# A ‘Truth’ Universally Acknowledged:
# Looking Further at Director Independence

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## I. Introduction

Corporate governance is ubiquitous in contemporary business and corporate law literature and practice, and an integral focus has been increasing the independence of the board.[1] Corporate debacles — such as Enron and Worldcom, HIH Insurance and One.Tel — have prompted jurisdictions world-wide to execute reforms centred on this ideal.[2] New Zealand is no exception, with our two main contributions to this body of reform being the NZX *Listing Rules*[3] and the Securities Commission's *Principles*. [4] The latter, especially, are predicated explicitly on a need to keep pace with international developments — the idea that, in a world increasingly characterised by competitive international transacting, New Zealand cannot afford to be an "outlier".[5] This is regarded as imperative given the smallness of the New Zealand economy, our reliance on international investment, and the comparative stagnation of New Zealand's markets during the recent period of 'light regulation'.[6] Despite the absence (to date) of any major corporate scandal illustrating any notable deficiency in our system, New Zealand entities are nonetheless being faced with demands that they adopt the independent director reform.

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[1] The utility of board independence has been described as a "principle thread in the development of the law" (W T Allen "Independent Directors In MBO Transactions: Are They Fact or Fantasy?" (1990) 45 Bus Law 2055) and "the trend in the prescription of codes of conduct seems to assume the premise" (The Failure of HIH Insurance, The HIH Royal Commission, vol. 1, Canberra, April 2003, para 6.2.6, Hon. Justice Owen Young).

[2] Exemplifying this are the major American stock exchanges' reaction to the Sarbanes-Oxley Act of 2002 (see Securities And Exchange Commission, "NASD and NYSE Rulemaking: Relating to Corporate Governance" (Release No. 34-48745), November 4, 2003.); the ASX Corporate Governance Council*, Principles of Good Corporate Governance and Best Practice Recommendations* (2003) (Internet) <http://www.shareholder.com/visitors/dynamicdoc/document.cfm?documentid=364&companyid=ASX > accessed 7/3/06; and the (UK) Financial Reporting Council's *The Combined Code On Corporate Governance* (June 2006) (Internet) <http://www.frc.org.uk/documents/pagemanager/frc/Web%20 Optimised%20Combined%20Code%203rd%20proof.pdf> accessed 1/10/06.

[3] NZX, *NZX Listing Rules* (2004) (Internet) <http://www.nzx.com/regulation/listed_issuer/listingRules TOC> accessed 30/4/06.

[4] Securities Commission New Zealand, *Corporate Governance in New Zealand: Principles and Guidelines* (2004) (Internet) <http://www.sec-com.govt.nz/publications/documents/governance-principles/index. shtml> accessed 30/4/06.

[5] L Kavanagh, Temporary Deputy Chairman of the Securities Commission, "NZ Securities Regulation: The importance of meeting stds of international best practice" (Speech delivered at the FINSIA Senior Business Forum, 23 May 2006) (Internet) <http://www.sec-com.govt.nz/speeches/2006/lks230506.shtml> accessed 18/7/06.

[6] Ibid. Between 1994 and 2001 the market capitalisation of the then NZSE increased by less than $1 billion ($43.3b to $44b), whereas its Australian counterpart expanded over 250% ($282b to $733b): *New Zealand Stock Exchange Annual Report for the Year Ended 31 June 2001* (New Zealand Stock Exchange, Wellington, 2001), cited in J. Healy, *Corporate Governance and Wealth Creation in New Zealand* (Dunmore Press Ltd, 2003) 30-31.

Thus in October 2003 the NZX amended their *Listing Rules* to *require* listed issuers to comply with a minimum level of board independence: namely, two independent directors on boards with up to eight directors, and the greater of three or one-third on larger boards.[7] These directors must be non-executives who have no "disqualifying relationship" with the company — broadly defined as relationships involving an interest that may materially impact on their impartial decision-making (such as a substantial security holder).[8] The NZX simultaneously introduced additional disclosure obligations, requiring issuers to name the directors considered to be independent,[9] and report against a corporate governance Best Practice Code.[10]

Within four months the Securities Commission released its *Principles*. Creating no new *legal* obligations, the *Principles* nevertheless "set out standards of corporate governance that the Commission *expects* boards of issuers to observe and to report on", and are intended "to be generally applied" by a wider range of entities[11] — albeit acknowledging that "different types of entities can take different approaches" to achieving the ideals.[12] The primary emphasis is on disclosure,[13] and the Principle relevant to independence requires the entity to disclose *how* they have achieved "a balance of independence, skills, knowledge, experience, and perspectives among directors so that the board works effectively".[14] This is accompanied by Guidelines intended to assist entities in their consideration of the issue, but that need not be specifically reported against:[15] thus, it is suggested that issuers "should have an appropriate balance of executive and non-executive directors, and should include directors who meet formal criteria for 'independent directors'."[16] It is only in the attached Commentary that the Commission makes any concrete recommendation —

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[7] *NZX Listing Rules*, above n 3, LR 3.3.1. It further mandated that issuers have audit committees (LR 3.6), the majority of members to be independent: LR 3.6.2(c).
[8] Ibid LR 1.1.2.
[9] Ibid LR 3.3.1A.
[10] Ibid LR 10.5.3(i). The Code includes recommendations including codes of ethics, director nomination, training and remuneration, intended to "enhance investor confidence": Appendix 16.
[11] Namely, "entities that have economic impact or are accountable to investors or to the public more generally", Securities Commission's *Principles* above n 4, "Foreword".
[12] Ibid "Principles in Context" (my emphasis).
[13] Ibid "Foreword".
[14] Ibid Principle 2.
[15] Ibid "How to report against the Principles".
[16] Ibid Guideline 2.1.

opining that *public* issuers should have one-third independent boards.[17] Like the NZX, they define 'independent directors' as not representing a substantial shareholder and having "no other direct or indirect interest or relationship that could reasonably influence their judgement and decision making as a director".[18] In effect, therefore, the *Principles* constitute no additional requirement for NZX issuers, and for entities *other* than public issuers, merely an expectation of disclosure as to the "balance" of their board.

This dissertation reviews New Zealand's position. It first does so by reflecting on whether independent directors *truly* add value. This is not to deny New Zealand's genuine and powerful interest in attracting overseas investment, nor the evidence that this will require demonstrably good corporate governance.[19] However, this appreciation cannot be the *sole* determinant of New Zealand's path. For example, the seemingly counter-intuitiveness of reforms predicated on disinterested — possibly uninterested — persons, and potential alternative means for achieving the objective, may militate against the independent board ideal. Thus the seemingly taken-for-granted[20] value of independent directors will be investigated further, both in theory and as indicated by the evidence in fact.

It is concluded that the powerful incentive of New Zealand regulators to embrace the global movement is likely to nonetheless compel a continued and perhaps increasing emphasis on board independence. Therefore, this dissertation primarily endeavours to expose some of the practicalities — and implications — of any genuinely effective implementation of the concept. This will involve canvassing possible descriptions of "independence", as well as the various means both of adopting the reform, and

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[17] Ibid Commentary to Principle 2. It further recommends public issuers should have a *majority* of *non-executive* directors, and issuers should have a "board including independent director representation".
[18] Ibid Commentary to Principle 2.
[19] A multinational investor survey undertaken in 2002 revealed that 31% of investors would avoid investing in countries with poor corporate governance, and 70-80% would pay a premium to invest in a well-governed company (valued at 12-14% in North America and Western Europe; 20-25% in Asia and Latin America; and more than 30% in Eastern Europe and Africa). (McKinsey & Company "Global Investor Opinion Survey" (July 2002) (Internet) <http://www.mckinsey.com/clientservice/organization leadership/service/corpgovernance/pdf/GlobalInvestorOpinionSurvey2002.pdf > accessed 1/10/06.
[20] The "independent director" is the "Holy Grail" of the corporate governance reforms, an "assumption [that] lies at the heart of the current reforms" despite the lack of evidential verification of its value: J G Hill, "Regulatory Responses to Global Corporate Scandals" (2005) 23 Wis. Int'l LJ 367, 386, 388. "Independent directors are now regarded as some kind of holy water that can be sprinkled over a corporation to save it from all sorts of intrigue on the part of its staff": R A Epstein "In Defence of the Corporation" (2004) NZ Law Rev 707.

thereafter enforcing the sought independent director behaviour. Given the (at least current) resolution of the former two issues in New Zealand, the key focus will be on enforcement.

The area of corporate governance is constantly evolving and inherently complex. It covers a continuum of issues, from micro-topics (such as the optimal drafting of incentive packages), to over-arching debate as to the public or private nature of the corporation itself. Even the concept of the independent director entails more questions than the current work can do justice to. Thus the aim is simply to generate greater reflection on some of these issues.

## II. A Sustainable Reform?

### *A. Arguments for Independent Directors*

Although corporate governance reformers seem to largely assume the validity of increasing board of directors,[21] a number of underlying rationales are identifiable.

Agency Costs

The most commonly articulated rationale[22] is predicated on the separation of ownership and control characteristic of the modern business corporation.[23] The control of the corporation by non-owning managers means shareholders are exposed to 'agency costs' arising from potential managerial conflicts of interest,[24] and recent corporate misconduct has augmented the public perception of this problem.[25] Thus, objective monitoring of management by an independent board is held up as minimising these costs[26] — a capability largely depicted as being inherent in their very 'independence'.[27]

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[21] Depicting "the dominance of independent directors as self-evidently virtuous": Epstein, above n 20, 719.

[22] This is the "heartland of corporate governance debate": R P Austin "Corporate Governance Symposium: What Is Corporate Governance? Precepts and Legal Principles" (2005) 3 NZ Law Rev 335, 341. See also B D Baysinger & H N Butler "Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition" (1985) 1 JL Econ & Organization 101, 109-10.

[23] Berle & Means classic proposition that the owner-shareholders have abdicated control to a separate group of professional managers: A A Berle & G Means, *The Modern Corporation and Private Property* (Macmillan Company, 1932). Shareholders are statutorily displaced by section 128 of the Companies Act 1993: the board is granted "all the powers necessary for managing, and for directing and supervising the management of, the business and affairs of the company".

[24] B R Cheffins "Current Trends in Corporate Governance: Going from London to Milan via Toronto" (1999) 10 Duke J Comp & Int'l L 5, 15, citing shirking, diverting corporate assets for their own benefit or using their influence to secure unduly extravagant compensation or entrenchment

[25] Including major corporate collapses, attributed to board failure, and seemingly disproportionate executive compensation packages: Austin, above n 22, 346.

[26] Cadbury Report (A Cadbury et al., The Financial Aspects of Corporate Governance (1992) (Internet) <http://www.ecgi.org/codes/documents/cadbury.pdf> accessed 1/1/06; R Grantham, "Corporate Governance Codes in Australia and New Zealand: Propriety and Prosperity" (2004) 23 U QLJ, 218, citing the central focus in Australia and New Zealand.

[27] W B Chandler III & L E Strine, Jr "Views from the Bench: The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State" (2003) 152 U Pa L Rev 953, 956 articulate reformers' view of "the integrity assuring benefits of genuinely independent directors whose ability to choose and oversee top management impartially could not be questioned."

A first criticism of this rationale questions the universal reality of the separation of ownership and control. Outsider, arms-length systems (such as exhibited by the United States and United Kingdom, where the rationale originates) are arguably uncommon.[28] As such, controlling shareholders should themselves be capable of ensuring managerial accountability, and the main corporate governance concern may instead be to protect minority shareholders from majority abuse.[29] Arguably, New Zealand falls within the latter group[30] — yet this does not preclude an agency costs rationale, conceived of more broadly. Independent directors might also serve as monitors of *dominant shareholder* discretion, minimising the agency costs inherent in the majority's control over the minority's interest.[31]

A further problem is that the actual evidence of independent directors' efficacy in reducing agency costs is, euphemistically, mixed.[32] Although they seem to add value in certain conflict of interest situations,[33] their overall performance in an accountability-enhancing role is unclear. However, the seemingly inexorable logic of the independent monitor ideal has led most theorists to attribute the lack of concrete substantiation to research deficiencies[34] and/or structural (and resolvable) impediments to the independent directors' performance.[35] As such, the "intuitive belief"[36] that independent directors minimise agency costs remains a primary driver of the reforms.

Corporate Performance

A second rationale suggests independent boards have a direct positive influence on

[28] Cheffins, above n 24.
[29] Ibid, describing the insider or control-oriented systems of Italy and Canada
[30] 30% of New Zealand's top forty listed companies are under majority control; 57% are under minority control: J H Farrar, *Corporate Governance in Australia and New Zealand* (Oxford University Press, 2001) 470.
[31] Cheffins, above n 24, 22, citing Italian evidence of such a role.
[32] Meta-surveys undertaken by S Bhagat & B Black, "The Uncertain Relationship between Board Composition and Firm Performance" (1999) 54 Bus Law 921 and L Lin "The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence" (1996) 90 Nw UL Rev 898 describe research indicating both positions, and appear to ultimately favour divergent standpoints.
[33] Including executive compensation and dismissal and behaviour during takeover situations: see Bhagat & Black, above n 32 and Lin, above n 32
[34] R W Hamilton "Corporate Governance in America 1950-2000: Major Changes But Uncertain Benefits" (2000) 25 Iowa J Corp L 349, 366-7 cites problems isolating the impact of board composition and determining causal direction; and the "moving target" nature of corporate governance best practice itself.
[35] See above Part II.B. Even Bhagat & Black (above n 32, 955) take this stance.
[36] Hamilton, above n 34, 365-6.

corporate performance. This is attributed to their functions of ensuring management acts in the shareholders' interests (their monitoring role), and/or providing an objective perspective in the formulation of corporate strategy (their strategic role).[37] Effective monitoring that constrains managers from abusing their position by acting in their own self-interest means that their skills and effort will be applied to achieving the *company's* goals.[38] Likewise, corporate performance may be enhanced by independent directors' "broader view and…fresh perspective" regarding policy and strategy, which may counter managerial biases.[39]

Thus this rationale depends partly on independent directors' capacity to reduce agency costs. Yet even if a positive correlation between independence and performance in discrete conflict situations was proven, *overall* performance may still not increase.[40] More holistic studies of the relationship between independence and performance are erratic and contradictory.[41] Moreover, there are indications that any positive correlation between independence and performance is non-linear, and may exist only up to a certain number of independent directors.[42] Anecdotal evidence also appears to contradict this rationale,[43] and exemplars of *bad* governance, Enron and HIH

[37] The dual roles are defined in the Higgs Report (D Higgs et al., Review of the Role and Effectiveness of Non-Executive Directors (2003) (Internet) <www.dti.gov.uk/cld/non_exec_review> accessed 1/1/06). Compare R C Nolan "The Legal Control of Directors' Conflicts of Interest in the United Kingdom: Non-Executive Directors Following the Higgs Report" (2005) 6 Theoretical Inq L 413, who suggests that independent directors cannot be both decision-makers and impartial decision-controllers.
[38] M Lipton & J W Lorsch "A Modest Proposal for Improved Corporate Governance" (1992) 48 Bus Law 59; N E Leech & R H Mundheim "The Outside Director of the Publicly Held Corporation" (1976) 31 Bus Law 1799.
[39] D C Langevoort "The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability" (2001) 89 Geo LJ 797, 803
[40] S Bhagat & B Black, "The Non-Correlation between Board Independence and Long-Term Firm Performance" (2002) 27 Iowa J Corp L 231, 235, arguing that corollary detriments (eg. less knowledgeable decision-making) might extinguish any benefits from reduced agency costs.
[41] See reviews of the vast labyrinth of research in Lin, above n 32; G P Stapledon & J Lawrence "Board Composition, Structure And Independence In Australia's Largest Listed Companies" (1997) 21 Melbourne U LR 150; and Bhagat & Black, above n 32.
[42] Baysinger & Butler (above n 22) found a causal relationship between independence and performance, but only up to around 30% independence, thereafter identifying "diminishing marginal increases and absolute declines in relative performance". Bhagat & Black (above n 40, 233) in "the first large-scale, long-time horizon study of the relationship" found indications of a negative correlation, which they largely attributed to super-majority independent boards (only 1-2 insiders on a 10-11 director board).
[43] Executive compensation has mushroomed over the same era as boards have become significantly more independent: Bhagat & Black, above n 32, citing G Crystal, "In Search Of Excess: The Over-Compensation Of American Executives" in "Value For Money: Executive Compensation In The 1990s" (E Iacobucci & J Trebilcock eds., CD Howe Institute, 1996). *Business Week*'s 'best' and 'worst' boards in terms of compliance with best practice corporate governance revealed some

Insurance, had (theoretically) independent boards.[44] Therefore, it seems that "the conventional wisdom favouring highly independent boards lacks a solid empirical foundation."[45]

Investor Confidence

A "related but subtly different" rationale for independent directors is to promote investor confidence.[46] Therefore, board independence may be advantageous notwithstanding the absence of concrete empirical evidence of improved performance or reduced agency costs.[47] For example, investors may pay another eighteen percent for companies with rigorous corporate governance practices.[48] Thus an explicit key purpose of the Securities Commission's *Principles* is to strengthen investor confidence in New Zealand's sharemarkets — a rationale expressed as being especially important to attract essential international investment. [49] The increasing expansion and competitiveness of the global capital market means countries cannot afford to disregard reforms and best practice elsewhere.[50] New Zealand must respond to the pro-independence reforms observed worldwide, or risk "becoming more and more economically irrelevant in international capital markets."[51]

However, the force of an investor protection rationale is questionable. Professor Epstein argues that the correct protective mechanisms for unsophisticated investors are indirect institutional investment or professional investment advice —*not*

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companies with the 'worst' boards "significantly outperform, in an economic sense, all of the corporations on the 'best' list": Hamilton, above n 34, 370-1.

[44] Enron had "a splendid board on paper" (with only two insiders), yet it was "ineffectual in the most fundamental way", with almost every director's independence undermined by side payments and/or over-familiarity: J N Gordon, "What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections" (2002) 69 U Chi L Rev. 1233,1241. The presence of several independent directors on HIH's board "provided little protection against the folly of management." HIH Royal Commission, above n 1, para 6.2.6.

[45] Bhagat & Black, above n 40, 233. The evidence is, at best, not conclusive (Lin, above n 32, 961-2) and the benefits of independence "uncertain" (Hamilton, above n 34, 371).

[46] J. Lawrence & G. Stapledon, "Do Independent Directors Add Value?" Research Report (Centre for Corporate Law and Securities Regulation, University of Melbourne, 1999) Executive Summary, cited in J H Farrar *Corporate Governance: Theories, Principles and Practice* (2nd ed., Oxford University Press, 2005) 36.

[47] Hamilton, above n 34, 371.

[48] K S Burke "Regulating Corporate Governance Through the Market: Comparing the Approaches of the United States, Canada and the United Kingdom" (2002) 27 Iowa J Corp L 341, 341, citing P Coombes & M Watson, "Three Surveys on Corporate Governance" McKinsey Q, Summer 2000 74, 75-76. See also McKinsey & Company study, above n 19.

[49] See Kavanagh above n 5.

[50] Cheffins, above n 24, 5-6.

[51] J H Farrar "Enforcement: A Trans-Tasman Comparison" (2005) 3 NZ Law Rev 383, 392.

interfering with market efficiency for other, more knowledgeable investors.[52] Moreover, if investor *over*-confidence enabled the massive United States frauds, a more sceptical investing public may be beneficial[53] — although it is possible that the pendulum has now swung too far in the opposite direction. Finally, proponents of this rationale are effectively arguing that director independence "offers to investors some assurance that the governance process has integrity"[54] *because* it enhances managerial accountability and thus (or additionally) improves the corporation's performance. Therefore, its validation relies on the substantiation of either or both these propositions — otherwise, the reforms are seemingly nothing more than an empty means of investor placation.[55]

Company Autonomy

Independence is also sometimes advocated as securing judicial and regulatory non-interference. For example, the greater laissez-faire in judicial review of conflicted transactions approved by independent directors has arguably created an incentive for United States companies to increase their boards' independence.[56] Likewise, both regulators and anti-regulatory groups exhort independent directors towards pro-activism by referring to the alternative of more onerous regulation.[57] Yet these arguments are again founded on the underlying conception that independent directors will minimise agency costs (and/or improve corporate performance), supplanting any (primary) role for the judiciary or regulatory agency.

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52 Epstein, above n 20, 714-5, albeit critiquing insider trading laws, not board independence.

53 L E Ribstein "Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002" (2002) 28 Iowa J Corp L 1, 52-3, citing investors speculating wildly on the basis of fads.

54 E N Veasey "Should Corporation Law Inform Aspirations for Good Corporate Governance Practices — Or Vice Versa?" (2001) 149 U Pa L Rev 2179, 2184

55 See also Ribstein, above n 53, 52-3.

56 Lin, above n 32, 904 especially.

57 Leech & Mundheim (above n 38, 1835-6) urge acceptance of outside directorships to preclude alternatives such as "public examiners or some other form of state appointed officials", which would eradicate *private* command of economic activity. Principle 1.06 of the Institute of Directors' *Code of Practice* states that compliance with the principles (including Principle 3.07 regarding independent director representation) may "help avoid a greater degree of imposed regulation" (Institute of Directors in New Zealand Incorporated, *Code of Practice for Directors* (2005) (Internet) <http://www.iod.org.nz/publications/Code%20Of%20Practice.pdf> accessed 30/4/06). The UK's Department of Trade and Industry has qualified its support of best practice (as opposed to legislation) as dependent on best practice "being seen to be working": Department of Trade and Industry, "Modern Company Law for a Competitive Economy" 9 (1998), cited in Cheffins, above n 24, 9.

Stakeholder Representation

A typically second-tier rationale for independent directors implicit in some of the debate is their potential as representatives for the interests of wider stakeholders and/or ensuring greater corporate social responsibility.[58] Under current orthodoxy, however, this seems to be cited more as a desirable 'by-product' as opposed to a primary justification.[59] Either way, it is for practical purposes a further incarnation of the agency cost rationale, simply widening the directors' constituency.

Thus, recapitulating, the basic proposition underlying the prevalent advocacy of independent directors is that their objective monitoring and/or insight can improve managerial accountability and corporate performance. Therefore, companies (and countries) who exhibit such boards will be perceived as safer investments. However, the *actual* empirical evidence seems to contradict this notion, and so further consideration is warranted.

[58] Baysinger & Butler, above n 22.

[59] Principle 9 of the Securities Commission's *Principles* (above n 4) advocates that the board "respect the interests of stakeholders", but the related Guidelines explicitly state this to be "generally subject to the interests of the shareholders" and the Commentary implies that relevance of stakeholder interests is largely only to the extent that it "furthers the interests of the entity and its shareholders." Similarly, the UK Government's White Paper, Modernising Company Law 9, 26 (2002), explicitly endorsed the fundamental proposition that companies exist to create wealth for their shareholders: see Nolan, above n37, n49. Compare M Sweeney-Baird, "The role of the non-executive director in modern corporate governance" (2006) Comp L 27, 3, 67-81.

### *B. Resolving the Discrepancy?*

Certain *structural* impediments may explain independent directors' failure to realise their theoretical raison d'être, and so reformers typically also advocate various conditions thought necessary to achieve the reform. Others, however, cite these impediments as inherent and thus illustrations that board independence is *not* the panacea it is supposed to be.

<u>Capability Factors</u>

Independent directors are generally thought to lack information about the company's operations and environment.[60] Therefore, they largely rely on the managers and inside directors they are supervising for the information their monitoring role requires — enabling insiders to manage this oversight through selective disclosure.[61] As the sole contacts linking the corporation and the board, executive directors can control the information flowing between the two networks.[62] To circumvent this, independent directors may depend more on externally discernible performance data (such as share price movements),[63] which may not mirror reality[64] and fail to provide *ex ante* damage control. Alternative information sources might be available,[65] but these are likewise removed from the corporation's hub and thus face similar information disparities. Conversely, independent directors could have independent advisers,[66] and

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[60] Bhagat & Black, above n 32, 951, describing an independence/information trade-off; Lipton & Lorsch, above n 38, 65, referring to independent directors' insufficient contextual and industry knowledge to properly scrutinise managerial choices.
[61] See HIH Royal Commission, above n 1. This may include inundating independent directors with too *much* information so that they "end up taking management's word for what it all means": Grantham, above n 26, 222, citing C Carter & J Lorsch, Back to the Drawing Board: Designing Corporate Boards for a Complex World (Harvard Business School Press, 2004) 150.
[62] L E Mitchell "Structural Holes, CEOs, and Informational Monopolies" (2005) 70 Brooklyn L Rev 1313.
[63] Bhagat & Black, above n 32, 925, citing M S Weisbach, "Outside Directors and CEO Turnover" (1988) 20 J Fin Econ 431.
[64] J G Hill "Deconstructing Sunbeam — Contemporary Issues in Corporate Governance" (1999) 67 U Cin L Rev 1099, 1108-9.
[65] Including unofficial information networks within the company, the media, institutional investors, the corporation's financiers and general business connections they have with people in the industry: B R Cheffins, *Company Law: Theory, Structure, and Operation* (Oxford University Press, 1997) 615-6.
[66] Independent counsel are typically suggested: Ibid 622; D M Branson "Too Many Bells? Too Many Whistles? Corporate Governance in the Post Enron, Post WorldCom Era" (Working Paper No 37, University of Pittsburgh School of Law, 2006) (Internet) <http://law.bepress.com/pittlwps/papers/art37> accessed 25/4/06, citing G Hazard, Jr & E B Rock "A New Player in the Boardroom: The Emergence of Independent Directors' Counsel" (2004) 59 Bus Law 1389, 1398-1412.

the increasing promulgation of a *duty* to obtain information might impel more active, determined enquiries.[67]

Even if they access the information, independent directors may be unable to comprehend it. This is especially relevant where stricter definitions of independence encourage appointing candidates from beyond the business context,[68] and in light of evolving business and accounting techniques.[69] Therefore, it is often suggested that independent directors receive compulsory orientation and/or relevant education,[70] or even that certification should be required.[71]

Lastly, the minimal time that most independent directors can and do expend on their role is arguably inadequate to provide them with sufficient awareness of the corporation and management's activities to be effective overseers.[72] Furthermore, time constraints may "contribute to the expectation…that directors are not supposed to voice their opinions freely and frequently".[73] This has led to meeting duration or frequency stipulations,[74] and proposals to restrict the number of directorships an independent director may hold.[75] Conversely, the time impediment may simply inhere in the independent director's part-time nature necessitating their holding other, full-time positions.[76] The proposed solution of full-time, "professional" independent directors[77] may be self-contradictory — reliance on their directorship(s) as their main source of income arguably serves to undermine their independence.

[67] HIH Royal Commission, above n 1, para 6.2.4 especially. See further, Part III.C.
[68] Ribstein, above n 53, 27-8.
[69] Ibid 10.
[70] HIH Royal Commission, above n 1, para 6.2.3.
[71] Branson, above n 66, n106, citing Institute of Corporate Secretaries (Hong Kong), *Professionalism or Incarceration – Will Future Directors Need To Be Accredited*, Company Secretary, July, 2004, 6.
[72] 1995 UK statistics revealed that the average independent director puts in one or two days a month, and mostly in meetings: Cheffins, above n 65, 611, citing KPMG Peat Marwick, *Survey of Non-Executive Directors,* (KPMG Peat Marwick, 1994) 5.
[73] Lipton & Lorsch, above n 38, 65.
[74] Branson (above n 66) sums this trend up: "If four meetings a year had been adequate, and some corporations had six, eight meetings per year is the new standard and ten or twelve is better yet. If meetings lasted an hour or an hour and a half in the 'bad old days', meetings now should go on for three, four, or five hours. More is better."
[75] Stapledon & Lawrence, above n 41, 160, citing AIMA, *Corporate Governance: A Guide for Investment Managers and A Statement of Recommended Corporate Practice* (1995) at [3.6].
[76] Ibid 160. Bhagat & Black, above n 32, 30.
[77] R J Gilson & R Kraakman, "Reinventing the Outside Director: An Agenda for Institutional Investors" (1991) 43 Stan L Rev 863, cited in Ribstein, above n 53, 29.

These factors may therefore deprive independent directors of any true control.[78] One, almost universally advocated answer is to entrench and institutionalise the independent directors' functions within a committee arrangement.[79] However, the very commonness of the 'solution' illustrates that it has not sufficed to ensure independent directors' efficacy in practice.[80] Separating the positions of chief executive officer and board chair may prevent the concentration of power and information in a sole individual,[81] yet the empirical proof of any performance benefits is again inconsistent.[82] Alternatively, independent directors might meet regularly in ex-management committee sessions,[83] subject to time constraints.

Incentive Factors

Regardless of ability, other factors may undermine independent directors' *willingness* to question management, creating a board culture "characterized by 'politeness'" that discourages open criticism.[84] Thus, arguments that "[t]he key isn't structural, it's social"[85] may explain the empirical inconclusiveness as to the value of independence. Yet the social characteristics associated with the ideal board seem nevertheless to endorse the importance of independence — "open dissent",[86] for example, is ostensibly more likely when directors are independent.

A principal psychological deterrent against rigorous scepticism is that independent directors commonly owe their nomination to an executive chair or chief executive,[87] and this is intensified by the practical *conclusiveness* of nomination.[88] Shareholders

[78] Mitchell, above n 62; Ribstein, above n 53, 26-9.
[79] Leech & Mundheim, above n 38, 1807; Stapledon & Lawrence, above n 41, 162; Bhagat & Black, above n 40, 267.
[80] J A Sonnenfield, "What Makes Great Boards Great" (2002) Harv Bus Rev, 80, 9, 106, 109. See also A Klein, "Firm Performance and Board Committee Structure" (1998) 41 JL & Econ 275, 283, cited in Bhagat & Black, above n 40, 237: supervisory committees, however staffed, seem to add little value.
[81] See Cadbury Report, above n 26, *Code of Best Practice* Principle 1.2; HIH Royal Commission, above n 1,para 6.2.1.
[82] Lin, above n 32, 954; Hill, above n 64, 1111-2, citing J A Brickley, J L Coles & G Jarrell, "Leadership Structure: Separating the CEO and Chairman of the Board" (1997) 3 J Corp Fin 189.
[83] New York Stock Exchange ("NYSE"), *NYSE Listed Company Manual*, s 303A(3) (Internet) <http://www.nyse.com/lcm/lcm section.html> accessed 23/9/06.
[84] Cited as contributing to the failure of the boards of both Enron and HIH Insurance: Gordon, above n 44, 1242; HIH Royal Commission, above n 1, xiii-lxiv.
[85] Sonnenfield, above n 80, 109.
[86] Ibid 111-2
[87] Hill, above n 64, 1110.
[88] Cheffins, above n 65, 609; G Colvin, "Shareholders are No Fools — Anymore", *Fortune*, (July 7, 2003) 42, cited in J M Holcomb "Corporate Governance: Sarbanes-Oxley Act, Related Legal Issues, and Global Comparisons" (2004) Denv J. Int'l L & Pol'y 175, 187: "…the very heart of corporate

who might attempt greater control are often dissuaded by the costs of financing a nominee's campaign, the comparative ease of selling out, and the unfairness of spending time and money that other investors free-ride on.[89]

The most popularly advocated solution is an independent nomination committee,[90] yet chief executives arguably retain significant backstage input.[91] Alternatively, some best practice codes recommend that companies provide shareholders with better access to nomination machinery.[92] However, expecting shareholder activism may overlook the collective action problems that necessitate independent directors as monitors of management-imposed agency costs to begin with.

Supplementing these general deterrents, independent directors who are (or were) executives may be 'ideologically disposed' to defer to management[93] — perhaps fearing their activism will encourage like behaviour from their own directors,[94] or simply because of social and/or professional rapport.[95] However, simply barring such persons may exacerbate expertise deficiencies and the allegedly minuscule candidate pool.[96] Over-long service may also create "feelings of cordiality and friendliness" that disincline independent directors towards dissension.[97] Tenure limits might consequently be advocated, although these again aggravate the independent board's

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governance, the election of directors, is still a sham. The shareholder ballots you receive with your proxy materials are just like those Stalin used to distribute. For every position there is exactly one candidate. Please mark your choice."

[89] Cheffins, above n 65, 630-7.

[90] See, for example, Higgs Report, above n 37, s 10.9.

[91] Cheffins, above n 65, 609.

[92] Branson, above n 66; Holcomb, above n 88, 187-188.

[93] Cheffins, above n 65, 610.

[94] Stapledon & Lawrence, above n 41, 159; Bhagat & Black, above n 32, 953.

[95] Stapledon & Lawrence, above n 41, 159; Hill, above n 64, 1110.

[96] "New Zealand's pool of high quality director talent is desperately tiny" according to former Air New Zealand managing director Ralph Norris; Sir Dryden Spring, former chairman of Fletcher Challenge Forests has expressed the view that "the best incubator for future directors is a chief executive or other senior management role in decent-sized companies. Problem is New Zealand is progressively becoming a branch operations economy. The pool of talent to choose from is drying up.": M Story, "Regulation Overdose: Will prescriptive regulations kill good corporate governance?" *The Director* (June 2003) (Internet) <www.management.co.nz> accessed 5/5/06. Compare the potential source of additional candidates implicit in UK statistics that only 4-6% of non-executives are women, and only 1% are from ethnic minority backgrounds: M Sweeney-Baird, above n 59, 75, citing the Tyson Report on the Recruitment and Development of Non-Executive Directors (London Business School, June 2003).

[97] Allen, above n 1, 207; Hill, above n 64, 1110; Gordon, above n 44, 1242, describing Enron's board.

inexperience and lesser company knowledge.[98] Thus, "…any change in actors' incentives may reduce one type of agency cost problem only to exacerbate another", casting doubt on regulators' identification (let alone enforcement) of an 'optimal' board culture.[99]

Moreover, eliminating independent directors' management-bias does not ensure they will use their freer discretion in the shareholders' best interests. The very concept of independence conveys connotations of "indifference".[100] Thus, the practical effectiveness of the reform will ultimately rest on the practical enforcement of their role — the measures available to align their interests with those of the shareholders.[101]

### *C. Potential Value Sufficient? Costs and Alternatives*

As discussed, the true value of increased board independence is uncertain. The ability of independent directors to reduce agency costs and/or maximise corporate performance may rely on the presence of structural conditions that facilitate their capability and motivation, but identifying and implementing these may be problematic. Conversely, it is likely that board independence is extremely valuable in the current climate simply to attract investors. Thus the reforms may nevertheless be justifiable — provided independence is not affirmatively detrimental, and the comparative net utility of other mechanisms is even less significant and/or certain.

Costs of Independence

The absence of substantiated correlation between independence and superior performance might actually stem from inherent *costs* associated with increasingly independent boards. Reforms that promote increased independence effectively reduce the number of inside directors,[102] and this may be a loss that overwhelms the benefits

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[98] Lin, above n 32, 950, citing B E Hermalin & M S Weisbach, "The Effects of Board Composition and Direct Incentives on Firm Performance" (1991) 20 Fin Mgmt 101, 101: longer tenured independent directors have greater knowledge of the company and so depend on management less.

[99] L E Ribstein "Sarbox: The Road To Nirvana" (2004) Mich St L Rev 279, 6.

[100] R Monks & N Minow, *Corporate Governance* (2nd ed., Blackwell Publishing, 2001) 191.

[101] See below Part III.

[102] Compare evidence that the average size of New Zealand boards increased from approximately 6 to 6.56 directors from 1996 to 2003, a trend ascribed to increased numbers of independent directors: M A Fox & G R Walker, "Characteristics of New Zealand Boards" (2003) 21 C&SLJ 474, 475.Yet this is contrary to both the international trend (Hamilton, above n 34, 361) and research suggesting a negative

their independent replacements convey.[103] Executive directors,[104] as full-time employees, typically have a better understanding of the corporation and its environmental drivers,[105] and might possess special skills or interests relevant to the industry. Of course, independent boards might access insiders' more extensive knowledge, short of giving them board seats, by formalising their routine input into board discussions.[106] However, inside directors might also add value by countering *outsider* biases, and this function will require their direct participation in decision-making.[107]

Inside directors, being more tied in to the company, may also contribute more resources (financial and human) to the board, [108] and so possess strong incentives to ensure corporate performance.[109] Conversely, the disparity might be remediable by amplifying independent directors' incentives,[110] and a primary motivation underlying independent director reform is that existing boards have *not* focused on corporate performance and pursued their own interests instead. However, inside directors may further serve by "vouching" for the internal "promotional tournament", facilitating the retention and motivation of key *internal* resource providers, such as middle managers.[111]

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correlation between board size and corporate performance: D Yermack, The Superior Performance of Companies with Small Boards of Directors (Apr. 1995) 27-31, cited by Lin, above n 32, 952.

[103] Evidenced, perhaps, by studies indicating super-majority independence (total independence but for 1-2 directors) may lead to decreased performance: see Bhagat & Black, above n 40; Baysinger & Butler, above n 22.

[104] Although this discussion focuses on executive directors, the arguments may also apply to non-independent non-executive directors as well — for example, investment bankers and directors of material suppliers.

[105] Evidence of a correlation between performance and executive directors' presence on investment committees supports insiders' value in tactical planning: A Klein, "Firm Performance and Board Committee Structure" (1998) 41 JL & Econ 275, 293, cited in Bhagat & Black, above n 40, 237.

[106] Langevoort, above n 39, 806.

[107] Ibid 807, citing biases arising from their tendency to be "overconfident in their inferences about the firm", despite their lesser knowledge and "fairly heuristic" decision-making (based on observable performance data).

[108] Bhagat & Black, above n 40, 264-5.

[109] Holcomb, above n 88, 180-1, citing A J Hillman & T Dalziel, "Boards of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives" (2003) 28 Acad Mgmt Rev 383, 383-84. Compare the view that independent directors' facilitate access to external resources via their wider external networks and/or staking their reputations as a "bond" to potential external contributors: Langevoort, above n 39, 802-4.

[110] See Part III below.

[111] Langevoort, above n 39, 807-10.

Lastly, an overly independent board may create a counter-productive culture, characterised by suspicion and constraint. Emphasising scepticism and monitoring may spur managers towards "impression management" and even obfuscation.[112] Thus, both the value obtainable from independent directors' fresh insight into strategy, and the board's general ability to function as an efficient and productive team, may be diminished.[113] Boards with a discordant culture will also be less appealing to serve on, augmenting any director shortage.[114]

Alternative Mechanisms

Copious other mechanisms have been proposed to safeguard shareholder value, both in addition[115] and as a less costly alternative to board independence.[116] These may reduce or oust the practical utility of the independent director reform.

It is possible that market pressures can compel managers to realise shareholders' best interests.[117] Proper behaviour is induced via competition in executive labour markets, and continued employment predicated on managers developing the corporation's product/service market share. Access to external capital requires resource-providers to perceive the corporation's leaders as honest and effective, as will the company's share-market performance: market dissatisfaction will theoretically lead to forced resignation or dismissal. However, the failure of the market to prevent the recent collapses has produced a marked reluctance to rely on its efficacy.[118] Moreover, the alleged weight of the market for corporate control[119] is arguably less strong today,[120] activates only *after* considerable damage to shareholders' interests accrues, and suffers from the inherent messiness and negative by-products of a takeover. Thus

[112] Ibid 810-4, 816.
[113] Ibid 810-4.
[114] Ibid.
[115] Hill (above n 64, 1127) prefers a "system of overlapping checks and balances."
[116] See Lin's discussion of this issue, above n 32, 957-963.
[117] See discussion in Cheffins, above n 65, 367; Austin, above n 22, 337-8.
[118] See Gordon's analysis of Enron as illustrating the fallacy of the efficient market hypothesis, above n 34, 1235-40.
[119] The idea that the executive redundancies consequent on a takeover will motivate managers to prevent the share price falling, making the corporation an attractive target: see M C Jensen & R S Ruback, "The Market for Corporate Control: The Scientific Evidence" (1983) 11 J Fin Econ 5, 6, cited by Lin, above n 32, 957.
[120] The 1980s "era of highly leveraged takeovers and buy-outs is behind us." Lipton & Lorsch, above n 38, 60.

shareholders apparently lack a "strong preference" for takeovers as a corrective device.[121]

Alternatively, equity-based compensation might motivate managers to pursue shareholders' best interests.[122] However, its practical efficacy is again unresolved,[123] with alleged problems including the potential for counter-productive pathologies,[124] managers' dominant bargaining power ensuring pro-management terms, and the lack of public and investor confidence it therefore provides.[125] Alternatively, prospective liability for failure might induce appropriate behaviour; yet recent events again seem to negate this hope. Moreover, the drawbacks of judicial enforcement[126] mean it is perhaps better employed as a back stop than the primary modus operandi to ensure management's integrity and the corporation's success.

Lastly, the growth of institutional investment may have created shareholders with sufficient leverage and incentive to *themselves* hold managers accountable.[127] However, the evidence suggests that institutional investors are, in fact, neither positioned[128] nor motivated to do so.[129] Thus, they, at least presently,[130] fail to equate to an adequate shareholder protection function.[131]

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[121] L E Ribstein, "Accountability and Responsibility in Corporate Governance" (Working Paper No 34, University of Illinois College of Law, 2005) 44 (Internet) < http://law.bepress.com/uiuclwps/papers/art34> accessed 14/7/06, citing American investors' willingness to include takeover defence provisions in corporate constitutions; Nolan, above n 37, 46, also cites UK shareholders' lack of confidence.

[122] A New Zealand study found a correlation between increased management equity ownership and the choice of a less restrictive takeover charter amendment, suggesting share ownership contributes to managers' "convergence of interests" with those of the shareholders: M E Bradbury & Y T Mak, "Ownership structure, board composition and the adoption of charter takeover procedures" (2000) J Corp Fin 6 165.

[123] Bhagat & Black, above n 40, 261-2.

[124] Including the "fraudster" and "risk-preferring executive" arguably present at Enron: Gordon, above n 44, 1246-7.

[125] Nolan, above n 37, 460-1.

[126] See further below n 396 and ensuing text.

[127] Hamilton, above n 34.

[128] Hamilton describes a typical maximum investment of five percent, which he attributes to diversification and/or legal disincentives deterring institutional investors from obtaining substantial proportions of shares and/or more active involvement in the company: ibid 355.

[129] Ibid 356 especially.

[130] There may be a growing tendency for certain institutions to hold larger shareholdings in chosen companies, become locked in and be forced to fall back on corporate governance activism to protect their interests: ibid 356-7.

[131] This 'solution' would also fail to protect the interests of *minority* shareholders: "Note: Beyond 'Independent' Directors: A Functional Approach to Board Independence" (2006) 119 Harv L Rev 1553, 1560.

A Pragmatic Conclusion

Therefore it seems that alternative mechanisms do not replace the need for an independent board, at least as perceived by investors. As a result, and notwithstanding the potential costs and inconclusive concrete benefits, New Zealand regulators' continued pursuit of board independence, seems inevitable. Thus, a primary concern is fine-tuning this pursuit so as to augment the likely practical achievement of the benefits and minimise the harms. How and by whom independent boards should be introduced and the concrete components of the abstract notion of "independence" are threshold questions. Even then, the reform's usefulness will depend on translating the theoretical value of independent directors into actual directorial behaviour.

## III. Implementing the Reform

### *A. Methodology*

As stated, New Zealand's implementation of board independence has been primarily via the NZX *Listing Rules* and the Securities Commission's *Principles.* However, there are numerous different methods through which a country might introduce (or further) corporate board independence —ranging from binding prescriptive statutory requirements, to much less intrusive options, including leaving it to the market entirely. These alternatives are now canvassed, so as to evaluate New Zealand's chosen methodology.

<u>The Market</u>

Market theorists contend that corporations have an incentive to adopt corporate governance best practice in order to attract market participants' investment: companies will *voluntarily* appoint independent directors to signal their integrity to the markets they operate in.[132] Furthermore, the flexibility of market-based implementation means it is arguably *preferable* to a regulatory alternative. Instead of a mandatory one-size-fits-all board composition, corporations can adopt the structure that best suits their needs — provided the market(s) concur.[133] This might be especially important for smaller companies, where any benefits of additional independent directors may be countervailed by extra remuneration expenses or the opportunity costs of fewer inside directors, or their greater difficulties sourcing candidates.[134] It would also acknowledge the unsubstantiated utility of the reform, and allow market participants to determine its value themselves.[135] Market-based norms are also more evolutionary, facilitating responsive governance change in light of developing wisdom.[136] This compares favourably to the slower process of regulatory

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[132] See Baysinger & Butler, above n 22; Ribstein, above n 99, 17, suggests this incentive is even more compelling post-Enron *et al.*, given greater investor wariness.
[133] Lin, above n 32, 966-7; Epstein, above n 20, 718-9; referred to in the New Zealand context by C Quinn, Securities Commission, "Corporate Governance Post-Enron" (Speech delivered at the Legal Teachers Forum, 8 July 2005) (Internet) <http://www.sec-com.govt.nz/speeches/cqs080705.shtml> accessed 25/4/06.
[134] Cheffins, above n 65, 648.
[135] Epstein, above n 20, 718-9.
[136] Lin, above n 32, 966-7; Langevoort, above n 39, 817.

revision,[137] where the standard of independence is entrenched (unless and until it is formally amended), even though it may become (proven to be) sub-optimal.

A chief objection, however, queries market participants' genuine power to compel their desired governance structure. Critics cite both their common ignorance as to the optimal arrangements, and their inability to force the corporation adhere to their edicts regardless.[138] For example, even though shareholders are theoretically empowered to elect (independent) directors, management-controlled appointment is the norm.[139] Additionally, where investors do not recognise the significance of board independence signals, corporations will lack such an incentive. More expert institutional investors may manage their investments according to market averages and thus also ignore such signals.[140] Lastly, investors may be prevented from demonstrating their preference for an independent board if they are distracted by other (perhaps more) important investment desiderata, such as market share, entrepreneurial drive and the industry's prospects.[141]

'Market-plus' Approaches

In response, market proponents often concede *some* intervention is necessary. Firstly, wide dissemination of the optimal board structure, such as through best practice codes, should serve to increase market participants awareness of its potential, and therefore corporations' signalling incentive.[142] Moreover, authoritative best practice guidance may provide a focus for shareholders, enabling them to enforce the required change through the company's internal mechanisms.[143]

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[137] Nolan, above n 37, 454 .
[138] Arguably, this directly proceeds from the separation of ownership and control: see above Part II.A.
[139] Organisation for Economic Co-operation and Development (OECD), "Survey of Corporate Governance Developments in OECD Countries" (2003) [51] (Internet) <http://www.oecd.org/dataoecd/58/27/21755 678.pdf > accessed 20/9/06. See further above Part II.B.
[140] Lipton & Lorsch, above n 38, 61, citing C Brancato, Columbia University Center for Law and Economic Studies, "Institutional Investors and Capital Markets: 1991 Update" 8 (1991) 9-10.
[141] It could be that "board independence may simply not be very important, on average and over time, compared to other factors" Bhagat & Black, above n 32, 956.
[142] For example, AIMA's *Corporate Governance: A Guide for Investment Managers and A Statement of Recommended Corporate Practice*, cited in Stapledon & Lawrence, above n 75.
[143] (UK) Financial Reporting Council, "Review of the 2003 Combined Code: The Findings of the Review" (January 2006) [39]-[40] (Internet) <http://www.frc.org.uk/documents/pagemanager/frc/Combined%20 Code%20review%20main%20findings%2018%20January%202006.pdf> accessed 1/10/06 noted increased shareholder activism, both in terms of voting and the resources institutional investors devoted to engaging with companies.

Yet, as stated, shareholders' real power (at least in the reform's paradigm domain, the listed public company) is limited. Moreover, the corporation might still not feel compelled to signal if, for example, they are not substantially dependent on external capital, or are otherwise perceived as being a first-rate investment.[144] Even if they do signal, the absence of any standard form of disclosure may inhibit inter-firm comparisons and/or enable selective or strategic disclosure tailored to create the right impression.[145]

Thus best practice dissemination might be more effective if supplemented by a disclosure obligation. For example, the United Kingdom 'comply or explain' approach *requires* corporations to disclose the extent of their compliance with the specified best practice, ensuring the signal reaches the market.[146] Yet it also retains the flexibility of market enforcement — the corporation need not comply with the best practice per se, but simply disclose their position and explain any divergence ('if not, why not'). The New Zealand Securities Commission's *Principles* might also fall within this category, albeit there is no built-in sanction enforcing the "expected" disclosure[147] (bar the Commission's potential publication of the fact)[148]. Moreover, issuers are required to report only against the broad principle advocating a 'balanced' board — not against the (slightly) more detailed Guidelines, let alone the Commentary containing the concrete independence provision.[149]

However, a 'comply or explain' approach has also been criticised as, alternatively, too rigid and insufficient. Critics of prescription assert that it creates a *de facto* imperative, eliminating the flexibility it purports to retain.[150] Highly competitive markets, the sheer number of potential investments and investors' common ignorance with respect to evaluating investments, mean investors might adopt a tick-the-box approach to corporations' disclosures. Instead of analysing the aptness of any

[144] See generally R A Prentice, "The Inevitability of A Strong SEC" (2006) 91 Cornell L Rev 775.
[145] Ibid 817.
[146] UK *Combined Code*, above n 2, Schedule C. See also *ASX Listing Rules*, above n 2, LR4.10.
[147] Securities Commission's *Principles*, above n 4.
[148] J Diplock, Chairman of the Securities Commission, "Corporate Governance: The Role of the Regulator" (Speech delivered at the Legal Research Foundation Conference, 18 February 2005) (Internet) <http://www.sec-com.govt.nz/speeches/jds180205.shtml> accessed 25/5/06.
[149] See above n14-18 and surrounding text.
[150] HIH Royal Commission, above n 1, para 6.1.3. This view was also acknowledged by the "Review of the 2003 Combined Code", above n 143, [32].

corporation's explanation for deviance, they may automatically filter the corporation out.[151] Thus corporations may be forced to adopt best practice, even when an alternative structure best suits their individual circumstances.

Conversely, *corporations* may apply a 'tick the box' approach to compliance[152] — they may abide by the formal criteria for independence, but without any true commitment to enabling the independent directors to fulfil their role in fact. Alternatively, the corporation might still have the market or financial power to decide *not* to comply, regardless of the market's preference, and without exposing themselves to regulatory sanction.[153] Thus, contrary to the United Kingdom *Combined Code*, seventy-five percent of companies were still under non-independent director control at the end of 2002.[154]

A Mandated Reform

Therefore, if unadulterated market enforcement is insufficient, and obligatory disclosure creates an effective imperative, the clarity and certainty of substantively mandated board independence could in fact be preferable.[155] This might be especially pertinent where the (perhaps principal) objective is investor attraction, requiring corporations' *patent* adoption of best practice.

However the machinery through which to introduce such a mandate has also proven contentious. One option is for the requirement to be imposed by a private stock

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[151] J Diplock, Chairman Securities Commission, "Corporate Governance Issues" (Speech delivered at the CLANZ Corporate Governance Forum, 7 April 2003) (Internet) <http://www.sec-com.govt.nz/speeches/ 2003/jds240403.shtml> accessed 24/7/06, referring to a concern about "regulatory creep" via which 'comply or explain' principles might, over time, be interpreted by fervent investors as 'just comply'.

[152] HIH Royal Commission, above n 1, para 6.1.3.

[153] For example, the Financial Services Authority in the United Kingdom will monitor and investigate compliance with the disclosure obligation *alone* — they will not (and have no legal mandate to) monitor either the accuracy or adequacy of the disclosure's substance: see E Wymeersch "The Enforcement of Corporate Governance Codes" (2006) JCLS 6, 1, 113, 131-32.

[154] PIRC's *Annual Review of Corporate Governance*, (December 2002), cited in the OECD Survey, above n 139, [44]. 2005 statistics reveal that only 46% of the FTSE 100 companies were fully compliant with the UK *Combined Code* requirements: J Dimmock, "Less than half FTSE 100 companies meeting CG standards" *Forbes.com* (New York), 10 December 2005 (Internet) <http://www.forbes.com/business/feeds/ afx/2005/10/12/afx2272701.html> accessed 14/5/06.

[155] Burke, above n 48, 356, citing B S Black, "Is Corporate Law Trivial?: A Political and Economic Analysis" (1990) 84 NW U L Rev 542, 563.

exchange — such as in the NZX's *Listing Rules*.[156] Here, issuers must comply with best practice under threat of the contractual sanctions the exchange may impose for breach of the listing agreement[157] — generally including disclosure orders, interim trading suspension orders, private or public statements of breach or censure, pecuniary penalties and, ultimately, delisting.[158] Moreover, private exchange enforcers possibly retain greater scope for more innovative and particularised rules, and their market immediacy, expertise and private nature may enable a quicker response to changing needs.[159] Costs of enforcement can be directly consigned to market participants.[160]

Yet exchanges may have a strong conflict of interest — much of their revenue accrues from Issuers' continued listing[161] and so they are unlikely to favour a delisting sanction.[162] In any case, delisting is "a heavy handed instrument which could actually harm the investors the code is trying to protect."[163] Lesser sanctions, though less injurious to shareholders, might be similarly cautiously employed in the increasingly competitive market exchanges operate in.[164] Moreover, the standard demutualisation of exchanges means the exchange itself operates as a profit-seeking company,

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[156] NYSE *Listed Company Manual*, above n 83, s 303A.08; National Association of Securities Dealers Automated Quotation System ("Nasdaq"), *NASD Manual*, Rules 4200(a)(15), 4350 (c) (Internet) <www.nasdaq.com/about/MarketplaceRules.pdf> accessed 23/9/06.

[157]NZX *Listing Rules,* above n 3, LR2.1.1 declares that the Listing Rules form a "contract enforceable against each Issuer for the benefit of every person who is or was a holder of Quoted Securities of that Issuer in the period in which the Issuer is or was listed."

[158] NZX *Discipline Rules* (2004) Rule 4.7, 4.3 and 11.5 (Internet) <http://www.nzx.com/regulation/ discipline_rules_clean.pdf> accessed 1/10/06, incorporated by NZX *Listing Rules*, above n 3, LR2.6A.1. NZX Discipline may also "publicly state that the retention of the office of director and/or executive of [an] Issuer named individual by a named individual is prejudicial to the interests of investors" (Rule 11.5(d)), which might arguably be used to pinpoint non-independent directors.

[159] Burke, above n 48, 347-350 especially.

[160] Ibid 350 especially.

[161] For example, more than 30% of the NYSE's overall revenue has often come from listing fees: J R Macey & M O'Hara, "From Markets to Venues: Securities Regulation in an Evolving World" (2005) 58 Stan L Rev 563, 583. Burke, above n 48, 351 cites evidence that "in 1999, listing, trading, regulatory, and market data fees accounted for 86% of the NYSE's total revenue and more than half of the TSE's total revenue":

[162] Macey & O'Hara, above n 161, 584, refer to "Nasdaq's reticence in 2001 to delist the more than 10% of stocks failing its listing requirements".

[163] OECD Survey, above n 139, [43].

[164] A "race to the bottom" or "competition in laxity", in which exchanges refrain from enforcing their own investor protection rules out of fear of losing their market share, is discussed in detail by Macey & O'Hara, above n 161. Compare R A Fink, "Social Ties in the Boardroom: Changing the Definition of Director Independence to Eliminate 'Rubber-Stamping' Boards" (2006) 79 S Cal L Rev 455, n237: firms generally do *not* choose an exchange on the basis of the leniency of its listing standards, citing, for example, the "prestige" of listing on the NYSE.

augmenting its income (as opposed to regulatory) incentive.[165] Arguably exchanges are still compelled to signal their integrity, both to attract listings and to appeal to investors if they themselves are listed on their market.[166] However, the incentive to *appear* reliable may create a *dis*incentive to aggressively pursue (and thus publicise) market participants' contraventions, or may encourage the exchange to draft a looser provision — more accurately 'window-dressing' than one that is genuinely effective.[167] On the other hand these problems can be ameliorated by regulatory oversight of the exchange.[168] Thus, both the content and enforcement of the NZX's *Listing Rules* are reviewable by the Securities Commission[169] — with recent events illustrating that the Commission takes this role seriously.[170]

One last potentially problematic aspect of exchange implementation is its application to *listed* companies only — a minimal segment of New Zealand's economy.[171] To the extent that board independence is desirable for other companies, or even other board-managed entities,[172] a wider reaching mechanism might be warranted. Yet, given the inconclusive evidence supporting the reforms, the differing power distributions of different entities, and the arguably true rationale being (international) investor

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[165] Practically all of the major global exchanges now fit this model (Macey & O'Hara, above n 161, 564), as does the NZX: see New Zealand Stock Exchange Restructuring Act 2002; NZSE, "NZSE announces successful demutualisation vote" (Press Release, 16 October 2002) (Internet) <http://www.nzx.com/ aboutus/news/press/2002/nzprsrls_16_Oct_02/view> accessed 1/10/06.
[166] Burke, above n 48, 376 ; Macey & O'Hara, above n 161, 575, citing P Mahoney, "The Exchange as Regulator" (1997) 83 Va L Rev 1453, 1454-55.
[167] M Kahan, "Some Problems with Stock Exchange-Based Securities Regulation" (1997) 83 Va L Rev 1509, 1518, cited by Burke, above n 48, 351; Macey & O'Hara, above n 161, 580-1.
[168] Burke, above n 48, 352
[169] See generally Securities Markets Act 1988, Part 2B.
[170] See the Securities Commission, "An Inquiry into the Performance by NZX of its Regulatory Functions as a Registered Exchange During 2003 and 2004 Prior to the Collapse of Access Brokerage", 13 December 2005 (Internet) <www.sec-com.govt.nz/publications/documents/access/01.shtml> accessed 1/10/06). More generally, see the Securities Commission, "Oversight Review of NZX 2005", 26 September 2006 (Internet) <http://www.sec-com.govt.nz/publications/documents/nzx/index.shtml> accessed 1/10/06.
[171] As at August 2006, there were 210 issuers listed on NZX's markets (161 domestic and 49 foreign companies): NZX, "August Statistics" (Internet) <http://www.nzx.com/market/monthly_stat> accessed 1/10/06. This is in relation to 331,941 business enterprises (169,290 registered limited liability companies) Statistics New Zealand, "New Zealand Business Demographic Statistics: At February 2005", 21 November 2005 (Internet) <http://www2.stats.govt.nz/domino/external/pasfull/pasfull.nsf/web/Hot+Off+The+Press+ New+Zealand+Business+Demographic+ Statistics+At+February+2005?open> accessed 1/10/06.
[172] The Securities Commission's *Principles* purport to apply to "any entity operating under a governing board that is accountable to investors and/or stakeholders. It includes companies registered under the Companies Act 1993, all issuers of securities, unit trusts and other collective investment schemes, and state-owned enterprises as well as many statutory bodies in the public sector", yet "not all of the Principles will apply entirely to all entities", and the statements regarding independent directors refer to issuers or public issuers: see above n 4 and surrounding text.

enticement, it is submitted that extending the mandate might be inappropriate. Moreover, if and where independent directors *are* valuable in other contexts, the *Listing Rules* might nonetheless act as a publicised best practice, providing inspiration for the entity and its (perhaps more empowered) participants.

A final option would be to mandate board independence directly by law.[173] For example, the legal requirement that companies appoint at least one director might be modified to require a certain ratio of *independent* directors.[174] This could apply to all companies or be more specifically tailored. Alternatively, delegated authority might be given to the Company Registrar or the Securities Commission to promulgate (more detailed) regulations to this effect.

However, this approach is noticeably absent on the world scene — even the United States (the paradigm example of prescriptive corporate governance) did not mandate board independence through statute or delegated legislation.[175] One explanation might be a predominantly private conception of the corporation.[176] This reticence is, moreover, endorsed by the flexibility and adaptability advantages of market enforcement and, to a lesser degree, exchange promulgations. It also avoids potential pitfalls of the political and legislative process, including interest groups'

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[173] Note that there are also intermediate positions, such as where the substantive law refers to a semi-official code: OECD Survey, above n 139, [43], citing the United Kingdom, Germany and Spain. See further Wymeersch, above n 153, canvassing the various European approaches.

[174] Companies Act 1993, s 10.

[175] The Sarbanes-Oxley Act of 2002 (US) itself only mandated independent audit committees: L M Fairfax, "Sarbanes-Oxley, Corporate Federalism, and the Declining Significance of Federal Reforms on State Director Independence Standards" (2005) 31 Ohio NUL Rev 381, 388; OECD Survey, above n 139, [98].

[176] See generally M Berkahn & L Trotman "Company Law Enforcement: Theory and Practice" in A Borrowdale, D Rowe & L Taylor (eds) *A New Zealand Collection* (Centre for Commercial & Corporate Law Inc, 2002) 215-244. Compare L Griggs, "The Role of the Board of Directors in Public Corporations" (1994) ABR LEXIS 10, 7. "Because of the reality of corporate governance today there is much to be said for moving away from a private law perspective of corporate governance where the parties determine their own relationship, to a position where the state does invoke certain requirements upon the board."

interference,[177] "policy giving way to politics",[178] and the tendency for the rule to overshadow the underlying concept (and thus norms of behaviour) that are sought.[179]

Thus it is submitted that implementing the independent director reform via the NZX *Listing Rules* is appropriate. It constitutes a happy medium, balancing the certainty of protection and application of a mandate, while retaining greater flexibility to alter the rule where and when needed. Furthermore, although the *obligation* is restricted to those companies where the reform makes most sense, it simultaneously broadcasts a best practice ideal as guidance for others. The question that ensues is what this obligation or recommendation should be.

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[177] Ribstein, above n 99, 16-7.

[178] R W Ide, "Post-Enron Corporate Governance Opportunities: Creating a Culture of Greater Board Collaboration and Oversight" (2003) 54 Mercer L Rev 829, 831, criticising the United States' Sarbanes-Oxley Act of 2002. See also Ribstein's discussion of "market panics" or "Sudden Acute Regulatory Syndrome" generating hasty, ill-drafted legislation in the wake of "market panics" (above n 99, 15-7).

[179] J M Lipshaw, "Sarbanes-Oxley, Jurisprudence, Game Theory, Insurance and Kant: Toward a Moral Theory of Good Governance" (2004) 50 Wayne L Rev 1083, 1090-5, with respect to the rule requiring disclosure of the corporation's audit committee's financial expert: Sarbanes-Oxley Act of 2002 (US), s 407. See also OECD Survey, above n 139, [37], suggesting a potential "'show me where it says we can't do it' mentality".

### *B. Defining the Concept*

Implementing independent director reform, through whatever mechanism, obviously requires identifying what is sought. "Independence" may be defined as "freedom from…the influence of others" or "individual liberty of thought or action".[180] Yet *absolute* autonomy is arguably unattainable in modern social life, and so the definition must be customised to the objectives at issue.[181] The majority of the reforms concentrate on ensuring independence from management (and, consequently, from the corporation itself, it being *controlled* by management), as dictated by the prevailing agency cost rationale.[182] Yet this may ignore a further dynamic commonly existing to reduce directors' capability of impartially upholding all shareholders' interests — namely *shareholder* hegemony. Thus, an alternative is to define independence more holistically,[183] expanding the independent directors' mandate from precluding managerial agency costs to restraining majority subjugation of minority shareholders as well.[184]

A further issue concerns the extent of freedom the board should have to determine directors' independence. Thus, the NYSE's comprehensive list of bright-line, absolute restrictions[185] can be compared to the UK *Combined Code's* approach, delineating circumstances thought to typically affect a director's independence, but enabling the board to nevertheless label the director as independent in fact (with the proviso they disclose the non-typical circumstances pertaining).[186] New Zealand, in accordance with its broadly principles-based approach, has largely taken the latter line. With respect to public issuers, certain, inherently prejudicial attributes form conclusive

[180] Concise Oxford English Dictionary (2nd ed., Oxford University Press, 1989) VII, 847.
[181] See "Beyond Independent Directors", above n 131, where the various definitions of independence are classified according to their underlying policy rationale of the director as (in ascending order of definitional strictness) a "disinterested outsider", "objective monitor" or "unaffiliated professional".
[182] OECD Survey, above n 139, at [10] especially.
[183] Ibid [99]-[100] especially. This is the approach taken in New Zealand: see NZX *Listing Rules*, above n 3, LR 1.1.2, and the Securities Commission's *Principles*, above n 4, Commentary to Principle 2.
[184] High Level Group of Co. Law Experts, Report of the High Level Group of Company Law Experts on A Modern Regulatory Framework for Company Law in Europe (2002) 59-60, cited by Hill, above n 20, 386-7.
[185] NYSE *Listed Company Manual*, above n 83, s 303A(2)(b).
[186] UK *Combined Code*, above n 2, Principle A.3.1.

disqualifications,[187] but the board is thereafter accorded wide discretion to determine whether the director has "any direct or indirect interest or relationship that could reasonably influence, in a material way, the Director's decisions in relation to the Issuer".[188] Moreover, unlike the UK position*,* this residual discretion is not even circumscribed by presumed prejudicial factors.

Thus, in New Zealand, the need for flexibility and the potential over-inclusiveness of bright-line exclusions seem to have eclipsed the cited advantages of unconditional embargoes — including certainty of shareholder protection and ease of application.[189] New Zealand's smaller director pool might indeed necessitate individual consideration rather than exclusion of categories of candidates per se. Moreover, bright-line standards might reduce independence due to an observed tendency for boards to look *solely* at the stated indicia, ignoring any extraneous factors impacting on the individual's actual (capacity for) autonomy.[190] Thus the definition forms not only a baseline for independence, but a de facto code as well — and the difficulties of applying complex definitions pragmatically preclude greater comprehensiveness.[191] On the other hand, board discretion essentially enables the 'guarded' to choose the 'guards'. Thus its legitimacy will again depend on the market's capability to enforce the substantive adequacy of the board's disclosed reasoning.[192]

Indicia of Dependence

The existing definitions largely take an exclusionary approach to independence — declaring what will *disqualify* an individual rather than specifying what independence

[187] The NZX *Listing Rules* bar "executive officers" and persons with certain deemed "disqualifying relationships" — essentially where the director or an associated person (again deemed to catch, for example, other companies the director holds directorships in and the director's "spouse, domestic companion, child or parent": LR1.3.3) has another relationship with the issuer or a substantial security holder of the issuer by virtue of which they are likely to derive a "substantial portion" (typically 10% or more) of their annual revenue: above n 3, LR1.1.2.
[188] NZX *Listing Rules*, above n 3, LR1.1.2.
[189] SEC Release, above n 2, Part V.
[190] Fink, above n 164, 490.
[191] Austin, above n 22, 354-8, criticising the complexity and potential concept distortion arising from Australia's detailed *auditor* independence provision of the Australian Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004 (Cth), pt 2M.4, div 3-5. See also Nolan, above n 37, 454, referring to investors' difficulties comprehending detailed legislation, and its consequent failure to generate confidence.
[192] See above Part III.A.

*requires*.[193] The OECD suggests that "such 'negative' criteria…can usefully be complemented by 'positive' examples of qualities that will increase the probability of effective independence". Yet they give no specific guidance as to what these attributes *are* — and beyond amorphous ideas such as possessing "an independent perspective",[194] attempting to delineate affirmative independence-enhancing qualities seems practicably unattainable. This may result from the nature of 'independence' being to *exclude* management (or shareholder) capture of the board, and/or its essential subjectivity.

Independence requires that the director be a non-executive or "outsider" of the company,[195] and there is a general consensus that other close and significant economic ties will also obviate the requisite objectivity.[196] However, beyond this there is greater contention.

As stated, some definitions seek to exclude directors who are (or are involved with) major shareholders, as this may allow minority exploitation.[197] In this way, independent directors can provide a simple, preventative protection mechanism for minority shareholders, reducing the need for *ex post* judicial enforcement, with all its attendant difficulties. Yet, the benefits accruing to minority shareholders need to be balanced against the fact that this might also disallow the very persons with the greatest incentives to monitor management.[198] Therefore, the legitimacy of the

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[193] An exception is the UK *Combined Code* definition which states that the director should be "independent in character and judgement" (before stipulating circumstances which may preclude this), above n 2, Principle A.3.1.

[194] Securities Commission's *Principles*, above n 4, Commentary to Principle 2; F Shu-Acquaye, "The Independent Board of Directors and Governance in the United States: Where Is This Heading?" (2006) 27 Whittier L Rev 725, 752 refers to "seriousness, commitment, dedication and good faith" as more important than formal elements of independence.

[195] Fairfax, above n 175, 384.

[196] Organisation for Economic Co-operation and Development, *OECD Revised Principles 2004*, Annotation VI.E (Internet) <http://www.oecd.org/document/49/0,2340,en_2649_201185_31530865_1_1_1_1,00.html> accessed 20/9/06. Also illustrated by the "domination and control" conception of independence exhibited in Delaware case law: see *In re Walt Disney Co. Derivative Litigation*, 731 A.2d 342, 355 (Del Ch 1998). Compare the more expansive definition *In re Oracle Corp. Derivative Litigation,* 824 A.2d 917, 920, 923 (Del Ch 2003).

[197] Stapledon & Lawrence, above n 41, 169-170.

[198] Bhagat & Black, above n 40, 266 found hints that "independent directors who hold significant stock positions may add value, while other independent directors do not"; Stapledon & Lawrence, above n 41, 169 cite research indicating that "significant share ownership by directors ensures profit-maximising behaviour". Compare R D Kosnik, "Greenmail: A Study of Board Performance in

stipulation will depend on the comparative efficacy of alternative minority shareholder remedies[199] and the means by which non-shareholder directors might be otherwise motivated.[200]

Yet people are not motivated *solely* by pecuniary interests, militating against such a "reductionist" approach to defining independence.[201] Thus some theorists emphasise the impact on autonomous judgment that *social* relationships may have,[202] citing investigations into the recent corporate scandals.[203] Moreover, social science literature endorses this view, recognising that board group membership may generate social pressures to conform[204] and "groupthink".[205] Directors will also tend to prefer their personal relationships with other directors over "stranger" relationships with shareholders.[206] However it is conceded that a certain level of cohesion is essential for the effective functioning of the board team[207] and, indeed, is an *inevitable* corollary of service.[208]

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Corporate Governance" (1987) 32 Admin Sci Q 163, 171, cited by Lin, above n 32, 947: equity ownership may impact negatively on independent directors' performance.

[199] For example, the buy-out right and minority oppression remedies of the Companies Act 1993, ss 110 and 174.

[200] See Part III.C below.

[201] *In re Oracle Corp. Derivative Litigation,* 824 A.2d 917, 920, 923 (Del Ch 2003), VC Leo E Strine Jr, criticising the "domination and control" model (see further above n 196).

[202] See Fairfax, above n 175; J J Kobeski, "In Re Oracle Corporation Derivative Litigation: Has a New Species of Director Independence Been Uncovered?" (2004) 29 Del J Corp L 849; Fink, above n 164. Compare V Brudney, "The Independent Director – Heavenly City or Potemkin Village?" (1982) 95 Harv L Rev 597, 613.

[203] The *Breeden Report* found that 80% of WorldCom directors would have conformed to the post-Enron reforms' technical independence requirements, but were nonetheless compromised by widespread social and private connections: R C Breeden, "Restoring Trust: Report to the Honorable Jed S. Rakoff on Corporate Governance for the Future of MCI" (August 2003), SK034 ALI-ABA 761, 787, cited by Fairfax, above n 175, 408.

[204] J W Lorsch & E MacIver, "Pawns or Potentates: The Reality of America's Corporate Boards" (1989) 91-96, 170-71, cited in Shu-Acquaye, above n 194, 744.

[205] P Tetlock, R S Peterson, C McGuire, S J Chang & P Feld, "Assessing Political Group Dynamics: A Test of the Groupthink Model" (1992)63 J Pers & Soc Psych 403, cited in Langevoort, above n 39, 811.

[206] R E Nelson, "The Strength of Strong Ties: Social Networks and Intergroup Conflict in Organizations" (1989) 32 Acad Mgmt J 377, 386, cited in Fink, above n 164, 492.

[207] See, generally, Langevoort, above n 39. Social ties might increase trust and communication, encouraging the chief executive to seek independent directors' advice and promoting both positive and negative feedback: J D Westphal & E Zajac, "Defections from the Inner Circle: Social Exchange, Reciprocity and the Diffusion of Board Independence in US Corporations" (1997) 42 Admin Sci Q 161, 163-64, cited in Fink, above n 164, 465.

[208] Fairfax, above n 175, 413.

Most definitions (explicitly) acknowledge influences arising from familial relationships only.[209] Other ties may come into the determination under the typical catch-all provision,[210] yet these pressures' strength arguably requires that they be given more definite attention. The difficulty is defining the type or magnitude of ties that will be detrimental, and so a certain amount of flexibility seems essential. This may favour the simple incorporation of typically prejudicial social relationships within the indicia of dependence[211] — including, perhaps, lengthy board service[212] and mutual club or committee membership.[213] More radically, independent assessment by external rating agencies might be required.[214]

Other arguments concerning the appropriate definition of independence highlight the low-visibility sanctions possible from receiving *any* non-director compensation from the corporation,[215] and the conflicts and time impediments that may arise from multiple directorships.[216] Yet the marginal utility of ever more strictly defined independence must be balanced against the availability of candidates,[217] the value obtainable from the classes excluded,[218] and the simple impossibility of *total* independence.

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[209] For example, the *NZX Listing Rules*, above n 3, deem the "spouse, domestic companion, child or parent" to be an "associated person" of a director (LR1.3.3), and thus relevant to the defined deemed "disqualifying relationships" in LR1.1.2. No other social relationships are referred to. See, generally, Fairfax, above n 175, 396-7.

[210] See above n 188 and surrounding text; see also ASX *Principles*, above n 2, Box 2.1: "An independent director…(g) is free from any interest and any business or other relationship that could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company."

[211] Fairfax, above n 175, 414, posited as the minimum response acceptable.

[212] See UK *Combined Code*, above n 2, Principle A.3.1.

[213] Covering*, inter alia*, directors' joint membership on university steering committees (*In re Oracle Corp. Derivative Litigation,* 824 A.2d 917, 920, 923 (Del Ch 2003)); and being members of the same country club (*Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1051 (Del 2004)).

[214] Fink, above n 164, suggests a listing requirement that corporations disclose the results of externally created independence ratings, based on Granovetter's three-factor sliding scale to quantify the strength of the social tie, based on duration and frequency of the contact, the depth of the relationship and the reciprocity of obligations (citing M S Granovetter, "The Strength of Weak Ties" (1973) 78 Am J Soc 1360, 1361).

[215] Gordon, above n 44, 1242, citing contributions to director-affiliated charities.

[216] J. Lawrence, "Multiple Directorships and Conflicts of Interest: Recent Developments" (1996) 14 *Companies and Securities Law Journal* 513, cited in Fox & Walker, above n 102, 478.

[217] Shu-Acquaye, above n 194, 746.

[218] P von Nessen, "Corporate governance in Australia: Converging with international developments" (2003) AJCL LEXIS 7, p17-18, citing the disadvantages of stricter United States definitions for Australian companies listed there.

Ultimately, independence is an inherently subjective quality — it relates to the individual director's state of mind; their willingness to think independently and engage with insiders without taking the arguably easier course of passive concurrence.[219] Thus, a director may technically comply with the formal definition of independence yet still fail to *truly* act independently. This may be ameliorated by defining the indicia of dependence more widely, and/or providing the necessary structural conditions to assist and channel their independent functioning.[220] But board-membership both inherently and *necessarily* entails inter-director relationships that may obviate their independence.[221] Thus, their *capability* for independence will not guarantee their efficacy — a more critical ingredient is the practicability of ensuring their independent behaviour *in fact*.

Level of Independence

A final issue entails defining the appropriate ratio of board independence. Many countries have stipulated a majority of independent directors, presumably so they can actually secure the shareholders' interests in the face of managerial opposition.[222] Some theorists even advocate *super*-majority independence, citing inside directors' inevitable CEO capture, the impracticality of requiring *unanimous* independent director action to overrule insiders, and the ability to obtain insider input short of granting them directorships.[223] However neither the theoretical nor empirical case for such a requirement is clear.[224]

Conversely, New Zealand's approach may err on the side of leniency. Neither the Principles nor the Guidelines of the Securities Commission's *Principles* require, or even recommend, any defined level of independence — and the accompanying Commentary suggests only that public issuers' boards should be *one-third*

[219] Langevoort, above n 39, 798-9.
[220] OECD Survey, above n 139, [10]. See further, above Part II.B.
[221] Ibid [99]. For the value of an effective board culture generally, see Langevoort, above n 39; Sonnenfield, above n 80.
[222] See, for example, NYSE *Listed Company Manual*, above n 83, s 303A(1); UK *Combined Code*, above n 2, Principle A.3.2; ASX *Principles*, above n 2, Recommendation 2.1.
[223] Breeden Report, 50-51, cited in Fairfax, above n 203.
[224] Bhagat & Black, above n 32, 950: "firms with supermajority-independent boards perform worse than other firms, and…firms with more inside than independent directors perform about as well as firms with majority (but not supermajority) independent boards". See costs of independence discussed above Part II.C.

independent.[225] Similarly, the general effect of the NZX *Listing Rules* is to require around a third of the board to be independent.[226]

The Securities Commission cite the practicalities of New Zealand's relatively small supply of independent director candidates and the inconclusiveness of independent boards' value as validating their stance.[227] Thus, the chief (perhaps sole) aim of the *Principles* might be to depict New Zealand as being "in the mainstream" of established corporate governance, to attract international investment.[228] The arguable downside of this less stringent approach is that boards may not be under independent voting control, reducing independent directors' leverage.[229] Yet stipulating greater ratios of independence for *committees* charged with paradigm conflict situations[230] may suffice to protect shareholders' interests, while retaining the value of inside directors for more general, strategic board tasks. Conversely, whether New Zealand's comparatively weaker response will suffice to generate greater investor confidence may be questionable,[231] and will likely depend on the visibility and applied enforcement of the independent directors' role[232]. Thus the adequacy of New Zealand's enforcement regime will largely determine the reform's value in practice.

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[225] Securities Commission's *Principles*: see above n14-18 and surrounding text. *No* specific recommendation pertaining to independence is directed at non-issuer entities.
[226] *NZX Listing Rules*: see above n 7.
[227] Securities Commission's *Principles*, above n 4, Commentary to Principle 2.
[228] Kavanagh, above n 5.
[229] See Cheffins, above n 65, 610-1; Stapledon & Lawrence, above n 41, 159.
[230] The *NZX Listing Rules*, above n 3, require the mandatory audit committee to have a majority of independent directors (LR 3.6.2(d)). The NYSE and Nasdaq Rules mandate total independence for the audit, nomination and compensation committees: see generally SEC Release, above n 2.
[231] Farrar, above n 51, 392.
[232] Ibid 392; Kavanagh, above n 5.

### *C. Enforcing Independent Behaviour*

The normative benefits of independent director reform are one thing; achieving these in practice may be another. The disinterest inherent in the concept of an 'independent' director means that a paradigm concern is ensuring they actually fulfil their role — "independence is not self-generative, but must be encouraged and channelled".[233] This might be done through legal and/or non-legal means, and, as each method brings costs and benefits, the choices made will be highly relevant to the achievement of the reform's objectives, as well as its overall beneficence.

Non-legal Mechanisms of Enforcement

Some theorists suggest that non-legal mechanisms suffice to ensure independent directors' effective performance of their duties. These are advocated as precluding the need for (further) legal measures — a position arguably illustrated by the New Zealand reforms' failure to provide for specific independent director sanctions.[234]

*Reputational Incentive*

Independent directors may have an incentive to monitor and act independently because failing to do so will expose them to loss of reputation. [235] People who want to participate in co-operative endeavours (such as corporate business) have an incentive to signal their integrity and value to other players in "the game".[236] Therefore, independent directors need to portray themselves as impartial, objective monitors, who will be pro-active in representing the shareholders. Failing to do so (or, the representation being exposed as fallacious) will result in their rejection by the other participants, and their inability to gain or retain their directorships. Thus, it is in their rational self-interest to comply with best practice for independent directors.

Much of this incentive's effectiveness relies on the prevalence of directors who are also professional business people — who not only stake their *directorship* on their

[233] "Beyond Independent Directors", above n 131, 1560.
[234] Compare however, the Chairman's statement: "I consider that current enforcement mechanisms, available both to the exchange and to the Securities Commission, are quite inadequate" (above n 151).
[235] See, seminally, E F Fama & M C Jensen, "Separation of Ownership and Control" (1983) 26 JL & Econ 301, cited in Prentice, above n 144, 785.
[236] See Lipshaw, above n 178, 1097-8, citing E A Posner, *Law and Social Norms* (Harvard University Press, 2000).

sustained image as a good independent director, but may also stake their business career.[237] Thus, for example, an independent director who is an executive of another company may feel the added incentive of preserving their reputation as a forthright, savvy and ethical businessperson, so as to retain their human capital in the executive labour market. Even if a stricter definition of independence mediates against appointing other business people, the typically suggested alternatives are also people likely to treasure their reputations — including legal professionals, academics and public service employees.[238] This will be especially germane where the relevant professional labour market is competitive,[239] or the individual serves on multiple boards.[240]

However, the (complete) efficacy of entrusting enforcement to a reputational incentive might be questionable. A first objection is its relative bluntness — arguably, it is only *some* deleterious behaviour that will generate harm to an independent director's reputation and thus be deterred by the incentive. It will only catch behaviour that is actually disclosed and noticed and, to cause any real impact to the director's reputation, the behaviour will generally need to lead to manifest losses (such as corporate failure).[241]

Of course, the reputation incentive might act not only to deter conduct causing reputational harm, but also to promote conduct that will *increase* one's reputation. Therefore, directors may be prompted to actively broadcast their independence, framing the incentive as enforcing positive behaviour, rather than (or as well as) deterring negative conduct. Again, though, only conduct of a certain threshold significance will be factored in by those who assess the director's reputation. Moreover, any signalling incentive depends on the market's absorption of and

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[237] B R Cheffins, B S Black & M Klausner "Outside Directors, Liability Risk and Corporate Governance: A Comparative Analysis" (Law and Economics Working Paper No 31, University of Texas Law School, 2005) 29 (Internet) <http://papers.ssrn.com/abstract=800584> accessed 12/4/06, citing M A Eisenberg, "Corporate Law and Social Norms" (1999) 99 Columbia L Rev 1253, 1268.
[238] Nolan, above n 37, 457.
[239] Ibid.
[240] Lin, above n 32, 917-8. However, this is quite rare in New Zealand: 85% of directors of NZSX companies at July 2003 held a single NZSX directorship: Fox & Walker, above n 102, 478
[241] Prentice, above n 144, 785

attention to this information, and there are reasons to doubt this in practice.[242] Similarly, the limited number of directorial candidates New Zealand yields might reduce directors' incentive to signal simply because of the lack of alternatives that exist.[243]

Another problem with enforcement based on a reputation incentive is that it is activated *after* the harms to shareholders arise — even if undesirable conduct does produce reputational harm, this occurs after the event.[244] Thus, the forced resignations and organised boycotts against the renomination of Enron directors cannot actually correct the problematic behaviour they engaged in, nor minimise the harms to shareholders (and others).[245] Of course, the reputational repercussions from directorial failures may influence the behaviour of directors in the future.[246] Yet, the reputational incentive is predicated on the actors *presently* recognising the threat, and it is unclear whether this future impact is accurately weighted at the time that the actions are engaged in.

This potential disregard for their reputation can be explained on both rational and irrational grounds.[247] Firstly, a rational assessment of the risks of being *caught* acting non-independently, and their reputation actually suffering *harm*, may be insufficient to justify the more evident costs of pro-active monitoring — namely imperilling their position and/or relationships with the managers (and perhaps interfering with managers' freedom to create optimal company value).[248] Thus, where executives are perceived as being generally honest and competent, it might well be rational for independent directors to favour a less sceptical role. Secondly, even if independent behaviour would be judicious, there are various ways in which a 'rational' calculation might be impeded. Immediate gratification (such as preserving their board

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[242] See above Part III.A; R J Gilson & R Kraakman, "Reinventing the Outside Director: An Agenda for Institutional Investors" (1991) 43 Stan L Rev 863, 875, cited in Fink, above n 164, 470, specifically referring to reputation absorption. This may be especially so in New Zealand's shallow and illiquid markets: Austin, above n 22, 340.
[243] Compare evidence of an operational directorial labour market in the United States: Lin, above n 32, 940-5.
[244] L M Fairfax, "Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty through Legal Liability" (2005) 42 Hous L Rev 393, 430-2.
[245] Ibid.
[246] Ibid n214.
[247] See Prentice, above n 144, 797-799.
[248] Ibid 797-798.

relationships) will typically be emphasised over the longer term reputational advantages.[249] Moreover, the typical director is predisposed towards self-confidence and overestimating their invulnerability, and thus might not quantify the risks accurately.[250] Lastly, behavioural research has indicated that people generally receive, collate, and recall information not objectively but with a self-serving bias,[251] and if the director does not *actually* perceive their behaviour as inappropriate, the reputational incentive can have no sway. Thus, while directors will value their reputation, it is less certain that this will suffice to compel their actual, proper behaviour.[252]

A further objection concedes that the reputational incentive might be effective but argues it is *misdirected* due to the current reality of managerial appointment of directors. Thus, a director with a reputation for loyalty towards management might be favoured over one who is reputed to play a more pro-active, sceptical role.[253] Managers' *own* reputational incentive to engage in reputation-enhancing behaviour may prompt them to appoint directors perceived by the market as truly independent.[254] However, the appointment of managers is even *less* at shareholders' discretion, and thus again the manager's reputational incentive is unlikely to (prima facie) relate to the shareholders. Shareholders can demonstrate disapproval of directorial and/or managerial candidates via the pressures of the capital market and the Wall Street rule. Yet management appointment at least dilutes the acuity and propinquity of the reputation incentive as an enforcement technique.

Lastly, collateral costs may arise from enforcement of independent directors' monitoring role based on a reputational incentive. If failure to monitor does generate perceptible harm to their reputation, independent directors may engage in *overly* proactive monitoring or prescribe managerial dealing *too* restrictively, precluding optimal value creation.[255] Alternatively, they may feel driven to expend *undue* time attempting ex post justification of decisions (or omissions), resulting in a counter-

[249] Ibid 798-9.
[250] Langevoort, above n 39, 825.
[251] Prentice, above n 144, 799.
[252] See generally J C Coffee, Jr, "Brave New World? The Impact of the Internet on Modern Securities Regulation" (1997) 52 Bus Law 1195, 1232-33, cited in Fink, above n 164, 470.
[253] Fairfax, above n 244, 412-3; Lin, above n 32, 955; Fink, above n 164, 470.
[254] Lin, above n 32, 955.
[255] See Langevoort, above n 39; and above Part II.C generally.

productive diversion of their attention from their real monitoring role to a preoccupation with defending themselves.[256] Similarly, prospective harm to their reputation might act as a deterrent to independent directors *admitting* to failures or wrong choices, and thus actually perpetuate the situation.[257] For example, they might be less likely to admit that a chosen chief executive officer is in fact less than optimal and so retain them when a more value-creating path would be to try again.

*Facilitating a Reputational Incentive*

Therefore, directors' concern for their reputation may not, by itself, readily and/or appropriately compel their behaviour. However, "more bite" might be obtainable by amending the law to enhance this incentive in practice. [258] The reputation sanction's deterrence effect depends on directors' belief both that the relevant behaviour will be detected, and that the behaviour will be deemed worthy of condemnation.[259] Therefore, strengthening its efficacy might be achieved by increasing the risks of exposure, and/or increasing the public recognition of the undesirability of the behaviour.[260]

Increased exposure might first be realised by greater disclosure of independent directors' performance to the market. Thus, for example, both the Toronto Stock Exchange and London Stock Exchange corporate governance guidelines comprise *prescriptive* best practices against which corporations are expected to disclose their compliance (or reasons for lack thereof).[261] Boards' comprehensive disclosure might therefore enable shareholders' assessment of the independent directors' efficacy as proactive monitors and representatives. Alternatively, increased exposure might be effectuated by pointedly broadcasting independent directors' failures.[262] This could, for example, be through a "public reprimand letter" such as the NYSE can issue in the

[256] See Langevoort, above n 39, 826 especially.
[257] Ibid 827 especially.
[258] Prentice, above n 144, 785; see generally Fairfax above n 244, 443-9.
[259] Fairfax, above n 244, p443-4.
[260] Ibid.
[261] See Burke, above n 48, 345-6 especially.
[262] See Gordon, above n 44, 1244, suggesting that prior association with companies disciplined for serious disclosure obligation breaches might be compulsorily disclosed on nomination for a directorship.

event of a breach of a listing standard.[263] Similarly, the Securities Commission has indicated its intention to report publicly where standards are not being met.[264]

Of course, again these avenues seem to catch behaviour only of a certain threshold; the daily minutiae of an independent director's job remain unobservable. The disclosure might cover issues such as the time the independent director spends performing their role, their receipt of financial reports and participation in committee meetings — yet none of these disclosures actually reveal or ensure that they are acting with independent judgment. Therefore, the disclosure might simply form another compliance exercise the director is required to tick off.[265]

Conversely, the mere fact of having to make such disclosures might suffice to focus the independent director on their obligations: they will be continuously and integrally cognizant of their role, and will consequently act appropriately — either as a result of this recognition, or fear of the adverse consequences of failure.[266] Moreover, the detail of the directors' behaviour underlying the disclosed position will (predictably) face greater scrutiny if and when problems are revealed. Thus, although the disclosure itself might not give rise to reputational harms, its subsequent unveiling as misleading *will* do so — and, to the extent that the ensuing reputational harms are more injurious, this will pose a greater reputational incentive to scrupulously comply with best practice.[267]

As indicated, the reputation incentive depends on the harm that will be occasioned to the director's reputation by failing to act independently. Unless there is a clear and public expectation that independent directors will act in certain ways, the reputational

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[263] NYSE *Listed Company Manual*, above n 83, s 303A(13)

[264] J Diplock, Chairman of the Securities Commission, "Why bother with better corporate governance?" (Speech delivered to the Institute of Directors of New Zealand Inc, Auckland, 11 May 2004) (Internet) <http://www.sec-com. govt.nz/speeches/2004/jds110504.shtml> accessed 24/7/06: boards and directors' who fail to adhere to the requisite standards may be identified in the Commission's annual reports, because "publication of examples has a salutary and lasting impression on the market".

[265] See further above Part III.A.

[266] Thus a principle aim of the Securities Commission's *Principles* was to "encourage boards to think about how they govern their companies": Diplock, above n 264.

[267] For example, the reputational costs of facing proceedings for making or authorising misleading statements under section 41 of the Financial Reporting Act 1993; the relatively small possibility of exposure is counterbalanced by the high cost: see R A Posner, *The Economics of Justice* (Harvard University Press, 1981) 197, cited in Fairfax, above n 244, 443-4.

incentive will not work to enforce these behaviours.[268] Consequently, the incentive independent directors experience to act impartially, sceptically and pro-actively depends on a societal dissemination of, and indeed concurrence with, their having this role.[269]

This might be facilitated by the promulgation of codes of best practice, such as the Securities Commission's *Principles*. However, these are arguably only as effective as they are, or are perceived as being, absorbed and endorsed by the persons with whom the director seeks to protect their reputation. Thus, investors' general passivity and apathy might be an impediment to the codes' enhancement of the reputational sanction. So, too, might the relative scarcity and brevity of validation or explanation proffered by the various code promulgators (if and to the extent that this fails to generate the internalisation of the posited independent director role).[270] Even more problematically, where managerial appointment results in the relevant reputation assessment resting, at least initially, with the managers, the efficacy of such codes may well depend on the *managers* buying in. Impeding this will be the conflicting evidence as to the actual benefits independent directors bring, and, indeed, the managers' own self-interest preferring greater discretion and less vigorous oversight.[271]

Therefore, to effectuate any real possibility of harm to a director's reputation, disseminated best practice might need to be complemented with legal consequences for failure to adhere.[272] As such the *objectionable* nature of the failure is reinforced, both for managers in their appointment role, and for the wider investment community in exercising their secondary market-based ability to register (dis)approval. In addition, judicial pronouncements might also expand on the standards that will be expected, and thus the behaviour required to ensure the preservation of the directors'

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[268] M A O'Connor, "The Enron Board: The Perils of Groupthink" (2003) 71 U Cin L Rev 1233, 1236-40, cited in Fairfax, above n 244, 444.
[269] Compare the traditional perception of directors as owing only a subjectively determined standard of care and skill; not needing to pay continuous attention; and being *prima facie* entitled to rely on other directors and executives (*Re City Equitable Fire Insurance Co Ltd* [1925] 1 Ch 407); and the "red flag test" of Delaware's *Graham v Allis-Charmers Manufacturing Company*, 188 A.2d 125 (1963).
[270] For example, the Securities Commission's *Principles* are criticised as "vague and broad", and providing little in the way of explication (O Krackhardt, "New rules for corporate governance in the United States and Germany — a model for New Zealand? [2005] 36 VUWLR 319, 328.
[271] See generally Cheffins, above n 65, 631.
[272] Fairfax, above n 244, 444-7.

reputation.[273] For maximum reputational importance, the legal consequences should be inherently public. Thus, a key possibility might be director disqualification proceedings — an inherently public mechanism declaring the director unfit to serve, and *why*.[274]

A second main avenue to increasing the efficacy of the reputational incentive is structural: directors' appointment should be more directly and genuinely at the shareholders' discretion. For example, boards might be obligated to provide shareholders with more information regarding candidates;[275] and/or a requirement might be introduced that the board nominate at least two candidates for each directorial position.[276] Alternatively, a recent suggestion has been proffered by the Chartered Secretaries Association of Australia that shareholders should be able to vote in absentia *directly*, via binding voting forms.[277] This would be another option to proxy voting, and avoids the disadvantages arising from the intervention of an intermediary party, such as the proxy's ability to choose not to vote. As such, it is thought to be an effective way to ensure better and less adulterated shareholder involvement. Other options would be to require boards to approve major shareholders' nominees where a specified number of shareholders refused to ratify the board's slate of candidates, or enabling long-term and significant shareholders to nominate their own candidates when, for example, the board fails to give effect to widely supported shareholder resolutions.[278]

Lastly, the costs associated with increasing the director's vulnerability to reputational harm are arguably consequential on *any* mechanism by which the independent directors' role is sought to be enforced. Thus, these costs need to be balanced against

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[273] Ibid 445-6, citing *inter alia,* M A Eisenberg, "Corporate Law and Social Norms" (1999) 99 Colum L Rev 1253, 1270. See further Langevoort, above n 39, 831-2.
[274] Nolan, above n 37, 432-3, albeit criticising the under-enforcement of the UK provision.
[275] See Gordon, above n 44, 1244. The NZX *Listing Rules* require issuers to disclose to persons entitled to attend the annual meeting the names of nominees and whether or not the board considers they would qualify as independent: above n 3, LR 3.3.2.
[276] Compare above n 88 and surrounding text.
[277] Chartered Secretaries Australia, "Expressing the voice of shareholders: a move to direct voting", Discussion paper, March 2006 (Internet) <http://www.csaust.com/AM/Template.cfm?Section=CSA_Titles & Template=/CM/ContentDisplay.cfm&ContentID=6109> accessed 1/10/06.
[278] Proposed by the US Securities and Exchange Commission, see Holcomb, above n 88, 187-8. Compare though New Zealand's greater *minority* shareholder focus: see above n30 and surrounding text.

the perils of no such enforcement — the likelihood that, absent some true incentive, independent directors *will* perform their designated role. This possibility is now examined.[279]

*Non-legal Moral Norms*

The preceding discussion has focused on independent directors' incentive to act independently based on others' perception of their behaviour. However, it may also be that directors *own* perception and internalisation of norms of behaviour will suffice to ensure or facilitate their monitoring role.[280] Instead of depicting independent directors as inherently self-interested actors who seek only to further their own economic ends, this perspective suggests that directors may recognise a moral duty to fulfil the commitments inherent in their undertaking.[281] Thus, it is argued that accepted practices can operate as *rules* of conduct simply as a result of their common acceptance and recognition as being duties.[282]

This does not deny law or regulation *any* role. Instead, codes and legal standards of conduct are depicted as investing behaviours with a '*moral* authority' and so ensuring their inclusion in the directors' perception of their obligations.[283] Thus the law has an endorsement and corroboratory function. However, it is argued that attempting to *enforce* independent behaviours via economic incentives (such as legal liability) might actually impede their attainment.[284] This is because these (dis)incentives focus the actor's attention on a cost-benefit analysis of engaging in the behaviour, rather than on the underlying policy (and duty) at issue. Thus, if the actor's economic analysis favours inappropriate conduct, it is unlikely that the moral norms will have retained sufficient significance to overrule this and ensure the converse.

Of course, enforcement relying solely on the independent directors' recognition and fulfilment of some moral duty might entail a rather naïve view of human nature —

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[279] These costs are also cited with respect to imposing legal liability: see below n 313 and surrounding text.
[280] Lipshaw, above n 178.
[281] Ibid 1107-9 especially, citing Kant's categorical imperative (I Kant, "Fundamental Principles Of The Metaphysics Of Morals" (T K Abbott, trans., 1785), in *Basic Writings Of Kant* (A W Wood, ed., Modern Library, 2001)). See also Allen, above n 1, 2061.
[282] Lipshaw, above n 178, 1110.
[283] Ibid 1110-1 especially.
[284] Langevoort, above n 39, 828.

arguably, although some people will act ethically and according to their sense of duty, there are many who simply will not. One would not accept that murder requires no legal disincentive because people are normatively and morally disinclined to perform it, and this is arguably even more pertinent where the desired behaviour is less integrally and fundamentally moral in nature: most agree that murder is unethical, whereas, even with the promulgation of codes of best practice, the desirability of sceptical and vigorous independent director monitoring is much less ascertained and perceived. Thus it is decidedly possible that an independent director identifies their *moral duty* as fulfilling a much more facilitative, advisory and support-oriented role.[285] Moreover, it is arguably the very nature and mind-set of business-people to base their actions on rational, pecuniary analyses, and even the typical alternative candidates — for example, public service employees[286] and academics from commercial disciplines[287] — seem to favour this mindset. Thus an incentive that can be integrated into this calculation is perhaps most appropriate and effective.

*Incentive Compensation*

As such, a more efficacious means of increasing independent directors' incentive to act in the best interests of their constituency might be to more concretely tie this to their pecuniary advancement. Thus, compensation for independent directors might be performance-based.[288] Moreover, given their immediate function of securing the shareholders' interests, this might be effected via *share*-based remuneration — their own economic incentives will be *directly* aligned with the shareholders',[289] and the board is precluded from holding the director's receipt of the compensation to

[285] The promulgations to the contrary might be dismissed as "the product of illegitimate forces: judges and SEC bureaucrats who do not understand the realities of business": ibid 828.

[286] For example, Britain's energy secretary, John Wakeham, appeared to be more influenced by his significant consulting fees from Enron than any moral obligation to either of his shareholder or public constituencies: see M Perin "Enron board conflicts raising questions" *Houston Business Journal* (Houston), 8 February 2002 (Internet) <www.bizjournals.com/houston/stories/2002/02/11/story2.html> accessed 1/10/06.

[287] Preferred for their greater business expertise: see generally Ribstein, above n 53, 26-28.

[288] Lin, above n 32, 918-9, citing, *inter alia*, J W Lorsch & E MacIver, *Pawns or Potentates: The Reality of America's Corporate Boards* (Harvard Business School Press, 1989), 176-77; Monks & Minow, above n 100, 216-17, 496-97; Hill, above n 64, 1112, citing arguments that it could counter personal ties between directors and the chief executive of the Australian 'corporate failure' Sunbeam.

[289] Lin, above n 32, 918, citing the "convergence of interests theory" of R Morck, A Shleifer & R Vishny, "Management Ownership and Market Valuation: An Empirical Analysis" (1988) 20 J Fin Econ 293, 293-4.

ransom.[290] An alternative might be to provide for shareholder approval of the director's sufficient performance to receive their fee (or maybe bonus).[291] Yet, this would seem to fall foul of the general apathy of shareholders, the relative bluntness of the disclosure that is possible, and the prospective opportunity and over-commitment costs[292] from the director being required to explicitly uphold their decisions in hindsight.[293] Thus, a direct share-based approach to alignment might be preferable both in terms of its relatively greater inclusiveness (in terms of catching any and all behaviour impacting on the share price) and the more holistic, 'value-creation' focus it provides. It would also avoid some of the pitfalls typically associated with designing incentive-based remuneration.[294]

There is, however, a need to balance the potential advantages of a compensatory incentive against the practicalities of maintaining the directors' independence from the company and management restricting the level and/or type of compensation a truly disinterested director can receive.[295] Additionally, the idea that share ownership necessarily aligns the director's interests with the whole of their constituency fails to account for the potential divergence of shareholders' interests, especially between those of the majority and minority. Thus, to the extent that independent directors are being promoted as the solution to a more expansively defined agency cost dilemma (arising from both management and controlling shareholders), share-based incentives might be inherently prejudicial.[296]

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[290] Compare Nolan's criticism of the Higgs Report's recommendation that the board sets non-executive directors' fees: above n 37, 457-8.
[291] Ibid 458.
[292] Langevoort, above n 39, 826-7. See further above n 256-7 and surrounding text.
[293] Compare the rationale for the business judgment rule, discussed below at n398 and surrounding text; see also J Farmer QC "Corporate Governance — The Role of Independent Directors" (Speech delivered at the Legal Research Foundation Conference, Auckland, 18 February 2005) arguing against independent directors as guarantors or trustees.
[294] Including translating subjective performance into monetary terms, choosing the right performance measure, and potential "work to rule" behaviour where only the letter and not the spirit of the performance required is exhibited. See generally A Schoenemann, "Executive Remuneration in New Zealand and Australia: Do Current Laws, Regulations and Guidelines Ensure 'Pay for Performance'?" [2006] 37 VUWLR 31; Healy, above n 6, 168-89.
[295] Hill, above n 64, 1112-3; Gordon, above n 44, 1242.
[296] Recognised by the deemed disqualification of directors who are substantial security holders in both the NZX *Listing Rules* (above n 3, LR1.1.2) and Securities Commission's *Principles* (above n 4, Commentary to Principle 2).

A share-based incentive might also be counter-productive in that it could divert the independent directors from any *true* monitoring role to one focused solely on the share price.[297] Thus, not only is their incentive tied solely to the short-term performance of the company,[298] but their monitoring will fall foul of the fact that many of the recent corporate scandals have involved behaviours which served to insulate the share price from the reality of the company's position.[299] Moreover, even if independent directors become aware of problems not reflected in the share price, a shareholding incentive arguably promotes their continued concealment of this fact, so as to conserve the value of their shares.[300] Instead of taking remedial action and/or disclosing the issue to the market, they might actively or passively maintain the information suppression and/or seek to realise their investment before the share price falls.[301] Strong disclosure and insider trading regimes might ameliorate these dangers,[302] or, more fundamentally, it could be provided that the shares are simply non-tradable during the tenure of the directors' service.[303] However, to the extent that the director believed the problems were concealable ad infinitum, this proviso may not suffice to encourage public dissemination.

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[297] Perhaps explaining the ineffectiveness of the substantial equity Enron's directors' held, and the even more perplexing fact that some of these directors were *still* buying as the company disintegrated: see Sonnenfield, above n 80, 107.

[298] Hill, above n 20, 409-11.

[299] For example, the derivatives trading, special purpose entity transactions and "marketing to market" accounting techniques that gave Enron its appearance of success: see Ribstein, above n 53, 4.

[300] Gordon, above n 44, 1242.

[301] C D Stone, *Where the Law Ends: The Social Control of Corporate Behaviour* (Harper & Row, 1975) 140-1.

[302] For example, public issuers in New Zealand are currently required to disclose material information when they (or a director or officer) become cognisant of it: Securities Markets Act 1988, ss 19B-19F. "Material information" is defined as information which would materially affect the price or value of the securities and is generally unavailable to the market: s 19E. Directors of public issuers who dispose (or acquire) of a "relevant interest" (expansively defined in s 5) in a security of the public issuer or a related body corporate must disclose this within 5 trading days: s 19T(2). Section 7 provides that an insider (defined in s 3 as including a director) who, with inside information about a public issuer, buys or sells securities, is liable to both the party they transacted with (for any loss they incur) and the public issuer (for any advantage the insider accrues as well as a pecuniary penalty). Breach of these obligations may give rise to *inter alia* court proceedings brought by the Securities Commission: see ss 19K-19P, 19ZD (with non-disclosure under s 19T creating a *criminal* offence), and s 18A, enabling the Commission to take over the public issuer's right of action with regards to inside trading. Moreover, the Securities Legislation Bill currently before Parliament will substantially strengthen the insider trading regime, and the Commission's powers and penalties available: see Securities Legislation Bill, Government Bill 2004 No 234-2, especially clauses 21 and 27 (Internet) <http://www.brookers.co.nz/bills/updated_bills/b042342.pdf> accessed 3/10/06.

[303] OECD Survey, above n 139, [100].

Thus, possessing shares might increase the independent director's motivation to monitor managers, yet it seemingly *inherently* decreases their incentive to fulfil their further function of ensuring relevant information disclosure to the market. Hence the ultimate utility of the device is dependent on any gain from its alignment effect being greater than the hindrance it poses for disclosure.[304]

Lastly, to constitute any real incentive towards sceptical and impartial monitoring, the compensation (or increased share value or dividends) received must outweigh the comparative benefits from *not* performing true and effective oversight. This is thus in direct competition with the canvassed stipulation that independent directors' compensation or shareholdings cannot be of such a quantum as to imperil their independence. Where shareholdings are dispersed, or independent directors are precluded from having substantial shareholdings,[305] the increased share value that the director personally receives is unlikely to be comparable to the values obtainable via, for example, inaction which safeguards their directorship.[306] Even at the arguably minimal levels of director remuneration, the value of intangibles such as the status associated with the directorship will be likely to counterbalance any increase in share value that greater monitoring may bring. This may be partly ameliorated by a definition of 'independence' that seeks to limit other motivations, but it is impossible to completely insulate a director from ties and status incentives arising from the very fact of service.[307] Thus, the limits on directors' personal receipt of increases in share value are likely to render any rival economic incentive towards proactive monitoring relatively negligible.

<u>Legal Enforcement</u>

Therefore, the arguable inadequacies of non-legal incentives (alone) mean legal enforcement is essential for any truly functional independent director reform. This has the alleged benefit of creating and reinforcing expectations as to what is required, as well as providing a real and powerful sanction to ensure that these expectations are

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[304] A question as yet undetermined: see Lin, above n 32, 947-8.
[305] NZX *Listing Rules* above n 3, LR1.1.2; Securities Commission's *Principles*, above n 4, Commentary Principle 2.
[306] Nolan, above n 37, 460-1.
[307] See above Part III.B.

met.[308] Again this approach understands directors as being rational actors who will choose the course of action that promises the better consequences.[309] This presupposes that the legal liability occasioned will be perceived as sufficiently weighty to discourage that behaviour — implicating once more the problems associated with directors' tendencies to minimise risks and accentuate short-term gratifications. However, an advantage of legal liability (over reputational harms) is that it is arguably easier to render legal disincentives more certain and formidable, increasing their significance within the director's determination of the rationally better behaviour.[310] Although legal rules cannot guarantee appropriate performance,[311] they may constitute a greater prompt by better ensuring that any costs to shareholders from directorial failures are mirrored by costs sheeted home to the directors themselves.[312]

*The Costs of Legal Liability*

Before considering the means by which to effect this, it must be acknowledged that there *are* collateral disadvantages associated with imposing extra — or enhancing existing — legal liability on directors. These primarily consist of the possibility of producing counter-productive conservatism and/or the deterrence of independent directors from serving. It is therefore important to account for these in assessing whether the enforcement benefits are justifiable all told.

The first paradigmatic cost has already been argued as potentially flowing from enhancing the reputation incentive. Here, it is likewise argued that the prospect of legal liability will spur the independent director to engage in *overly* sceptical monitoring and they will *excessively* curtail the types of decisions and actions given approval.[313] As a result, the corporation will either forego higher-value, greater-risk opportunities (which may well be in the company's best interests) and/or management will be less likely to engage in a free, open and comprehensive dialogue with the

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[308] Fink, above n 164, 470-1.
[309] Farifax, above n 244, 443-7, explaining the "rational choice theory" of deterrence.
[310] Ibid 437-9.
[311] M J Barrett, "Enron and Andersen – What Went Wrong and Why Similar Audit Failures Could Happen Again" in *Enron Corporate Fiascos and Their Implications* (N B Rapoport & B G Dharan eds., Foundation Press, 2004) 155-168, cited in R F Burch "Director Oversight and Monitoring: The Standard of Care and the Standard of Liability Post-Enron" (2006) 6 Wyo L Rev 481, 531.
[312] Ribstein, above n 99, 12.
[313] See, *inter alia*, Fairfax, above n 244, 440; Cheffins, et al., above n 237, 30.

directors, thus impeding the directors' ability to discover real problems.[314] Moreover, the independent directors' preoccupation with precluding their culpability may result in the board's time being wasted on trivialities and compliance 'box-ticking', rather than more productive employment elsewhere.[315] Costs associated with time expended on ex post justification, and over-commitment, are also likely to arise.[316]

Secondly, legal liability may deter potential independent directors from serving, possibly foiling the reforms.[317] This may be especially relevant in New Zealand, where the small pool of directorial candidates is already of concern.[318] Evidence of such a deterrence effect already exists. For example, the post-Enron reforms in the United States (and increased perception that directors of corporations *would* face legal consequences where they had failed to safeguard the shareholders' interests)[319] have been accompanied by a marked decrease in directorial candidates,[320] Moreover, *independent* directors, not relying on their directorship for their livelihood, are expected to be even less inclined to accept positions.[321] Thus, difficulties Chinese corporations have experienced obtaining independent directors have been attributed to the regulator's exacting and onerous enforcement approach.[322] The culmination is that fewer (and perhaps less capable) candidates might be available, thus potentially

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314 Langevoort, above n 39, 826-7 especially.

315 Cheffins, et al., above n 237, 30.

316 Langevoort, above n 39, 826-7 especially.

317 For example, 40% of directors in the top 500 UK companies indicated they would be less likely to accept a non-executive directorship subsequent to the highly publicised and drawn-out action against the non-executive directors in *Equitable Life Assurance Society v Bowley* [2003] EWHC 2263 (Comm), QBD, [2004] 1 BCLC 180: Sweeney-Baird, above n 59, 77.

318 Preliminary results from a survey currently underway have indicated that, over the next five years, a further 1,960 independent directors will be required to meet the respondent companies' demand alone (based on the 2,000 responses obtained at the time of the article): R Le Pla, "Spotlight on Directors", *The Director* (New Zealand) May 2006, 8-13, 11. (Internet) <http://governance.tpk.govt.nz/docs/mgt-spotlight-on-directors.pdf> accessed 24/6/06.

319 A survey has disclosed the belief that the average public company in the United States has a 1 in 10 chance of having to defend at least one shareholder class action over any 5 year period: NERA Economic Consulting, "Recent Trends in Shareholder Class Action Litigation: Bear Market Cases Bring Big Settlements", February 2005, cited in J Betts, "The Rise of Shareholder Class Actions in Australia" (updated June 2000) (Internet) <http://www.findlaw. com.au/article/13436.htm> accessed 1/10/06.

320 Fairfax, above n 244, 451, citing K J Dunham, "Reforms Turn Search for Directors into a Long, Tedious Task" *Wall St J* (New York) August 29 2002, B1.

321 Fairfax, above n 244, 451. See also Lipshaw's analysis of the economic irrationality of service of a wealthy outside director: above n 178, 1098-1103.

322 Including the imposition of fines more than twice the value of the compensation the independent director receives, necessitating the postponement of the implementation date for adopting the mandatory independence: M Wang, "Notes and Current Developments: The independent directorship system in China" (2004) AJCL Lexis 27, 14-16.

decreasing the quality of the board. [323] A solution might be to increase the compensation offered to independent directors. But, the level of compensation required to offset the financial risk would create its own problems,[324] and would constitute a further agency cost the shareholders are forced to shoulder.[325] Similarly, the idea that increased insurance and indemnification for directors[326] can offset this service disincentive is met by arguments both that it is insufficient to remedy the disincentive,[327] and, conversely, that it obviates the true enforcement effect of liability at all.[328]

However, the problems with imposing legal liability might be insufficient to entirely undercut the enforcement value brought about, especially given the alleged deficiencies of any alternative means. Thus, the conservatism occasioned by the prospect of legal liability may be counter-balanced by the perils of the passivism likely to arise in its absence. This is perhaps especially pertinent given a characterisation of the typical director as being other than naturally cautious. Moreover, the equilibrium between value-creation and effective oversight might best be maintained, not by forsaking liability completely, but by framing the independent directors' obligations so as to *patently* permit acceptable risk-taking — by a clear "business judgment rule".[329] Clearer and more explicit guidance as to their actual function and obligations may ameliorate any tendency towards overzealous action — despite the raison d'être for fiduciary duties being to govern situations where clear-cut rules are practically unfeasible,[330] these duties might be rendered *less* abstract via greater statutory prescription[331] or even, given New Zealand's preference for a less

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[323] Cheffins, et al., above n 237, 30-1.
[324] Ibid 31.
[325] Ribstein, above n 99, 6, citing M Jensen & W Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 J Fin Econ 305, 308 for the proposition that agency costs include agent defection *and* preventative mechanisms.
[326] Companies Act 1993, s 162.
[327] The costs of defending litigation comprise more than just the actual financial penalty: see generally Cheffins et al., above n 237, 29
[328] See generally Fairfax, above n 244, 412-4, but acknowledging that insurance has been at least temporarily harder and more expensive to obtain since the Sarbanes-Oxley Act (at 415) and that it *is* possible for shareholders to insist on settlements structured to avoid directors' insulation by insurance (at 424, citing the Enron and WorldCom settlements).
[329] Ibid 450. See further, below n 398 and surrounding text.
[330] See generally Nolan, above n 37, 422-4.
[331] Ide, above n 178, 854-7. See also the proposed Australian Corporate Law Reform Bill 1992, subs (4AA) which purported to set out a list of factors relevant to an officer's duty of care. Although it was abandoned pursuant to submissions suggesting that the guidance was unnecessary and potentially counter-productive (Explanatory Memorandum to the Corporate Law Reform Bill 1992, cited in *ASIC*

rigid, principles-based approach,[332] explicit and established judicial utilisation of corporate governance codes.[333]

These arguments apply equally to the suspected diminution of candidates willing to stand — ensuring independent directors are obtainable performs little good if they will not thereafter have any incentive to perform their requisite role. Moreover, there *are* reasons why an independent director might accept service other than on a purely rational calculus — the non-pecuniary benefits of attaining "membership in an elite club" are potentially strong incentives.[334] If the latent economic burden is nonetheless perceived as outweighing these considerations, a solution might be to cap the directors' liability so that the penalty imposed is a sufficient incentive but does not entail financial ruin.[335] This is both pragmatic and arguably justifiable given the primary rationale of imposing liability on independent directors being to guide director's conduct, rather than compensating those harmed.[336]

*Available Mechanisms*

Thus, imposing legal liability on independent directors is ostensibly both necessary and justified. The ensuing issue is *how* this might be done in practice. Directors already owe legal obligations to the shareholders and company — for example, under the company's constitution[337] and in terms of the duties and obligations promulgated under both company and securities legislation.[338] The question therefore arises

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*v Rich* [2003] NSWSC 85 [37]-[39]), the enforcement value might be sufficient to justify further deliberation of the costs/benefits of such prescription.

[332] Securities Commission, *Principles*, above n 4, "Foreword"; Diplock, above n 148. E N Veasey "An Economic Rationale for Judicial Decisionmaking in Corporate Law" (1998) 1 Del L Rev 169, advocating a case-by-case approach as opposed to legislative codification.

[333] See, for example, Austin, above n 22, 347-353, and Justice Austin's judgment in *ASIC v Rich* [2003] NSWSC 85, as discussed below (see below n 379 and surrounding text); and Burch, above n 311, 502-3.

[334] Fairfax, above n 244, 452.

[335] Ibid 454-5; Cheffins, et al., above n 237, 31.

[336] Fairfax, above n 244, 454.

[337] A constitution is mandated for public issuers by LR3.3.1, although the obligatory content of such is limited to procedural matters: Appendix 6, NZX *Listing Rules* (above n 3). Section 134 of the Companies Act 1993 provides for a duty not to act, or agree to the company acting, in contravention to the constitution (and Act). This will cover failing to act: A Borrowdale, *Duties and Responsibilities of Directors and Company Secretaries in New Zealand* (3rd ed., CCH New Zealand, 2003) [63]. Section 170 of the Companies Act 1993 enables a shareholder to obtain a court order requiring a director to comply with the constitution.

[338] Duties in the Companies Act 1993 include (non-exhaustively): duties to the shareholders personally to supervise the share register, and to disclose their interests and share dealings (ss 90, 140 and 148, and actionable by a shareholder under s 169(1)) — potentially helping shareholders to supervise their

whether these existing legal requirements can (or can be made to) ensure the desired independent director behaviour, or whether the introduction of more specific obligations to do so might be feasible. This involves a consideration of both the scope of these obligations and their practical capacity to influence actors' behaviour — an issue which will depend heavily on the extent of their effective enforcement.

This dissertation only considers one avenue in any great depth — the duty of care directors owe to the company pursuant to section 137 of the Companies Act 1993.[339] It is submitted that this duty constitutes the most far-reaching and promisingly potent mechanism available, and thus is the most likely and appropriate way to enforce a more stringent independent director role. Independent directors *are* subject to other legal obligations which could serve to promote their proper functioning. [340] However, these provisions arguably target more discrete actions and/or omissions, or require some element of mental culpability or *active*, knowing breach.[341] In contrast, the inclusiveness — currently or potentially — of the duty of care means that it is arguably capable of enforcing the *entire* range of sought-after behaviours. It is acknowledged that it is theoretically open for the shareholders to impose similarly comprehensive *constitutional* obligations on the independent directors, which may thereafter be enforced via section 134 of the Companies Act 1993.[342] However, the practical realities of passive and dispersed shareholders' incapacity to impose controls on the board form one of the basic rationales for the independent director reform.

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continuing independence; duties to the company, including a duty to act in good faith and in the company's best interests(s 131) — including not to fetter their discretion, perhaps covering an abdication from exercising independent judgment; a duty to supervise the accuracy of the company records (including the minutes and resolutions of directors' meetings and financial statements: s 189(1)): s 190; and so on. For directors of issuers, these are supplemented by securities law provisions — for example, relevant interest disclosure obligations (Securities Markets Act 1988, ss 19T-19X) and personal liability to compensate for misstatements in advertisements or prospectuses (Securities Act 1978, s 56(1)). See further above n 302; Borrowdale (above n 337).

[339] Other possibilities might include: requiring greater independent director certification of public disclosures (increasing their involvement and thus ability to identify problems or exposure to liability in the event of misleading disclosure: see Langevoort, above n 39, 829); mandating a certain level of activism via independent director service contracts (see generally Wang, above n 322, 34-5); introducing a professional registration requirement, perhaps administered by a professional body (see Sweeney-Baird, above n 59, 79; and above n71 and surrounding text); and/or construing (or extending) other duties directors owe so as to require independent directors' greater involvement (see above n338).

[340] See above n 339.

[341] For example, s 56(1) of the Securities Act 1978 (liability for misstatements in advertisements or prospectuses) has a general defence of lack of knowledge that may limit this provision's application to independent directors. See further Fairfax, above n 244, 420-3.

[342] See above n 337.

Thus, enforcement of the implementation of this reform being predicated on *ex ante* shareholder activism may diminish its advocated concrete effect.[343]

*The Duty of Care, Skill and Diligence*

Section 137 of the Companies Act 1993 posits a duty on directors "exercising powers or performing duties as a director" to "exercise the care, diligence, and skill that a reasonable director would exercise in the same circumstances". The ambits of this duty are to be assessed in light of, *inter alia*, the "position of the director and the nature of the responsibilities undertaken".[344] Thus, it is arguable that undertaking the *position* and *responsibilities* of an independent director might give rise to an extra or different standard, and failure to adhere to this might constitute a breach of their duty.

This contention, in relation to the largely equivalent Australian section, was ostensibly rejected by the New South Wales Court of Appeal in *Daniels v Anderson*, where the Court held that the *same* legal duty of care applies to both executive and non-executive directors. [345] On the other hand, this duty was itself an expansive one, requiring directors to remain conversant with the company's activities and affairs and to "take reasonable steps to place themselves in a position to guide and monitor the management of the company.[346] This therefore ascribed to the board an "aspirational monitoring role", requiring pro-activism and precluding reliance on delegates where the directors *ought* to have seen a "red flag".[347] Similarly, Delaware cases such as *In re Caremark International Inc. Derivative Litigation*[348] and *Smith v Van Gorkom*,[349] also indicate increasing expectations being placed on directors, both to ensure that appropriate monitoring and reporting systems are implemented, and to follow suitably vigorous, deliberative and independent decision-making processes.[350] Thus, there may

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[343] The inadequacies of *ex post* shareholder enforcement of the duty of care are considered below.
[344] Companies Act 1993, s 137(c).
[345] 16 ACSR 607 (1995). The argument here was that non-executive directors should have a *lesser* standard of care.
[346] *Daniels v Anderson* 16 ACSR 607 (1995), 500-503.
[347] Hill, above n 64, 1118-1119.
[348] 698 A2d 959 (Del Ch 1996).
[349] 488 A2d 858 (Del 1985). See also *Baker v Secretary of State for Trade and Industry* [2001] BCC 273 in the UK.
[350] There may, however, be a more recent reversal of this trend: see *In re Walt Disney Co. Derivative Litigation*, No. Civ.A 15452, 2005 WL 2056651 (Del Ch Aug 9, 2005), and discussion in Fairfax, above n 244; Fink, above n 164.

be a growing recognition that boards have a true supervisory role to play,[351] that they are not just "an important ceremonial and legal fiction" that "do not function"[352] — possibly giving rise to a duty on *all* directors to fulfil the monitoring role that the reforms propose.[353] This is supported by the Court of Appeal's recent statement:[354]

> Directors must take reasonable steps to put themselves in a position not only to guide but to monitor the management of a company. The days of sleeping directors with merely an investment interest are long gone.

However, if the board in general has such duties, to what extent is an independent director expected to act any differently; what real advantages do they bring? Attributing to independent directors no additional obligations might seem to illustrate the irrelevance of an independent director reform at all. Thus, one might cynically view the reforms as a shallow means of placating shareholders unsettled by the recent collapses, and/or presenting an image of security to entice international investors. To the extent that independent directors are equally able to perform the multifarious roles of a non-independent director, this may be unproblematic — consciously acting to attract investors might be supportable. However, there are inherent disadvantages of independence that may impede independent directors' overall effectiveness, [355] and so stipulating board independence on the basis of image might *devalue* the board's utility in reality. Therefore, if a distinctive function is non-existent, the rationale of the reform is rendered essentially questionable — instead of mandating independent

[351] Holcomb, above n 88, 178; Hill, above n 20, 401, 406-7; Burch, above n 311, proposing a signalling effect from the Sarbanes-Oxley Act of 2002 towards less judicial deference. Compare, however, Fairfax, above n 244, 405-27, arguing that the scarcity of actual director liability for breach of duty of care is partly the result of judicial non-interference with directors' business judgment (along with procedural hurdles, indemnification and insurance, and exculpatory statutes), although she subsequently hints at a lessening of this deference (440-2).

[352] The view of a leading management guru: P Drucker, Management: Tasks, Responsibilities, Practices (Harper & Row, 1973), cited in Allen, above n 1, 2056

[353] See also *ASIC v Rich* [2003] NSWSC 85, at [71-72] especially, discussing the increasing standard expected; *Re HIH Insurance Ltd; Australian Securities and Investments Commission v Adler* (2002) 41 ACSR 72, 166-8) avers to the directors' obligation to remain informed. There have been few New Zealand cases on the issue, yet Thomas J's earlier decision in *Dairy Containers Ltd v NZI Bank Ltd* [1995] 2 NZLR 30, 99-118 especially, indicates an openness towards an expansive duty.

[354] *Mason v Lewis* [2006] 3 NZLR 225 at [83], discussing the extent to which the directors of a closely-held company could plead s 138 of the Companies Act 1993, which validates directors' reliance on information sourced from employees, professional advisers or other directors, provided they act in good faith, make proper inquiries when required by the circumstances, and have no knowledge that reliance would be undue.

[355] See above II.C.

directors, reformers might more beneficially have attended to increasing the capability and drive of general directors to engage in the appropriate oversight.

It could be argued that stipulating directors' independence simply better ensures their *actual* ability to perform the board's posited supervisory role.[356] Thus, although they fulfil no recognised niche, they will be more effective directors in practice.[357] Yet, unless there is a recognised higher duty placed on independent directors, they would seem to have no incentive to act in any different manner than they observe of other directors; even if they are *able* to act more independently, they will not be encouraged to do so in face of group pressures to conform.[358] Conversely, emphasising that theirs is a higher duty of monitoring will enable them to use this fact to rationalise and legitimise their fulfilment of this role — both to others and to themselves.[359] It may therefore increase the extent to which they feel compelled to act, as well as serve to alleviate the dissension and factionalisation that vigorous and sceptical independent monitoring might bring (increasing the value thus obtainable).

Moreover, if the legal duties of independent directors are no more strenuous than those of other directors, this presumably renders the incentive occasioned by their prospective liability for breach no more effective than that felt by non-independent directors.[360] Thus, to the extent that this incentive has proven insufficient — arguably illustrated by the executive defections that have given rise to the perceived need for independent directors in the first place[361] — it is unclear what real influence it will have. For independent directors to fulfil any unique, useful role, the legal (or other) consequences of non-conformity must be rendered sufficiently vigorous and particularised to induce them to this special activism.

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[356] Justice Young, in HOH Royal Commission, above n 1, para 6.2.6: "Perhaps all that can be said with assurance is that independence significantly reduces the prospect that performance will be inhibited by considerations other than the best interests of the company as a whole."
[357] Provided that they *are* better monitors or otherwise enhance corporate performance: see Part II.
[358] Shu-Acquaye , above n 194, 744-5.
[359] Stone, above n 299, 141-4.
[360] Provided independent directors are not more readily deterred than other directors, for example, by having more to lose in terms of reputation or fortune, or simply being prone to quantify the risks more liberally: see generally Fairfax, above n 244, 453, 455; and above n 321 and surrounding text.
[361] Fairfax, above n 244, 437-8, although proceeding to explain how legal disincentives can be augmented.

Thus independent directors' duties should be recognised as being distinctive: imposing an additional or increased duty of monitoring and oversight seems integral to stimulate and validate independent directors' activism (and, indeed, presence). Moreover, since *Daniels v Anderson*,[362] there *has* been judicial recognition that directors who occupy special roles may be held to a higher standard of care. This might permit a like argument as regards independent directors.

*ASIC v Rich* considered whether Mr Greaves (of One.Tel notoriety) owed a higher duty of care as the chairman of both the board and audit committee.[363] It was alleged that the reasonable director holding these offices and responsibilities in a corporation in One.Tel's circumstances,[364] would have discharged specified duties beyond those normally attributable to a director.[365] Austin J accepted this argument: although there is a *baseline*, objective standard of care, the concept of "responsibilities" also comprised a consideration of, *inter alia*, Greaves' "occupation of the position of 'foundation' director, chairman and chairman of the Finance and Audit Committee" in fact.[366] His Honour then canvassed the obligations of chairpersons (of listed public companies) more generally, and accepted it was reasonably arguable that their factual "responsibilities" (if not their legal duties directly)[367] might entail that they are "responsible to a greater extent than any other director for ensuring that the board is

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[362] 16 ACSR 607 (1995).
[363] [2003] NSWSC 85.
[364] The Australian equivalent to our s 137 states: "A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they: (a) were a director or officer of a corporation in the corporation's circumstances; and (b) occupied the office held by, and had the same responsibilities within the corporation as, the director or officer." s 180(1) of the Corporations Act 2001 (Cth). (The case was decided under the identical earlier provision.)
[365] These are summarised by Austin J as including responsibilities to take reasonable steps to: make sure the board received financial information (involving creating and maintaining systematic information processes); to ensure the public dissemination of information; to employ a finance director; to maintain the corporation's solvency; and to advise the board regarding prudent management: *ASIC v Rich* [2003] NSWSC 85 at [15].
[366] *ASIC v Rich* [2003] NSWSC 85 at [50]. Austin J also averred that the individual director's "qualifications, experience and expertise" were *directly* pertinent, but this has subsequently been criticised: R Wallis & P German, "Corporate Governance: Expanding Board Responsibilities" (2004) 1 ADLS CLE Seminars 1, 5-8.
[367] Austin J stressed that the ASIC's argument pertained to the responsibilities of a "company chairman who is also chairman of the audit committee, having regard to the particular circumstances of the company and his special personal qualifications" and was "not a case about the duties of a company chairman at large" (*ASIC v Rich* [2003] NSWSC 85 at [18]). Thus he refrained from predicating his decision on any general legal duty of a chairperson (although not ruling this out), and instead focused on the "factual responsibilities" of Greaves, *including* as the chairperson, in the particular company and situation at issue.

familiar with the financial circumstances, position and performance of the company, and ensuring the performance of the board of its supervisory duties".[368]

It might, thus, be open to argue by analogy that the monitoring responsibilities of independent directors are greater than those borne by the board in general — that the "factual responsibilities" an independent director assumes constitute a greater oversight role. The applicability of this approach in New Zealand will depend on how our section 137(c) is interpreted — whether the consideration of the "position of the director and the nature of the responsibilities undertaken" will be read in the same way as the Australian provision. Arguably such an interpretation *is* open.[369] Our section is admittedly framed in more positivist terms — requiring a director's express *undertaking* of the responsibilities at issue.[370] Yet it would be difficult for an independent director to claim, in light of the current fixation with the concept, that they were unaware of the special nature the community ascribes to the position. Thus, it is probable that they would be held to have affirmatively "undertaken" the higher responsibilities communally expected of the role.

Furthermore, in the later case of *ASIC v Vines*,[371] Austin J defined the section 180(1) duty as comprising an objective standard of care that would be "enhanced where an appointment to the board of directors is based on the appointee having some special skill, by an objective standard of skill referable to the circumstances".[372] He thus held that professional persons, such as lawyers, auditors and chief financial officers, holding themselves out as having those special skills, would be bound to the general standard of care and diligence of that profession.[373]

Therefore, it is also possible that a director holding themselves out as "independent" could be held liable to live up to the skills and behaviours thus professed — that the position of an independent director entails an "identifiable specialist skill" that can

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[368] *ASIC v Rich* [2003] NSWSC 85 at [66], [70].
[369] Wallis & German, above n 366, 8 especially.
[370] Wallis & German, above n 369, 7: the Companies Act 1993, s 137 avers to "responsibilities *undertaken*" rather than simply *"had* the same responsibilities", as in the Australian Corporations Act 2001 (Cth), s 180(1)(b).
[371] (2004) 22 ACLC 37.
[372] *ASIC v Vines* (2003) 48 ACSR 322 at [38]-[46]; *ASIC v Vines* (2004) 22 ACLC 37 at [1058].
[373] *ASIC v Vines* (2004) 22 ACLC 37 at [1075].

give rise to a higher obligation. Recent ideas that directors should be adhering to *professional* standards might support such an analogy.[374] Moreover, boards' obligation to name the directors they consider to be independent[375] is arguably an explicit "holding out" of those directors as having the capabilities and "skills" objectively associated with this fact. Thus, it seems apposite that these directors should be held to the higher standard of a 'reasonable independent director'.

Either argument, of course, depends on delineating the precise additional responsibilities and/or identifiable skill that the position of 'independent director' entails. Furthermore, legal liability as an effective deterrence requires that the actor is able to recognise the situations in which they are acting inappropriately.[376] The incentive is predicated on their ability to *choose* not to engage in the behaviours that will give rise to liability: if they cannot make a choice, the incentive is incapable of promoting the desired behaviour.[377] Alternatively, pronounced uncertainty might produce counter-productive cautiousness or desertion from service.[378]

Here, pursuant to *ASIC v Rich*, one could look to the corporate governance literature: in declining Greaves' application to strike out the action, Austin J endorsed the Commission's intention to adduce such evidence.[379] This was predicated on the

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[374] See, for example, the New Zealand Institute of Directors' Code of Practice for Directors, which begins: "This Code provides guidance to directors to assist them in carrying out their duties and responsibilities in accordance with the highest professional standards" (above n 57). Specifically referring to independent directors, Grantham suggests that their efficacy depends on their "sense of propriety and professionalism" (above n 26). This idea is similarly advocated by Leech & Mundheim, above n 38, 1835), although they also express the idea that (at least by 1976) it is "yet to be demonstrated that there are mysteries to the work of the board that require a peculiarly 'professional' approach" (1811). More recently, Shu-Acquaye has suggested that proposals for including so-called "professional directors" on the board (persons employed *full-time* as independent directors, per R J Gilson & R Kraakman, "Reinventing the Outside Director: An Agenda for Institutional Investors" (1991) 43 Stan L Rev 863) would merely serve to reproduce the proper function of the independent director (above n 194, 748-9). Sweeney-Baird suggests that a professional institution for non-executives is warranted (above n 59, 79 especially).

[375] NZX *Listing Rule*, above n 3, LR3.3.1A; Securities Commission's *Principles,* above n 4, Guideline 2.11.

[376] Fairfax, above n 244, 434, citing R Paternoster & S Simpson, "Sanction Threats and Appeals to Morality: Testing a Rational Choice Model of Corporate Crime" (1996) 30 L & Soc Rev 549, 550-56.

[377] Fairfax, above n 244, 434, citing G S Moohr, "An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime" (2003) 55 Fla L Rev 937, 960.

[378] See above n 313 and ensuing text.

[379] *ASIC v Rich* [2003] NSWSC 85 at [70]. The ASIC's statement of claim signified an intention to introduce "expert opinion evidence of responsibilities ordinarily undertaken by the chairmen of listed public companies in Australia, and the tender of relevant extracts from books, articles and papers by learned commentators describing the customary responsibilities and the role of chairman of a listed public company" (at [66]). However, the judgment concerned a strike-out application and the case was

Court's role being "to articulate and apply a standard of care that reflects contemporary community expectations" and Austin J's view that utilising corporate governance literature to do so was "preferable" to the alternative of "rely[ing] on unassisted armchair reflection".[380] It was also despite conceding that this may entail holding directors to standards never before delineated in legal form,[381] and admitting that the literature "is sometimes vague and less than compelling".[382] Again, Austin J took a like position in his subsequent judgments in *ASIC v Vines*.[383]

In like manner, it is thought that the relatively prescriptive guidelines promulgated by the Toronto Stock Exchange might be used as baseline standards with which to judge directors' actions.[384] Therefore, failure to adhere to these will constitute a breach of duty unless they prove the digression was in good faith.[385] Similarly, the United Kingdom Code is thought to provide prima facie obligatory best practice.[386]

There is thus an apparently greater willingness to use extrinsic material to give content to the obligations directors owe. Moreover, there is no shortage of such information on offer, being promulgated by a multitude of international regulatory

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subsequently settled, leaving two questions open: (1) whether, under strict evidence law, corporate governance literature will be admissible against the defendant; and (2) whether the inability to cross-examine will be grounds to exclude it in any event: see Justice Austin, writing extra-judicially, and suggesting that it might be admissible as analogous to a dictionary, law report or legal textbook: above n 22, 352-3.

[380] *ASIC v Rich* [2003] NSWSC 85 at [71-72]. Austin J also explicitly averred that "evidence of corporate *practice* about the distribution of work between the chairman and other directors is relevant to the establishment of the factual responsibilities of the chairman" and could thus inform the s 180(1)(b) consideration (at [64], my emphasis). See also Burch, above n 311, 502-3.

[381] *ASIC v Rich* [2003] NSWSC 85 at [71].

[382] *ASIC v Rich* [2003] NSWSC 85 at [70]: "Much of the literature of corporate governance is in the form of exhortations and voluntary codes of conduct, not suitable to constitute legal duties. It is sometimes vague and less than compelling, and must always be used with caution. Nevertheless, in my opinion this literature is relevant to the ascertainment of the responsibilities to which Mr Greaves was subject." Similarly, directors' legal duties themselves have been criticised as "famously written in shades of gray": Moohr, 959, cited in Fairfax, above n 377.

[383] Austin J admitted expert opinion evidence as to the norms of behaviour of a reasonably competent chief financial officer in the circumstances at issue (based on the identifiable specialised skill attaching to the office: *ASIC v Vines* (2003) 48 ACSR 322 at [48]; *ASIC v Vines* (2004) 22 ACLC 37 at [1059].

[384] Burke, above n 48, 366, citing L Waisberg & R Vaux, "Board Governance: The Importance of Process" in *The Future of Corporation Law: Issues and Perspectives* (Carswell, 1997) 97, 115. Perhaps, too, these guidelines are more similar to 'legal texts' as per Austin J's analogy: see above n 379.

[385] Burke, citing Waisberg & Vaux, above n 384.

[386] Burke, above n 48, 366-7, citing the UK Law Commission and Scottish Law Commission, "Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties", Law Commission Consultation Paper No 153; Scottish L Commission Discussion Paper No 105 (1998) para 1.38-1.44.

bodies, academics and business groups.[387] The difficulty may be, however, the paucity of *authoritative* explication for New Zealand — the lack of detailed guidance as to the extent to which this material applies here.[388] Therefore, enhancing the enforcement incentive promised by prospective legal liability for breach of the duty of care might necessitate extra authoritative clarification of the duty — either judicially or via more explicit regulatory guidance.[389]

*Enforcement of the Duty*

Even if a legal obligation to fulfil a defined, vigorously independent monitoring role is occasioned by the directors' duty of care, this will arguably only create a true incentive to the extent that it is actually enforced.[390] Unless there is a real risk that the liability *will* be inflicted, the deterrent effect will be minimal.[391]

New Zealand's company law is primarily a private-enforcement model. As the directors' duty of care is statutorily owed to the company,[392] the remedy for its breach rests with the board.[393] However, recognising the conflict of interest that is inherent in board members bringing an action against themselves and/or their fellow directors, section 165 of the Companies Act 1993 provides for derivative actions. Thus a shareholder, with the leave of the court, can bring an action against the director(s) where the company will not diligently do so, or where it is not in the company's best interests to leave the matter to the board or the shareholders en masse.[394]

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[387] See Securities Commission, "Strengthening Confidence in New Zealand's Capital Markets A Statement on Certain Aspects of Corporate Governance and Financial Reporting" (November 2002) (Internet) <http://www.sec-com.govt.nz/publications/documents/capital_markets.shtml?print=true> accessed 24/7/06; European Corporate Governance Institute, "Index of All Codes" (Internet) <http://www.ecgi.org/codes/ all_codes.php> accessed 9/10/06. See also Sonnenfield's summation of the array of best practices advocated (above n 80, 106-9); and Branson's description of "the morass [of regulation] that has been overlaid on Sarbanes-Oxley" (above n 66, Abstract).

[388] See Krackhardt, above n 270. However the Securities Commission's *Principles* recommend that boards "should set out in writing its specific expectations of non-executive directors (including those who are independent", potentially sufficing to clarify the "factual responsibilities" of its independent directors: above n 3, Guideline 2.8.

[389] Ide, above n 178, 854-7.

[390] See generally Fairfax, above n 244. Compare, however, Lipshaw's idea of law providing moral authority, as discussed above n 280 and ensuing text.

[391] Fairfax, above n 244, 438-40.

[392] Companies Act 1993, s 169(3)(h).

[393] Note though that s 170 of the Companies Act 1993 does enable a shareholder to apply to the court for an order requiring a director to *comply* with their duty of care under the Act.

[394] Companies Act 1993, s 165(3). Note that directors also have standing to bring a derivative action (s 165(1)), and thus this provision might also constitute an avenue for independent directors to affirmatively act for the shareholders — provided they can be motivated to do so.

As stated, the incentive provided by potential liability for breach of due care is dependent on the directors' perception of the likelihood of a shareholder (or the board) bringing an action. This then founders on a prime rationale for independent directors in the first place — the collective action problems occasioned by a dispersed, apathetic and disempowered shareholder body, rendering them unlikely and/or unable to exercise any direct control.[395] These concerns may be perceived as being less problematic in New Zealand where there is a higher rate of concentrated ownership.[396] Yet if a further consequence of our divergent ownership structure is that the reform is being justified as providing *minority* shareholder protection,[397] the argument may have similar application.

Shareholders who seek to bring duty of care actions face the added hurdle of a general judicial preference to rely on an independent directors' judgment.[398] This is typically predicated on judges' dearth of expertise and competence to substitute *their* subjective views, and an aversion towards hindsight review of byzantine decisions.[399] Furthermore, directors are perceived as possessing a mandate from the shareholders, and the court's countermanding this discretion is viewed as an unjustifiable interference.[400] Therefore, a shareholder has a heavier burden than merely proving an independent director's judgments failed to ensure the corporation's success or the managers' bona fides — they essentially have to prove some element of bad faith and/or incompetence, or that the director failed to make any business judgment at all.[401] Conversely, there may be a lessening of this judicial deference — and

[395] See above Part II.A.
[396] See Farrar, above n 30.
[397] See Cheffins, above n 24, 22, discussed at above n 31.
[398] The so-called "business judgment rule", which provides for judicial non-interference with directors' good faith business decisions: see, for example, the Australian Corporations Act, 2001 (Cth), pt. 2F.1A. Although New Zealand has no legislative equivalent, it is arguably a "persistent theme" evident here as well: see R B Grantham & C E F Rickett, *Company and Securities Law: Commentary and Materials* (Brookers, 2002) 568.
[399] *Dodge v. Ford Motor Co.* 170 NW 668, 684 (Mich 1919). See also Grantham & Rickett, above n 398, 568; W T Allen, J B Jacobs & L E Strine, Jr, "Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny as a Standard of Review Problem" (2002) 96 Nw UL Rev 449 generally.
[400] See Grantham & Rickett, above n 398, 568; Chandler & Strine, Jr, above n 27, 979.
[401] For example, the Australian provision creates a rebuttable presumption in favour of directors' decisions where the director has "acted in good faith for a proper purpose", was not materially personally interested in the decision, reasonably informed themselves about the decision and "rationally believed that the decision was in the best interests of the company" (defined as a belief other than one "no reasonable person in their position would hold"): Corporations Act 2001 (Cth), s 237(3)(c). In America, a shareholder must prove essentially that the director's decision was

especially a greater willingness to require directors to have undertaken actual inquiries.[402]

Moreover, the general deterrent to shareholder actions posited by New Zealand's loser-pays costs regime[403] is ameliorated by the ability to get the costs of bringing a derivative action from the company.[404] Yet, although this mediates the financial *dis*incentive to bring an action, the Act arguably does little to create an effective incentive.[405] This is because the award obtainable prima facie belongs to the company, and, at best, may be diverted to the past or present shareholders *in toto* instead.[406] Thus, free-riding problems arise once more — shareholders might be reluctant to undertake litigation where the benefit will be enjoyed by the shareholders collectively.[407] Even where there are fewer shareholders (and thus a higher personal award possible), the availability of *personal* means of recovery (such as the minority oppression remedy in section 174 of the Companies Act 1993) may constitute more attractive alternatives[408] — but may provide less incentive for independent directors (perhaps constituting lesser reputational harms or personal financial detriment). Furthermore, the procedural requirement of obtaining leave to bring a derivative action may also impede its employment.[409]

Given such hurdles, it is perhaps not surprising that a multinational study has revealed only a slight incidence of outside directors being held liable for breaching their duties

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compromised by bad faith, self-interest or procedural flaws or that the decision simply cannot be reconciled with a rational business purpose — in other words, gross negligence: E N Veasey, "The Defining Tension in Corporate Governance in America" (1997) 52 Bus Law 393, 394, cited in Fink, above n 164, 462-3. See further Grantham & Rickett, above n 398, 568-74.

[402] See above n 346-54 and surrounding text.

[403] See generally B R Cheffins & B S Black, "Outside Director Liability Across Countries" (2006) 84 Tex L Rev 1385, 1406.

[404] Companies Act 1993, s 166. Of course this does not cover psychological and opportunity costs of litigation.

[405] See Farrar, above n 51, 384, making this criticism of the Companies Act 1993's shareholder remedies generally.

[406] Companies Act 1993, s 167(d).

[407] The equivalent pro-rata award provision in the Canadian legislation has been pinpointed as a reason for the small number of actions brought there: see L Griggs, "The Statutory Derivative Action: Lessons that may be Learnt from its Past!" [2002] UWALRev 4, 4.4.

[408] L Taylor, "The Derivative Action in the Companies Act 1993" in A Borrowdale, D Rowe & L Taylor (eds) *A New Zealand Collection* (Centre for Commercial & Corporate Law Inc, 2002) 245-262, at 257-260 especially; see also Griggs, above n 407, 4.4 averring to a similar position in Canada.

[409] Griggs, above n 407, 4.4. See also Farrar, above n 51, 384, for the general proposition that the Companies Act 1993, although clarifying directors duties, failed to provide shareholders incentives to pursue breaches of these.

in fact.[410] This included directors' exposure to both "out of pocket" liability and nominal liability, where any financial penalty was removed via insurance or indemnification.[411] Outside the United States — with its user-pays costs regime, well-established class and derivative actions, and provision for 'commission-like' lawyer's fees[412] — shareholder actions were rare.[413] An earlier New Zealand survey compatibly found that three-quarters of private actions were brought against closely-held companies, verifying the model 'passive investor' of the large public corporation.[414]

Then again, the international study did note a potential trend towards shareholders bringing actions where they are motivated not so much by the possibility of compensation, as by a sentiment that the director *should* be accountable.[415] Therefore, actions may be brought where a purely economic calculus would tend against it. On the other hand, this will depend on the shareholders' attitudes and sense of propriety, and will be hard to predict in advance. Thus, the extent to which this possibility increases the *disincentive* associated with breaching the duty might be minimal — unless and until the likelihood of "public-minded"[416] actions increases. This might best be achieved by conferring the enforcement right on a formal, public body — an enforcer inherently mandated to bring actions based on deterrence and principle,[417] rather than on a utilitarian calculation of the potential compensation.

*A Public Enforcement Model*

The inadequacies of private enforcement might therefore mean that effective enforcement necessitates public agency action. Congruently, the Securities

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[410] Cheffins et al., above n 237. The study looked at America plus three major common law countries (Australia, Britain and Canada) and three major civil law countries (Germany, France and Japan).
[411] Ibid 5.
[412] Ibid 8.
[413] Ibid 19. The United States exhibited more actions, but a similarly low incidence of out-of-pocket liability (8-10).
[414] Berkahn & Trotman, above n 176, 242 especially. The survey included reported and unreported cases brought between 1986-1998 against company directors and managers, resulting in at least one judgment. Private actions included those brought by shareholders, directors, the company, creditors and other external parties (as opposed to the Securities Commission and Registrar of Companies). Closely-held companies had up to ten shareholders.
[415] Cheffins et al., above n 237, 22-5.
[416] Ibid 6.
[417] See generally ibid 25-6.

Commission has recently pledged to redouble its enforcement efforts.[418] However, except where the directors' failure to adhere to their duties also constitutes particular securities law breaches[419] or certain contraventions of an NZX conduct rule,[420] the Securities Commission's powers are basically limited to publicising the breach.[421] Except so far as this augments the reputational incentive, the Commission's enforcement of independent directors' duties is consequently negligible. Nor does the Registrar of Companies have any real powers with respect to enforcing directors' duties.[422]

The asserted advantages of greater public enforcement are primarily more certain and more uniform enforcement.[423] Thus, the regulator can take up proceedings for breaches of a directors' duty where the shareholders are unable or unwilling to do so. This may be especially significant where the costs of bringing an action are high, and/or the shareholders' disengagement from the company is such as to significantly diminish their access to, or comprehension of, the material information.[424] Additionally, the cumulative effect is allegedly total market regulation, as opposed to sporadic enforcement of individual failures.[425] Thus, not only is there greater certainty of penalties accruing (increasing the disincentive felt), but it reinforces the perception of the market as a safe, regulated, and therefore *attractive* site of investment. Public enforcement may therefore directly and powerfully enhance the investor-confidence rationale for the independent director reform.

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418 Chairman Jane Diplock, has recently reiterated the Commission's intention "to take appropriate action, including by reporting publicly, where we see examples of corporate governance that does not meet the standards we expect to see in our markets": above n 264.
419 See above n302.
420 Securities Markets Act 1988, ss 36ZO-36ZV, enabling the Commission to direct the NZX to take action where an issuer is in non-compliance with a continuous disclosure obligation or it is in the public interest, to protect traders.
421 See Diplock, above n 151, generally discussing the Commission's "inadequate" enforcement powers.
422 The Registrar's powers of enforcement are essentially limited to inspecting documents pursuant to potential breaches of the Companies Act 1993, Financial Reporting Act 1993, and Securities Act 1978 (Companies Act 1993, s 365; Securities Act 1978, s 67); enforcing more administrative provisions such as those relating to registration (the Companies Act 1993, pt II) or a company's name (Companies Act 1993, pt IV); and seeking the disqualification of directors implicated in insolvent trading (Companies Act 1993, s 385): see Berkahn & Trotman, above n 176, 229.
423 See generally Prentice, above n 144; Berkahn & Trotman, above n 176, 217-8.
424 See generally Berkahn & Trotman, above n 176, 217, 220.
425 Ibid 217.

However, militating against public enforcement are arguments that this will curb the creation of value — public enforcement might stifle innovation, competition and efficiency via diverting directors' attention away from the creation of value to a more compliance-oriented mindset.[426] This is expressed as a criticism of imposing legal liability in general, but is allegedly more problematic where the regulator has no *direct* interest in value creation, and thus may require categorical compliance: formal conformity is potentially elevated above the substantive achievement of shareholder value.[427] Moreover, to the extent that New Zealand companies do not fit the dispersed-ownership, public corporation model,[428] external enforcement might be seen as inappropriate interference.[429]

Conversely, public enforcement has also been criticised as being *less* effectual. This might arise where the enforcer lacks the capacity (in terms of time, staff and financial resources) to properly fulfil its task.[430] It may also result from disincentives such as the revolving door phenomenon,[431] general regulatory capture[432] and/or simply lacking the motivation to act.[433] On the other hand, New Zealand's Securities Commission has explicitly recognised the need for evident and significant enforcement,[434] and these pressures have not appeared to impede the Australian

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[426] See, for example, I Francis, "The Responsibilities of Corporate Governors: Conformance or Performance?" [1995] 12 BCLB 8, cited in ibid 219.
[427] See H H Mason, "Possible Alternatives to an Australian Securities and Exchange Commission: Contingent Fees and Derivative Actions by Shareholders" (1976) 50 ALJ 26, 27-28, cited in Berkahn & Trotman, above n 176,219.
[428] Recent statistics show that 86% of registered New Zealand companies had one-two shareholders and 95% had under five: R Dugan, P McKenzie & D Patterson, *Closely Held Companies: Legal and Tax Issues* (CCH New Zealand Ltd, Auckland, 2000) 3.
[429] See Berkahn & Trotman, above n 176, 220-1. Compare Krackhardt above n 270, v.a, who argues that the large number of such companies means that they significantly impact on New Zealand's corporate governance culture and must be held to a high standard.
[430] See Farrar, above n 51; Diplock, above n 151; D C Langevoort, "Managing the 'Expectations Gap' in Investor Protection: The SEC and the Post-Enron Reform Agenda" (2003) 48 Vill L Rev 1139, 1140.
[431] Three of the ten members of the Securities Commission hold company directorships: Securities Commission,
*The Annual Report of the Securities Commission 2005-2006* (12 August 2006) 4 (Internet) <http://www. sec-com.govt.nz/publications/annrep-06/> accessed 1 October 2006.
[432] Burke, above n 48, 352-3. Compare Prentice, above n 144, 801, discussing the United States regulator.
[433] Berkahn & Trotman, above n 176, 219.
[434] Diplock, above n 151. See also J Diplock, Chairman Executive Committee of IOSCO & Securities Commission, NZ, "Is regulation keeping up with or fettering cross-border developments?" (Speech delivered at the ASIC Summer School, 17 February 2006) (Internet) <http://www.sec-com.govt.nz/ speeches/2006/jds170206.shtml> accessed 18/7/06.

regulator in the performance of its enforcement role.[435] Thus this objection might be met simply by ensuring the appropriate structure, jurisdiction and resources of the enforcement agency. Moreover, introducing public enforcement of directors' duties need not eliminate the ability of shareholders to take action if, for any reason, the regulator fails to do so.[436]

Yet a last fundamental drawback of a regulatory enforcement model is perhaps more compelling: it displaces the costs of enforcement from those who directly benefit, onto the members of the state as a whole; the general public is effectively taxed for the exclusive shareholder benefit.[437] This might be inappropriate in New Zealand where the proportion of people possessing any significant stake in large corporations is comparatively low.[438] To the extent that the people who thus benefit are the wealthier members of the population,[439] it may further serve to augment the growing disparity that exists within society. It may also amount to taxing New Zealanders for the advantage of wealthy, *foreign* investors.

On the other hand, the benefits occasioned by public enforcement are broader than simple shareholder compensation for (and even prevention of) directorial misconduct.[440] Collateral advantages flow from the attraction of international investors by visibly stringent enforcement of basic corporate governance standards. Increased capital will be available for the expansion of our share market and the corporations listed thereon.[441] Moreover, this should serve to ameliorate the alleged

[435] The ASIC has "fulfilled its role as the primary Australian corporate regulator with assiduousness", and "used its statutory powers extensively to act swiftly to institute action against the directors of most of the collapsed corporations": J du Plessis, "Reverberation after the HIH and Other Recent Australian Corporate Collapses: The Role of ASIC" (2003) AJCL Lexis 8, 2, 50.
[436] See generally J Cooper, Deputy Chairman ASIC, "Corporate wrongdoing: ASIC's enforcement role" (Speech delivered at the International Class Actions Conference, Melbourne, 2 December, 2005) (Internet) <http://www.asic. gov.au/asic/asic.nsf/lkuppdf/ASIC+PDFW?opendocument &key=ICAC2005_speech_021205_pdf> accessed 1/9/06.
[437] Berkahn & Trotman, above n 176, 218.
[438] 2002 statistics revealed that company shares (both closely-held and public) were owned by only 21% of New Zealanders: D Skilling and A M Waldegrave, *The Wealth Of A Nation: The Level & Distribution Of Wealth In New Zealand*, The New Zealand Institute Discussion Paper 2004/1 (2004) (Internet) <http://www.nzinstitute.org> accessed 27/8/06. This can be compared to 55% of adult Australians: ASX, "ASX Share Ownership Study – 2004 findings" (Press Release, 24 February 2005) (Internet) <http://www. asx.com.au/about/pdf/ShareStudy2004media release.pdf> accessed 1/10/06.
[439] 89% of New Zealanders possessing financial assets in 2002 were located in the top 50% of the wealth distribution: Skilling & Waldegrave, above n 438.
[440] See generally Healy, above n 6.
[441] See generally Diplock, above n 151; Healy, above n 6, 223 especially.

exodus of New Zealand's business talent overseas.[442] Both of these consequences should boost (or preserve) New Zealand's economy,[443] for the benefit of New Zealanders in general. Equally, public regulation may in fact make investing in the share market more viable for the general person.

Thus, there may be grounds for New Zealand implementing a more empowering public enforcement regime, replacing our chiefly enabling approach — in which "parties [are] free to set their own rules, subject only to certain basic restraints"[444] — with one where a specified regulatory agency plays the primary enforcement role.[445] This would admittedly constitute a jurisprudential shift from conceiving of director-shareholder relationships as entirely private to recognising a public interest in, and element to, these interactions. Yet it may be that an implicit acknowledgement of the public's interest is *intrinsic* to the independent director concept.[446] The appointment of inherently *external* persons[447] to control the company arguably belies its private nature — especially as these independent directors are being principally advocated as securing investors' — and the broader market's — interests. Thus public enforcement of their duties may simply be a conceptual corollary of the nature of the reform.

Regardless, for a legal liability incentive to have any real impact, public enforcement such as that illustrated by the Australian approach seems to be required. The Australian Securities and Investments Commission (in addition to its regulatory responsibilities),[448] is charged with administering the companies legislation[449] — giving it jurisdiction to bring statutory civil penalty actions against directors who breach their duties.[450] As stated, the ASIC has undertaken this compliance role with

[442] Healy, above n 6, 263-4.
[443] See generally Farrar, above n 51, 392
[444] Berkahn & Trotman, above n 176, 216.
[445] This could be modelled on the Australian Securities and Investments Commission (see generally Farrar, above n 51), or the independent regulatory agency Ireland has recently adopted (see Office of the Director of Corporate Enforcement (Internet) <http://www.odce.ie/about/default.asp> accessed 1/10/06).
[446] See, for example Griggs, above n 176, 6-8, advocating a public law element to corporate law that would *enable* the state to prescribe a monitoring role for the board.
[447] In New Zealand, they are definitively disengaged from management *and* the shareholders of the company: NZX *Listing Rules*, above n 3, LR1.1.2; Securities Commission's *Principles*, above n 4, Commentary to Principle 2.
[448] Australian Securities and Investments Commission Act 2001 (Cth), pt 2.
[449] Australian Corporations Act, 2001 (Cth), s 5B.
[450] Australian Corporations Act, 2001 (Cth), s 1317J(1) provides the ASIC's standing to bring applications for a declaration of contravention of a civil penalty provision (defined in s 1317E(1)(a) as

considerable vigour.[451] Moreover, its *success* in securing liability has been manifestly greater than private actors have commanded.[452] Thus New Zealand's attainment of the (dis)incentive required to ensure the authentically independent behaviour of the much-espoused independent director seems likely to compel a similarly activist, publicly mandated institution. The powers granted to the Securities Commission under the current Securities Legislation Bill[453] might therefore merely preface more extensive powers to follow.

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including breaches of directors' duty of care) and to seek penalty or compensation orders. Disqualification orders are available under ss 206C-206E.

[451] During 2004-5, the ASIC achieved 27 criminal prosecutions resulting in imprisonment, plus 23 additional convictions; 215 criminal, civil and administrative proceedings (concerning 300 different respondents, and generating approximately $119 million in recoveries, costs, compensation and fines); the disqualification of 58 people from managing corporations or offering financial services; and the liquidation of 60 companies: Australian Securities and Investments Commission, *Annual Report 2004-2005* (14 October 2005) (Internet) <http://www.asic.gov.au/asic/asic.nsf/lkuppdf/ASIC+PDFW?opendocument&key =ASIC_AR_05_pdf> accessed 1/10/06.

[452] For example, the ASIC's successes with respect to HIH Insurance include declarations of contravention of statutory civil penalty provisions against many actors (eg. against non-executive director Mr Adler, resulting in a $450,000 pecuniary penalty, shared aggregate liability for an approximately $8 million compensation order and 20 years disqualification); along with numerous criminal convictions (eg. 4.5 years imprisonment for Adler). Compare the class action shareholder suit, which has suffered two interlocutory defeats — Justice Tamberlin stating in the latter that there were "substantial and pervasive" deficiencies that would "warrant the striking out of the entire Application and Statement of Claim" (although he refrained from doing so): *Johnstone v HIH Insurance Limited* [2004] FCA 1414 at [27]). Of the original 14 defendants, the class action is now proceeding against the former chief executive officer alone. See "deListed, HIH Insurance Ltd", deListed, BRG Pacific Pty Limited (Internet) <http://www.delisted.com.au/ CompanyDisplay.aspx?id=3953> accessed 8/10/06.

[453] See generally Farrar, above n 51.

## IV. Conclusion

Arguably the true value of the independent director for New Zealand lies in its proclamation of our conformity with international best practice. Therefore, despite the lack of concrete substantiation of independent directors' greater aptness for increasing managerial (or majority shareholder) accountability or improving corporate performance, and despite our differing ownership paradigm and absence of apparent governance problems, board independence will remain a fundamental tenet of our corporate governance regime. As such, the concrete rudiments of best executing this reform will be highly apropos to achieving the alleged benefits.

New Zealand's exchange-based approach arguably best reconciles the demands for certainty and flexibility. Moreover, the latitude of our relatively fact-specific definition of independence, and the recognition of prejudice from association with major shareholders, are probably necessary definitional facets given our smaller director pool and different corporate ownership. Conversely, 'independence' might require greater attention to the (admittedly partially inevitable) prejudice arising from social ties, and it is unclear whether one-third independence will suffice to inspire international confidence in light of stronger responses overseas. Ultimately, however, independence is subjective, and so the efficacy of independent directors — to realise either shareholder value and/or investor confidence — will depend on the incentive for directors to manifest the requisite independence in fact.

This reality promises wide-spread implications. Unless board independence is to be an empty gesture of *attempted* investor placation, structural and behavioural impediments to independent directors' sought-after functioning will necessitate affirmative enforcement action. Non-legal incentives are unlikely to (be seen to) suffice, but independent directors' duty of care might well serve to compel a progressive monitoring role. Yet this encounters a primary raison d'être of independence: a disempowered (minority) shareholder constituency. Therefore, the state's intervention may develop from prescribing the composition and role of the board, to enforcing it in practice as well. The 'universally acknowledged truth' of the independent director solution may, in the end, require a substantial alteration to our

company law model. Whether the threat of ‘international economic irrelevance’[454] is enough to justify such an upheaval is a matter very open to debate.

[454] Ibid 392.

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