being located in the fraudulent use of technical accounting practices it has sparked the imagination of a more general public resulting in a successful West End play and an award winning commercial documentary film, see L Prebble, *Enron*, Methuen Drama, 2010 and *Enron: the Smartest Guys in the Room*, Magnolia Pictures, 2005.

39 T Clarke, 'Corporate Governance and Corporate Reputation: A Disaster Story' in R Burke et al (Eds), *Corporate Reputation*, Gower Farnham, 2011, p 275f.

40 R Monem, 'The One.Tel Collapse: Lessons for Corporate Governance' (2011) 21 *Aus Acc Rev* 340.

41 The best account of this era of corporate failure and the reform processes that were embarked upon to deal with the different aspects of failure is provided by J Hill, 'Regulatory Responses to Global Corporate Scandals' (2005) 23 *Wis Int LJ* 367.

42 There was also considerable activity by the SEC and others, notably Eliot Spitzer, then Attorney-General of New York, around exposing examples of non-compliance as a way of effecting policy change which again indicates that the two regulatory families of corporate governance are not as far apart as they might initially seem, see J O'Brien, 'The Politics of Enforcement: Eliot Spitzer, State-Federal Relations, and the Redesign of Financial Regulation' (2005) 35 *Publius* 449.

43 Review of the Role and Effectiveness of Non-Executive Directors, 2003, (the Higgs Report), at <http://www.berr.gov.uk/files/file23012.pdf> (accessed 7 June 2012).

44 The United Kingdom in common with Australia also revised their approach to accounting standards and the role of auditors. In the United Kingdom this was dealt with by means of the Smith Report *Guidance on Audit Committees*, at <http://www.frc.org.uk/documents/pagemanager/frc/Smith%20Report%202005.pdf> (accessed 7 June 2012) published in January 2003 which resulted in changes to the relevant sections of the Combined Code. This was then the name given to the expression of the corporate governance requirements linked to the Listing Rules, see <www.frc.co.uk/corporate/combinedcode.cfm>. In Australia, the response on accounting standards and audit requirements was led by the recommendations in the Ramsey Report of October 2001, *Independence of Australian Company Auditors*, at <http://azcz.chinazeus.com/documents/183/PDF/Ramsay.pdf> and both legislatively based

the Higgs Report was to look at the role of non-executive directors; their identity, their independence, their effectiveness. The decision to look at non-executive directors was no doubt inspired by the view that they and their independence were thought to be a factor of some significance in the failure of Enron.[45] Enron looked, at first glance, to have a largely independent board with only two of its directors occupying executive positions within the corporation. However when industry ties and other factors such as charitable donations were factored in, the board had 43% independent directors as opposed to 72% in its peer corporations and 63% for investment banks.[46]

The Higgs Report resulted in amendments to the Combined Code that included a requirement that outsider directors make up a significant part of the board.[47] The Australian response to the Sarbanes Oxley legislation was, in part, the creation by the Australian Stock Exchange of the Corporate Governance Council[48] which subsequently drafted and released in 2003 the Principles of Good Corporate Governance and Best Practice (Principles). Those principles were broadly similar to those created in the United Kingdom on the role of independent directors,[49] for example, there was a definition of independence given which had many of the same characteristics even if the time limits on particular activities were at slight variance and a declaration of independence was required in the Annual Report. There were also some specific differences.[50] The principles asserted that a majority of the board should be independent which was stricter than the UK Combined Code but there was a need to explain independence only in cases where it was declared in spite of non-compliance with the terms of the definition. What can be seen here is that as a result of these reforms, in both the United Kingdom and Australia, independence has become the defining characteristic of boards. The tests of independence are tests in relation to each particular corporation where office is held. The approach to independence in both jurisdictions is one that attaches importance to structural not behavioural determinants and this is to be

in the form of amendments to the Corporations Act 2001 and principles based. For a summary see F Robins, 'Corporate Governance After Sarbanes Oxley: an Australian Perspective' (2006) 6 *Corporate Governance* 34.

45 J Gordon, 'Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley' (2002–2003) 35 *Conn L Rev* 1125.

46 S Gillan and J Martin, 'Corporate Governance post-Enron: Effective reforms or closing the stable door' (2007) 13 *J of Corporate Finance* 929 and C Elson and C Gyves, 'Enron Failure and Corporate Governance Reform, The Changing Role of Directors In Corporate Governance' (2003) 38 *Wake Forest L Rev* 855.

47 Combined Code Main Principle A3.

48 Z Matolcsy et al, 'The Impact of Quasi-Regulatory Reforms on Boards and their Committees During the Period 2001–2007' (2011) 21 *Aus Acc Rev* 352 contains an interesting accounting account of these developments. The Horwarth Report on Corporate Governance was released in 2002 and was influential in the design of the response see <http://www.ecgi.org/codes/documents/horwath_cg_02.pdf> (accessed 7 June 2012).

49 At <http://asx.ice4.interactiveinvestor.com.au/ASX0301/Principles%20of%20Good%20Corporate%20Governance/EN/body.aspx?z=1p=1v=1uid>, Principle 2 (accessed 7 June 2012).

50 T Ritchie, 'Independent Directors: Magic Bullet or Band-Aid?', at <http://epublications.bond.edu.au/cgej/5> (accessed 7 June 2012).

expected within systems where agency theory is the underpinning rationale.[51] The tests are not tests of network independence or of the loose social ties that might exist outside that particular boardroom.[52] There is an acknowledgment that the corporate sector is embedded in social relationships and social networks and that power of these needs to be captured in the use of social capital to draft and gain traction[53] for both moves towards independence, hence the involvement of elites in both jurisdictions.[54]

The effect of using a structural test of independence rather than one which overtly tries to capture a broader notion of independence can be seen from the finding that Australia's largest corporations appointed few new, as opposed to 'recycled'[55] non-executive directors in the period 2004–07[56] and yet could still be judged to have a high degree of compliance with the independence requirement.[57] A similar pattern can be found in the United Kingdom based on data drawn from 2005 on the pattern of interchange of all non-executive directors sitting on the boards of corporations listed in the FTSE 100 and on a sample study of the backgrounds and careers of some 150 of those non-executive directors.[58] Sixty percent of FTSE 100 companies had a non-executive director who was an executive director at another FTSE 100 and in excess of 40 FTSE 100 companies shared a non-executive director with another listed company. This confirms the findings of an earlier review actually commissioned by Higgs;[59] 16 non-executive directors drawn from the

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51 A Zattoni and F Cuomo, 'How Independent, Competent and Incentivized Should Non-executive Directors Be? An Empirical Investigation of Good Governance Codes' (2010) 21 *Brit J Man* 63.

52 The boardroom arrangements of HIH would have satisfied the independence test despite the fact that five out of seven directors were for a variety of reasons, based upon prior professional connections, not independent in anything other than a structural sense.

53 Participants in governance are discriminating about who they acknowledge as a relevant and meaningful insider in any particular context, G Davis and H Greve, 'Corporate Elite Networks and Governance Changes in the 1980s' (1997) 103 *Am J Soc* 1.

54 In Australia this was Corporate Governance Council which had a membership which represented 21 of the country's leading business organisations with representation from across the spectrum of the market with both corporations and investors included. In the United Kingdom this was through the familiar appointment of a 'City figure'. Derek Higgs was well known as an executive and non-executive director of listed PLCs including institutional investors. See I Jones and M Pollitt, 'Understanding How Issues in Corporate Governance Develop: Cadbury Report to Higgs Review' (2004) 12 *Corporate Governance* 162 at 164.

55 Recycled in this context is used to mean that the non-executive directors appointed as independent were already non-executive or executive directors in other listed companies.

56 A Brooks, 'The Role of the Independent Director: Evidence from a Survey of Independent Directors in Australia' (2009) 19 *Aus Acc Rev* 161 and R Chen et al, 'The Link Between Board Composition and Corporate Diversification in Australian Corporations' (2009) 17 *Corp Gov* 208.

57 H Kang et al, 'Corporate Governance and Board Composition: diversity and independence of Australian boards' (2007) 15 *Corp Gov* 194. This is research that is carried out using the structural definition of independence. It finds a very high level of compliance with that requirement but also very little age or gender diversity amongst board members. This suggests, it is submitted, the presence of social capital bonds.

58 J Froud et al, 'Everything for Sale: how non-executive directors make a difference' in M Savage and K Williams (Eds), *Remembering Elites*, Blackwell, Oxford, 2008, p 162.

59 T McNulty et al, 'Beyond Agency Conceptions of the Work of the Non-Executive Director: Creating Accountability in the Boardroom' (2005) 16 *British Jnl of Management* S5.

FTSE 350 held 54 non-executive directorships between them.

This suggests that the structural test of independence failed to prevent interlocked boards in both jurisdictions. Views on the desirability of interlocks vary.[60] In the United States, where there has been considerable empirical research on interlocks, consideration has been given to issues such as the concentration of corporate power[61] that might result in a negative sense and the potential for the spread of innovation from one corporation to another through boardroom relationships in a positive sense. The incentive for boards to recruit as non-executive directors existing executive directors or non-executive directors already serving elsewhere is based upon valuing their prior experience — their recruits will know what to expect — skills in the area of shareholder relations, takeover defence strategies, and network endorsement.[62] The structural test of independence creates a particular type of independence that does not take account of behaviour and so it cannot guarantee independence of thought or action.

Section 3 — From independence to independence plus

In 2006 several US banks reported higher than expected losses. In 2007 the UK bank Northern Rock effectively failed, so too rather less publically, did a second smaller bank, Bradford and Bingley. These were the first retail banks in the United Kingdom to fail since 1866 and, as they were deposit taking banks,[63] they were effectively taken into government ownership.[64] In 2008 the US investment banks Bear Stearns and Lehmann Brothers suffered high profile failures. Revelations of other banks' financial difficulties soon followed with HBOS and RBS in the United Kingdom being notable casualties. The global nature of banking business meant that the contagion spread quickly, although not in the main to Australia.[65] For this reason much of the early part of this section focuses on the pressures that were brought to bear upon the independent director model in the United Kingdom. The reasons for the financial problems of each individual bank are complex and often specific to

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60 It was Andrew Pettigrew who first posed the 'so what' question about interlocks. The answer to that question depends on which story is being told — the story about firm performance (to which Pettigrew's comments are directed) or the story about the prospects for independent *thinking* in the boardroom, see A Pettigrew, 'On Studying Managerial Elites' (1992) 13 *Strategic Management J* 163.

61 M Mizruchi, 'What do interlocks do? An analysis, critique and assessment of research on interlocking directorates' (1996) 22 *Annual Review of Sociology* 271.

62 S Westphal and I Stern, 'Flattery will get you everywhere (especially if you are a male Caucasian): How integration, boardroom behaviour and demographic minority status affect additional board appointments at US companies' (2007) 50 *Academy of Management Jnl* 267.

63 See the RT Hon Alistair Darling's, Chancellor of the Exchequer, statement on Northern Rock, 17 February 2008, <http://www.fsa.gov.uk/pages/Library/Communication/Statements/2008/nr_chancellor.shtml> (accessed 13 June 2012).

64 The Banking (Special Provisions) Act 2008 and the The Northern Rock plc Transfer Order 2008.

65 S Konzelmann and M Fovargue-Davies (Eds), *Banking Systems in the Crisis*, Routledge, London, 2012 and S Eslake, 'The Global Financial Crisis of 2007–2009 — An Australian Perspective' (2009) 28 *Economic Papers* 226 at 232f.

its particular history[66] and model of trading. An examination of the background to and the causes of the financial crisis are well documented at a variety of different levels elsewhere[67] and beyond the scope of this article. The one factor that these failures share in common is that their failure was not as a result of non-compliance with regulatory demands or the dishonesty of individuals.[68] Rather it was their core business models which were revealed to be fundamentally flawed and unsustainable. Northern Rock for example did business on the basis of leveraged high volume lending which was dependent on obtaining affordable short-term funding from wholesale money markets.[69] Once the market for asset-backed securities failed it was left with illiquid assets. RBS pursued a model that exposed it to a flawed model of securitisation involving sub-prime mortgages sold in the United States.

Once again corporate governance regimes around the world were exposed. In effect the activities of the board of Northern Rock offered the first documented failure of non-executive director monitoring of corporate governance in the post Higgs Report era. The response of the United States, the European Union and the United Kingdom to the financial crisis was a plethora of reports and recommendations that in some jurisdictions, for example, the United States, have resulted in extensive legislative intervention. The UK government commissioned independent inquiries, parliamentary inquiries and independent reports that have looked at numerous different dimensions of financial 'life' with aim of exposing the reasons for failure and airing possible avenues for regulatory reform. The results, many of which are not relevant here, have included a series of codes of practice that seek to inculcate behavioural change not least in individual boardrooms.[70] In relation to the position of independent directors the most pertinent reports from within the United Kingdom are the Walker Report,[71] the Treasury Select Committee Report on Northern Rock[72] and the Review and Report of the Financial Reporting Council on the Combined Code.[73] In the context of the European

66 J Marshall et al, 'Placing the Run on Northern Rock' (2012) 12 *J of Econ Geog* 157.

67 C Goodhart, 'The background to the 2007 financial crisis' (2008) 4 *IEEP* 331; D Weitzner and J Darroch, 'Why Moral Failures Precede Financial Crises' (2009) 5 *Critical Perspectives on International Business* 6; J Crotty, 'Structural causes of the global financial crisis: a critical assessment of the "new financial architecture"' (2009) 33 *Cam J of Econ* 563.

68 Although it is the case that action against former executives of failed banking entities has been considered on the grounds of misfeasance rather than malfeasance, see R Tomasic, 'Corporate rescue, governance and risk-taking in Northern Rock: Part 1' (2008) 29 *Company Lawyer* 297.

69 H Shin, 'Reflections on Northern Rock: The Bank Run that Heralded the Global Financial Crisis' (2009) 23 *Jnl of Economic Perspectives* 101.

70 See, eg, the Stewardship Code issued by the Financial Reporting Council in July 2010 at <http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx> (accessed 15 June 2012).

71 D Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities', 2009, at <http://webarchive.nationalarchives.gov.uk/+/http://www.hmtreasury.gov.uk/walker_review_information.htm> (accessed 15 June 2012).

72 5th Report of Treasury Select Ctte session 2007–2008, *The Run on the Rock*, 24 Janauary 2008.

73 Financial Reporting Council, '2009 Review of the Combined Code: Final Report', December 2009; Financial Reporting Council, 'Consultation on the Revised UK Corporate Governance Code', December 2009, at <http://www.frc.org.uk/images/uploaded/

Union, two Green Papers, one on corporate governance in financial institutions[74] and one on the corporate governance framework,[75] are relevant.

The failure of the board of Northern Rock, in particular its non-executive directors, to recognise the unsustainability and flawed nature of the business model that it was pursuing is put in stark terms by the Treasury Select Committee:

> The non-executive members of the board, and in particular the chairman of the board, the chairman of the risk committee and the senior non-executive director, failed in the case of Northern Rock to ensure that it remained liquid as well as solvent, to provide against the risks that it was taking and to act as an effective restraining force on the strategy of the executive members.[76]

This criticism seems to mark a watershed in the story of independent directors within the principles based unitary board systems of corporate governance. With the exception of the Walker Report findings, which are discussed below, from this point in time onwards the view taken by politicians, regulators and financial journalists[77] is that boards are not independent enough; their members have too much in common. In other words, the structural tests of independence have produced what they were designed to produce; boards of directors that have members that are independent of the corporation itself but are familiar to each other, if not exactly tied, by common prior experiences in educational and professional terms. This left non-executive directors in the view of the Higgs Report unable to 'challenge, question, and speak up'.[78] The questioning of the effectiveness of current board recruitment strategies that complied with the structural test of independence occurred at the same time as a strong lobby for diversity, by which is meant gender diversity, in business leadership[79] and political life[80] was making its voice heard across the developed world. Often these arguments for the inclusion of women were being structured in terms of social justice and economic rationality. The Australian Human Rights Commission[81] and the European Union through its

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documents/2009%20review%20of%20the%20combined%20code%20final%20report.pdf> (accessed 20 June 2012) <http://www.frc.org.uk/images/uploaded/documents/Consultation%20on%20the%20Revised%20Corporate%20Governance%20Code.pdf> (accessed 20 June 2012).

74 EU Green Paper of June 2010, *Corporate governance in financial institutions and remuneration policies*, COM(2010)285 final.

75 EU Green Paper of April 2011, *The Corporate Governance Framework*, COM(2011) 164 final.

76 House of Commons Treasury Committee, *The Run on the Rock*, above n 72, p 19.

77 See the comments referenced by R Tomasic, 'Corporate rescue, governance and risk taking in Northern Rock: Part 2' (2008) 29 *Co Lawyer* 330 at 332f.

78 Above n 43, at [9.1], quoted in the Tyson Report, *The Tyson Report on the Recruitment and Development of Non-Executive Directors*, at <http://www.london.edu/facultyandresearch/research/docs/TysonReport.pdf>, p 5 (accessed 20 June 2012).

79 L Husu et al, *Leadership through the Gender Lens: Women and Men in Organisations*, Hanken School of Economics Research Reports Helsinki, Finland, 2010, p 71.

80 J Squires, 'Intersecting Inequalities: Britain's Equality Review' (2009) 11 *International Feminist Jnl of Politics* 496 and J Squires et al, 'Gender Quotas and Models of Political Citizenship' (2009) 39 *British Jnl of Political Science* 781.

81 At <http://www.hreoc.gov.au/sex_discrimination/programs/women_leadership.html> (accessed 20 June 2012).

equality strategy[82] provide good examples of this. There is no doubt that the creation of quota legislation for boardroom participation, in addition to existing political representation guarantees, across a variety of European states fuels this lobby. Norway, Sweden, the Netherlands, Italy and France, for example, have all introduced legislation requiring gender quotas.[83] Spain[84] and Germany have declared that they will also take this approach if the situation has not resolved itself by 2015 and by 2012 respectively.[85]

The lack of diversity in boardrooms had been seen as in issue in the United Kingdom previously. The Higgs Review had highlighted it and the Tyson Report[86] had been set up later the same year to examine ways in which the recruitment base for non-executive directors could be broadened. However the Tyson Report is couched in terms of a behavioural approach. It stresses the need to find and appoint people with diverse skills rather than identifying a particular group and appointing from it. The need for different people who as a group are untainted by failure is something that occurs post the financial crash. We see a gradual fusion of the social justice and economic arguments for diversity with a third argument that maintaining and delivering independence of thought and avoiding 'group think'[87] can be solved by pulling into the boardroom 'women' as a collective group identity, who have previously, undoubtedly, been under-represented, and who will also apparently, using at best a rather equivocal evidence[88] base for its justification, improve financial performance. Women are being used as a structural solution to the problem of seeing independence as a structural issue. There seems to be confusion between independent ideas and thinking and independence as some sort of identity.[89]

The referral of the diversity issue in Australia by the Minister for Superannuation and Corporate Law to the Corporation and Markets Advisory Committee in September 2008 illustrates the construction of the link between diversity and a vague idea of improved performance. The referral letter makes reference to commentators noting the homogenous character of corporate boards and the existence of some evidence that diversity improves corporate performance and concludes that these two things taken together make diversity worthy of further investigation.[90] Apparently diversity in and of itself will produce 'better decision-making', with better decision-making defined as

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82 *Strategy for equality between women and men 2010–2015*, COM(2010) 491 final.

83 S Terjesen and V Singh, 'Female Presence on Corporate Boards: a Multi-Country Study of Environmental Context' (2008) 83 *J Bus Eth* 55.

84 2006 Unified Code of Good Governance and the Equality Law of March 2007.

85 For a summary of developments across Europe, see A Sweigart, 'Women on Board for Change: The Norway model of Boardroom Quotas as a Tool for Progress in the United States and Canada' (2012) 32 *Northwestern J of International Law and Business* 81 at 84–9.

86 Above n 78.

87 EU Green Paper, *The Corporate Governance Framework*, above n 75, at [1.13] specifically mentions group think as an impediment to effective decision-making.

88 For a review of these arguments see M McCann and S Wheeler, 'Gender Diversity in the FTSE 100: The Business Claim Explored' (2011) 38 *JLS* 542.

89 E Beecher-Monas, 'Marrying Diversity and Independence in the Boardroom: Just How Far Have You Come, Baby?' (2007) 86 *Or L Rev* 373.

90 CAMAC, *Diversity on Boards of Directors*, Report, March 2009.

the ability to *identify, understand and ultimately control* risks.[91] In the United Kingdom the influential academic economist Charles Goodhart was quoted as saying in evidence to a Treasury Committee that he believed the banking crisis would have been less likely had there been more women on the boards of financial corporations.[92] The presence of a woman on the board of Enron and the presence of two female NEDs on the board of Northern Rock PLC are not mentioned in any of the discussions that link a lack of gender diversity to a lack of independence. On one level this female presence at the site of failure is irrelevant as those women are not necessarily representative of anything. However it is tempting to point to their presence as the counterpoint to an argument that so blatantly confuses the sex category of woman with gendered behaviour and practices.[93]

Biological sex is one among several determinants of behaviour. Individuals of either sex may exhibit a high degree of both feminine and masculine traits, with feminine traits commonly defined as expressive and masculine traits as instrumental.[94] A structural test of independence, appropriately drafted, could produce for consideration for boardroom selection individuals that did not share common ties of educational and professional experience with existing directors. These individuals might be male or female. A test of independence constructed around particular behavioural characteristics such as those that signify feminised[95] practises would also produce a group of men and women. What is happening in both the United Kingdom and Australia it seems is an attempt to fuse a debate about a demographic deficit, with a debate about particular cognitive skills and behavioural attributes.[96]

Section 4 — Independence in the boardroom

It is important to recognise that there are very few studies of actual boardroom behaviour.[97] Access to boardrooms to conduct empirical study has been consistently difficult to negotiate[98] and the minutes of boardroom

91 Above n 74, at [3.3].

92 House of Commons Treasury Committee, HC 482 [Incorporating HC 967 i–ii, Session 2008–09] *Women in the City*.

93 G Powell, 'Six ways of seeing the elephant: the intersection of sex, gender, and leadership' (2012) 27 *Gender in Management: An International Jnl* 119.

94 S Bem, 'Gender Schema Theory: A Cognitive Account of Sex Typing' (1981) 88 *Psych Rev* 354 and M O'Connor, 'Women Executives in Gladiator Corporate Cultures: The Behavioural Dynamics of Gender, Ego and Power' (2006) 65 *Maryland LR* 465.

95 Much of this debate can be stylised into a discussion of Gilligan's position in her seminal work, *In a Different Voice: Physiological Theory and Women's Development*, Harvard University Press, Cambridge Mass, 1982. The question is whether Gilligan's work in this volume was a description of women or a description of feminine traits. For the contours of the debate see C Greeno and E Maccoby, 'How Different Is the "Different Voice"?' (1986) 11 *Signs* 310; Z Luria, 'A Methodological Critique' (1986) 11 *Signs* 316 and C Gilligan 'Reply' (1986) 11 *Signs* 324.

96 F Milliken and L Martins, 'Searching for Common Threads: Understanding the multiple effects of diversity in organizational groups' (1996) 21 *Academy of Management Review* 402.

97 R Leblanc and M Schwartz, 'The Black Box of Board Process: Gaining Access to a Difficult Subject' (2007) 15 *Corporate Governance* 843.

98 The two obvious exceptions to this are A Pettigrew and T McNulty, 'Power and Influence in and around the Boardroom' (1995) 48 *Human Relations* 845 and T McNulty and

deliberations are not made available even to shareholders. Such accounts of boardroom deliberations that we have are usually the result of auto-biographical reflection and cannot be viewed as anything other than post hoc narratives of the most general kind.[99] This means that to make suggestions about boardroom dynamics or draw conclusions about what happens in boardrooms we must draw on psychological research on group decision-making that has been developed either in laboratory based experiments or observed in other decision-making contexts. There has been cross-fertilisation between the results of research into group decision-making and the debates about directorial independence. However some research seems to have had a much greater impact than the evidence it presents would warrant while other more significant and relevant research has had little impact. What this final section of the article highlights is the dissonance between the claims of better decision-making quality that are made for independence and independence plus and the available evidence from research on decision-making.

Measures to foster boardroom diversity are now in place in both the United Kingdom[100] and Australia[101] and some success is being reported in attracting not only women into the boardroom but 'new' women as opposed to those 'recycled' from other boardroom appointments. While these developments are very welcome from the standpoint of social justice and economic participation, this should not be allowed to detract from the fact that once again a structural solution has been applied to a perceived behavioural problem. The sort of questioning behaviour that the Higgs Report considered to be regrettably absent from boardrooms is termed task conflict by psychologists who work on the theory of group decision-making and performance. Task conflict concerns debates and disagreements around issues such as policies, procedures and the interpretation of facts. It is thought to be beneficial to the quality of group decision-making that elements of task

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A Pettigrew, 'Strategists on the Board' (1999) 20 *Organization Studies* 47. The first of these pieces of work was based on a pilot study of 20 directors in 1994. The fact that it is still cited as one of the leading studies is a testament not only to its enduring quality but also to the dearth of subsequent empirical studies.

99 See, eg, the accounts of boardroom deliberations referred to in J Barnard, 'Institutional Investors and the New Corporate Governance' (1990–1991) 69 *North Carolina LR* 1135 at 171.

100 The United Kingdom set up a review of the issue which culminated in *Women on Boards* (the Davies Report), February 2011. The report made a number of suggestions the only one of which that managed to make it into the UK Corporate Governance Code was a suggestion that diversity 'including gender' be considered in the context of appointments, see Supporting Principle to Main Principle B2. A *Women on Boards: 6 month monitoring report* complied and released by Cranfield School of Management reports that progress is being made post the Davies Report, at <http://www.som.cranfield.ac.uk/som/dinamic-content/news/documents/wftse2011.pdf> (accessed 23 July 2012).

101 *ASX Corporate Governance Principles and Recommendations with 2010 Amendments*, at <http://www.asxgroup.com.au/media/PDFs/cg_principles_recommendations_with_2010_amendments.pdf> (accessed 23 July 2012) contain requirements, on a comply or explain basis, for corporations to have a diversity policy that contains measureable outcomes against which they must report in their Annual Report, see Recommendations 3.2–3.4. The Australian Institute of Directors reports that some progress is being made, see at <http://www.companydirectors.com.au/General/Header/Media/Media-Releases/2010/Women-on-the-rise-on-Australian-boards> (accessed 23 July 2012).

conflict be present.[102] Key to establishing task conflict and harnessing its power is the creation of an atmosphere of high trust and respect based around individuals that do not dislike each other and have shared values and norms.[103] In this environment group members are likely to raise and discuss differing opinions and ideas because they feel it is appropriate to do so.[104] This in turn results in greater cognitive understanding across the group of both the issue at hand and the decision reached.[105]

Pursuing independence plus as a policy for director appointment seem to be at odds with this idea. There seems to be a desire to attract into boardrooms individuals that do not share norms and values with those already there. Groups that posses this type of diversity[106] are said to be prone to relationship conflict, the presence of which is thought to have a negative effect on the performance of groups affected by it.[107] Perceived or real differences between group members that are unrelated to actual tasks but instead find their root in surface level diversity (observable characteristics) such as biological sex or deep level diversity (not directly observable) such as political views lie behind relationship conflict.[108] Observation of surface level diversity by group members can trigger a more damaging search for deep level diversity that is then exacerbated by context.[109] What this means is that characteristics that might be quite obvious in some situations such as higher status in a particular social context or greater experience of a particular aspect of business life, for example, are more difficult to discern in other situations.

The boardroom is a classic example of this — individuals who would be confident of exhibiting higher status or greater knowledge within their own employment experience than others meet those others as supposed equals in the boardroom of a corporation where both have been appointed non-executive directors. These differences result in the distraction of group members from the tasks at hand and an unhealthy focus on each other[110] and the incorporation of negative emotions such as anger and frustration into discussions as reasons are attributed for the behaviour of other group

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102 S Schultz-Hardt, 'Productive conflict in group decision-making: Genuine and contrived dissent as strategies to counteract biased information seeking' (2002) 88 *Organizational Behaviour and Human Decision Processes* 563.

103 C De Dreu and A Van Vianen, 'Managing Relationship Conflict and the effectiveness of organizational teams' (2001) 22 *J of Org Beh* 309.

104 K Jehn et al, 'The effects of conflict types, dimensions and emergent states on group outcomes' (2008) 17 *Group Decision and Negotiation* 465.

105 O Janssen et al, 'How task and person conflict shape the role of positive interdependence in management teams' (1999) 25 *J of Man* 117.

106 M Roberge and R van Dick, 'Recognizing the benefits of diversity: When and how does diversity increase group performance?' (2010) 20 *Human Resource Man Rev* 295.

107 The distinction between task conflict with its broadly positive connotations and relationship conflict with its negative conations has been current in research on group decision making for some 50 years, see T Simons and S Peterson, 'Task Conflict and Relationship Conflict in Top Management Teams: The Pivotal Role of Intragroup Trust' (2000) 85 *J Appl Psychology* 102 for an account of the development of research in this area.

108 D Harrison et al, 'Beyond relational demography: Time and the effects of surface- and deep-level diversity on work group cohesion' (1998) 41 *Acad Man J* 96.

109 L Pelled et al, 'Demographic dissimilarity and workplace inclusion' (1999) 36 *J Man St* 1013.

110 J Jehn and E Mannix, 'The Dynamic Nature of Conflict: A Longitudinal Study of Intragroup Conflict and Group Performance' (2001) 44 *Acad Man J* 238.

members.[111] Individuals who find themselves in relationship conflict situations experience lower trust in their fellow group members, communicate less frequently, exhibit lower commitment to the group and contribute less to tasks.[112] Groups where social cohesion is present, exactly the sort of boardrooms appointments that independence plus is considered to prevent, are more likely to see individuals voice dissent and the group then deal with that dissent as an opportunity for discussion than those where social cohesion is lacking. Socially cohesive boards are likely to have high 'effort' norms. These are the group expectation about the amount of effort, with effort being an individual judgement, that is to be applied to collective tasks.[113] Boards that are socially cohesive are more likely to offer settings where directors give advice to each other.[114]

The one area of psychological research that has been embraced by academics[115] and those appointed to investigate the events of the financial crisis and recommend policy and regulatory changes is that around group think. For a definition of group think we need look no further than the oral evidence to the Treasury Committee inquiry set up to examine the position of women in the City of London Paul Myners, then the Financial Services Minister. He described one of the largest risks in any decision-making forum as decisions being taken in such a way as to involve 'the mutual reinforcement of prejudice and a desire to achieve early consensus in a comfortable way'.[116] This is a summary of the effects of group think. It is probably the best known application of psychological principles to group decision-making and, in addition to the defects Myners refers to, he could have added poor risk appraisal and illusions of invulnerability which are also thought to be behaviours associated with group think.[117]

Group think as a phenomenon is a mode of thinking where the pressure and desire for unanimity and conflict avoidance overcomes the search for alternative causes of action.[118] It could be described as the negative side of social cohesion. It involves a close knit group that is confident of its capabilities both in terms of intellectual ability and decision-making capacity and is impervious to wider influences that might introduce alternative views, acting on shared opinions. The original construction of group think suggested that it comprises four elements; a cohesive group where cohesion is enhanced by homogenous backgrounds and experiences, an absence of outside sources

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111 E Torrance, 'Group decision-making and disagreement' (1957) 35 *Social Forces* 314.

112 A Kristof-Brown et al, 'When opposites attract: A multi-sample demonstration of complementary person-team fit on extraversion' (2005) 73 *J of Personality* 935.

113 R Wageman, 'Interdependence and group effectiveness' (1995) 40 *Admin Sci Quart* 145.

114 M Huse, 'Accountability and creating accountability: a framework for exploring behavioural perspectives of corporate governance' (2005) 16 *British Jnl of Management* 65.

115 M O'Connor, 'The Enron Board: The Perils of Group think' (2002–2003) 71 *U Cin L Rev* 1233 and J Cox and H Munsinger, 'Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion' (1985) 48 *Law and Contemp Problems* 83.

116 Above n 92 Treasury Committee on 4 November 2009, HC (2009–10) 1088–ii, Q 174

117 M Turner and A Pratkanis, 'Twenty Five Years of Group think Theory and Research: Lessons from the Evaluation of a Theory' (1998) 73 *Org Beh and Human Decision-making Processes* 105.

118 M Hogg and S Hains, 'Friendship and group identification: A new look at the role of cohesiveness in group think' (1998) 28 *European J of Soc Pysch* 323.

of information, the presence of a strong leader and the presence of stress such as the need to make a decision quickly or an external threat of some kind.[119] The internal dynamic of social cohesion and the external dynamic of the insulation from information creates an environment where decision-making processes are fundamentally flawed. This is clearly an attractive descriptive model for those who see boards of directors as sharing values, professional experience and social background to the detriment of the decisions they make.

However group think is far from the solid edifice that critics of board composition seem to think it is. It is a complex model to test[120] in that it relies on post hoc scenario analysis that cannot be fully replicated in laboratory experiments or observation. In its original form it involves a series of historical case studies in which well known political events that required crucial decisions to be made are reviewed.[121] This accessibility, coupled with the very public dissection of the events of the Enron collapse, probably account for the popularity of group think as an explanatory mechanism for corporate law scholars and commentators. Sufficient information is known about the way in which the Enron board conducted itself for the model that was designed around such events as the Cuban Missile Crisis to be applied. However there will also be questions about the ascription of causality in the application of the model. As a result of these difficulties modifications have been suggested to parts of the original group think hypothesis. One of the suggested modifications that is most damaging to the assertion of its corrosive effect on boards is that an essential element is not group cohesion but perceived collective efficacy[122] based upon the group's prior success. Translated into the language of boards this looks like an argument for limiting the length of service of non-executive directors lest continued success should make them over confident in their judgment rather than an argument for using independence to cut through social ties.

The most recent work in social psychology on group think suggests that it is a ubiquitous presence occurring in most if not all group settings where decisions have to be made as a collective.[123] When group think is constructed in this way there are three necessary components. The first is social identification with the group which creates in the individual pressure to show allegiance and the desire to conform. The second is the presence of a shared philosophy and the third is a feeling of low situational self-efficacy where individuals lack confidence in their own ability. Boards of directors are a decision-making collective that incorporate a role for individual contribution.[124] However the difficulty for the proponents of independence plus who view group think as the mischief that is to be rooted out, is that

119 I Janis, *Victims of Group think: A psychological study of foreign-policy decisions and fiascos*, Houghton Mifflin, Boston, 1972.

120 See the comments of I D Steiner on this point in 'Heuristic models of group think' in H Brandstatter et al (Eds), *Group decision-making*, New York Academic Press, 1982, p 503.

121 D Welch, 'Crisis Decisionmaking Reconsidered' (1989) 33 *J Conflict Res* 430.

122 G Whyte, 'Recasting Janis's Group think model: The key role of collective efficacy in decision fiascos' (1998) 73 *Org Beh and Human Decision-making Processes* 185.

123 R Baron, 'So right it's wrong: Group think and the ubiquitous nature of polarized group decision-making' (2005) 37 *Advances in Experimental Social Psychology* 219.

124 D Forbes and F Milliken, 'Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision–Making Groups' (1999) 24 *Acad Man Rev* 489.

social identification can be created through the familiarity of meeting settings. All new appointees will be socially attuned to this setting reasonably quickly. Additionally new appointees are more likely in the face of social cohesion amongst a group that they are joining to feel low situational self-efficacy. Group think is almost certainly routinely present amongst members of boards of directors. However it appears to be almost impossible to exclude and may not be as damaging to board performance as the presence of relationship conflict. Research on decision-making in small groups is inherently more complicated than the reformers of corporate governance acknowledge. It turns up seemingly contradictory answers to propositions that have been presented in the world of corporate governance as straightforward.

Conclusion

If we situate corporate governance more broadly than simply an application of agency theory then it becomes possible to see the tasks that board members are entrusted with in a frame which actually values some of the things that structural concerns with independence do not value.[125] McNulty et al offers a threefold classification of board member functions;[126] control and monitoring functions (the agency view) where non-executive directors are called upon for example to set remuneration levels and hire the CEO, service functions where the tasks include assisting in the development of strategy and advising on administrative issues and resource dependency functions where what matters is the ability of the board to provide symbolic, material and financial resources for the corporation to exploit. The current corporate governance codes of the United Kingdom and Australia can be mapped against this classification in terms of the tasks that they specify.

Independent directors must be able to display an awareness of how business works and be able to assimilate quickly information about how the particular business works. They need to be able to understand the dynamics between individual executive directors and those between executive directors and their own non-executive group. They need to understand how individual strategic decisions will impact on share price and how strategy is formulated within the organisation and then packaged to those outside the organisation.[127] They need to be able to display sufficient knowledge in these areas to garner the trust of executive directors and management thus enabling their comments and views to have any effect and yet they need to maintain a sufficient distance such as to avoid capture by executive directors and remain independent. These requirements raise the question of whether industry specific knowledge is something that needs to be weighed against structural independence and favoured over it. Certainly this was the position taken by the Walker Review[128] of the UK banking and financial sector post the financial crisis of 2007–8. Walker is something of an outlier on this point, although clearly a

125 See the literature cited above n 25.

126 T McNulty et al, ‘The role, power and influence of company chairs’ (2011) 15 *J Manag Gov* 91 at 101.

127 P Stiles, ‘The Impact of Boards on Strategy: An Empirical Examination’ (2001) 38 *J of Man Studies* 627.

128 Above n 71, at [3.6] and [3.7]. For further discussion of this tension see M Moore, ‘The

very significant one, in his views on the need for industry insiders to be board members. He favoured the creation of a boardroom atmosphere and culture where informed challenge could be mounted to the CEO and management[129] and was of the view that this could only be done effectively by those with industry specific knowledge.

Independent directors are likely to be influenced by executive voices around them but not they need not to be cowed by that influence. Trust is a two way process as independent directors have to feel able to rely on the extent and quality of information they are given by executive directors in order to perform their monitoring function.[130] Distrust between the two groups splits the board and results in a 'circle of control and counter control'.[131] Investors need to feel that the independent directors have sufficient influence within the board dynamic such that they can get their voice heard. These tasks are not made more possible or more likely to be carried out diligently by the rigid adherence to a test of structural independence or any expansion of it. Nor to be carried out successfully do these tasks require the introduction of a 'new group', even though the introduction of that group should be welcomed and supported on other grounds.

Independence constructed on the basis of structural tests will not produce automatically the type of behaviours that the proponents of independence and diversity think it will. If such behaviours result then they are occurring most probably through chance rather than as a result of corporate governance mechanisms advocating independence. An assertion that boards of directors do behave or will behave in a particular way unless the pool of potential members is widened is a claim unsupported by any robustly gathered empirical evidence. It relies instead on anecdotal recollection at best.[132] Individual corporations can, of course, plan through the use of psychometric testing and profiling to appoint individuals with complimentary personality types. They can consciously try to construct a climate which fosters within-group trust and psychological safety[133] and thus allows for robust debate and dissension to avoid the potential pitfalls inherent in diversity and relationship conflict but this requires knowledge on their part that the structures suggested by official mechanisms may produce lower quality outcomes than they have been encouraged to think would result.

Evolving Contours of the Board's Risk Management Function in UK Corporate Governance' (2010) 10 *J of Corp Law Stud* 279.

129 Above n 71 recommendation 6.

130 R Hooghiemstra and J van Manen, 'The Independence Paradox: (im)possibilities facing non-executive directors in The Netherlands' (2004) 12 *Corporate Governance* 314.

131 P Daudi, *Power in the Organisation*, Blackwell, Oxford, 1986.

132 R Marahaji, 'Corporate Governance, group think and bullies in the boardroom' (2008) 5 *Int J of Dis and Gov* 68.

133 V D Wall et al, 'Task-Oriented Groups: Conflict, Conflict Management, Satisfaction, and Decision Quality' (1987) 18 *Small Group Beh* 31.