Pros & cons of independent directors

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This topic really is part of the sweeping concept of corporate governance and the issue of Board function, make up and delivery and corporate governance changes both from commercial, organisational and regulatory requirements. It is about the evolution of governance standards and acknowledgement that there is no 'right' governance model and that the governance of entities cannot be regulated or decreed to provide failsafe governance; that the traditional benchmarks of experience and skill, integrity, duty of care and diligence, avoiding conflict and meeting fiduciary obligations are the inherent requirement in any Board. The issue as well in this paper is one of ‘independent director’ as a criteria and 'independent judgement' as a quality, and the factors that might or might not deliver this.

"Independent Director' has different connotations in the co-operative and corporate world; in the debate rarely is the matter of the perceived lack of independence of co-operative directors analysed. In fact it could be argued that co-operative directors have an untenable conflict of interest in that they are the major owners and beneficiaries of the business that they direct and govern. Obviously this 'compromised situation' is enabled by statute but despite that directors must avoid conflict, both by practice and declaration. However there are counter views; that this owner/control nexus is one of the most effective governance models and that the directors are close to member needs and as well benefit no more than any other member. However this governor/owner/user situation is a major challenge to the function and decision-making of co-operatives, especially in this new market environment of the commercial and organisational evolution of co-operatives – many are not what they once were.

Independent Directors in the Corporate World

In the corporate world the matter of governance has been highlighted by the high profile failures of, for example, Enron, HIH, Tyco, WorldCom, OneTel, etc. and increasingly regulatory standards are imposing requirements on the structure of corporate boards. One such requirement is the number and qualification of independent directors. Aust has not yet followed US/EU recommendation for the number of independents (and there is some apprehension on this) but the ASX Corporate Governance recommendations as a guide are that a majority of directors are independents. In 2006 a large international survey found that independence of directors was viewed as the most important corporate governance issue.

There are seven criteria for an ‘independent director’ in the ASX principles but, in summary, in the corporate world in Aust an independent director is one with no direct or indirect connection to the business entity and is not a substantial shareholder (less than 5%). Of the top 250 Australian companies 38 % have majority of independents and all but 8% have some. If a company does not have a majority it must acknowledge that it does not comply with these ASX guidelines. This acknowledgement can be a stigma.

Reasons for independent directors - the role of any director is to scrutinise the highest decision makers within the firm – that management decisions are consistent with enhancing member/shareholder value.

- selected to provide specialist skills
- add diversity to the board, to change the culture of a unitary Board
- provide an independent appraisal – separation of ownership and control

- corporate experience and leadership qualities
- to provide expertise, explicitly to support the CEO
- status/credibility to governance model – to present the public face of the business
- as chair –provide leadership, vision

The general impression is that independents are appointed to assist the Board in monitoring and directing management and that governance is better for it. The concept of 'independence' is powerful; is the delivery? Below are some 'worst case' case studies of corporate failure

Is it independence ?

	Enron	Worldcom	Tyco	OneTel	HIH	Air NZ
Independents	82%	73%	83%	63%	58%	100%
Non executive chair	yes	yes	no	yes	yes	yes
Board Size	17	11	12	8	12	14
Independent audit cm'ttee	yes	yes	yes	yes	75%	yes

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Is it skill?

Enron Directors

-former CEO of insurance company
- " " " international bank
- hedge fund manager
- Asian financier
- economist, former head of US Commodities Future Trading

HIH Directors

- former senior partner in major accounting firm
- former partner in major accounting firm
- " " and consultant to major law firm
- Queens Counsel
- International expert in liability insurance
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source © Competitive Dynamics

There is an accepted thinking that independent Directors are good for Boards; it seems a given, in that they are independent, not in conflict and are selected for skill set and experience. On this basis and on the back of these current trends in high profile corporate failure (albeit a small percentage of all businesses), regulators are imposing guidelines with the implication that this governance model is the answer. However, with this trend there are strong counter arguments developing against the *carte blanc* value of independents. Generally there is a relationship between poor governance structure and poor performance and independents are only a part of the game. In this increasing requirement for 'independence' there is the counter view that the close connection between a director's self interest and the interest of the company need not be bad for corporate governance practice.

There is some doubt whether having 'independents directors' is the panacea that it is thought to be.

The cons of independent directors - (these issues are from the corporate arena but the same matters have relevance to co-operatives**)**

- their interests are 'artificial' compared to executives/management people who are more aware of the companies performance and have more experience.

- lack relevant experience and hence tend to be more conservative

- thought to be unaffected by self interest and, with that, interest in company performance is disconnected

- business is risk taking, it is felt those with a sense of loyalty (long serving, business familiarity and incentive) will work harder than independents who have nothing to gain and everything to lose, i.e. status, reputation

- the main and fundamental cause for poor financial decisions stems from one reason : *they are spending other peoples money*

- time of service is a moderator of independence ; *paternalism*

- there are as well subtle ways to compromise independence –
  (1) one such is significant director networking, often social, amongst a small elite.
  (2) by being part of a strong team, desire to maintain group cohesiveness –this can evolve into a trend to socialise
  (3) how truly independent are the directors who sit on many boards - the 'select', the 'elite'

Independent directors are not the assurance of sound governance; however independence of judgement is a key quality, whether it is in corporate or co-operative entities.

The Co-operative Act has requirements on directors

Section 206(1)

(2) a person is not qualified to be a director of a co-operative unless he or she is;

(a) an active member of the co-operative or representative of a body corporate unless which is an active member of the co-operative ("an active member director")
(b) an employee of the co-operative or a person qualified as provided by then rules ("an independent director")

Section 206 (3)

(1) A simple majority of directors must be active member directors. However, this subsection does not prevent the rules of the co-operative from requiring that a greater number than a simple majority be active member Directors.

In a comment on this from Tony Addison he notes that section 206(1)(b) means that a co-operative can set up in the rules the criteria which qualifies the persons or employee to be a director. This gives the co-operative flexibility as to how wide or narrow the members want the Director qualification rule to be.

Board composition and changes in governance in agricultural co-operatives

Co-operatives traditionally have boards comprised of directors from the member base only. The next progression, but not accepted by all, is that the Executive Manager/CEO should as well sit on the Board as a Director. The rationale here is that it is practical, since the CEO attends all meetings and provides the information and that obviously management is inextricably tied to decision-making and should have the same fiduciary and statutory obligations relative to those decision outcomes. However some would argue that this is the beginning of vested interest/conflict of the CEO and lack of independence for the Board as a whole. Most analyses of corporate governance focus on the responsibility of Boards to manage the 'agency' problem - that managers are not necessarily good agents of the owners and that self-interest , status seeking and “rent” extraction is their main motive.

However some governance appraisal assesses that co-op directors and the model of owner controlled Boards advance corporate governance in that

1. self interest and interests aligned to the owners drives performance
2. close owner control monitors management better
3. founding tenets/ philosophy – the tradition of “societal” responsibility to deliver members expectation
4. democratic communication and obligation – close to members –listen to and understand, empathy with owners, more so than corporate directors.

So if there is governance advantage in close control by member owners, why is this model changing, what goes wrong? What are the reasons for changes to agricultural co-operative Boards and the introduction of outside, independent directors?

- The co-operative model functions most purely with a homogeneous owner/user /control base with a single function in a primary market and defined geographic locality – first stage co-operative evolution
- Co-operatives are changing as businesses in response to the market and new skills are needed on the board
- At times this market re-alignment or co-operative re-organisation might require new leadership, vision, direction.

- Co-operatives do have allocation problems which reflect political influence and conflict of interest – pressure from owners to distribute funds and have less retained capital for ongoing investment- "horizon " problems as well; lack of willingness to invest for the distant future.

- With growth co-operatives have decision-making problems; the political pressure of trying to meet the expectations of a large and diverse member base

- Co-operatives and democratic control are effective at short term delivery, those with immediate benefits to members. However long term delivery is an outcome of 'strategy', the most important role of a board. This new commercial strategy is a new field for traditional directors and as well takes the member owned business into another arena- it is complex decision-making

- The member pool for directors does perhaps not have the diversity and skill base to draw upon and the education/election/selection process does perhaps not deliver the skills required, and there is a low level of member participation.

- Commercial and geographic diversity, new business units and business complexity in response to market pressures (business evolution) introduces a new separateness and disunity of ownership and control. Heterogeneity and diversity enters the ownership pool and can polarise the director base.

- This business diversity and complexity, can be a strength – leading to specialisation within the business with specialist and skilled management

- However it is also a weakness in a traditional board– it should lead to diversity of board experience and decisions but leads to an unsure, introverted board; complexity leads to confusion (even in management), then weakness and then dominance by management and leadership cliques; management takes over.

- These are the 'agency' problems and must be understood by co-operative decision-makers

- In the corporate world analysts and the market monitor business performance – co-operatives finances and performance are monitored by the Board and directors need the independence, skill and experience to do so

- Experienced directors from a diverse background enhance the development and performance of all directors - the performance and culture of the whole board improves

These comments are some general ones that reflect on issues in co-operative governance ('the agency issues') but perhaps emphasise the greater challenges to co-operatives that move on in a very commercial and aggressive market orientated, risk taking direction. Co-operative Boards have to broaden their skill base and experience and add to their inherent nature, as the owners, to be independent of management. In this intensification of the commercialisation of co-operative businesses there must be caution that the business does not expand beyond the member's needs or the member's ability to fund and hence both economic benefits are not delivered and the economic risk is compounded.

Owners are still the best judge of what is best for themselves and their money; farmers are astute business people but readily acknowledge, as anyone should, when their skills need to be complemented .However the directors should be ever watchful that this quest for business scale and position, for market share and other such business measures does not detract from member value, does not deliver. Value return is often not measured because ownership is at nominal value and much unallocated equity is held in co-operatives. There is often too much buffer for poor performance.

Members are often too forgiving of co-operative performance (or lack of) because the entity is there as well to provide the service to them; they value its custodial and historic contribution and the intangible quality of being 'collective'. Members cannot leave with their money, they need the services, they think long term and performance is not measured by a critical market. This leads to one of the great risks in co-operative governance, especially in this new era of commercial and organisational change; that the trend to re-position the business does not lead to wealth creation but rather ownership, value and even price transfer; between the members, between the members and their agents (management) and to other players in the supply chain. .Farmers directors must have an understanding of co-operatives and their problems and challenges and ensure that independent directors, needed for their specialist skills and expertise, are not attracted like moths to the glow of the commercial market, risk the business because it is not their money and become a non independent clique because of their commonality with management.

This is not a diatribe against independent directors. They are important and increasingly so but governance is evolutionary as businesses change and there is concern in the corporate world that mandating governance will compromise the performance of individual and distinct business entities. In co-operatives we should be conscious that there is more to member return than investment return and that the quest for business positioning by the business experts, managers and introduced outside experts, does not erode the core values that provide the cohesiveness in co-operatives and lead to the demise of the co-operative. The main risk is diversity, complexity and geographic spread. The drivers for the restructure of co-operatives are invariably management.

What is success for a co-operative? .Since members are so highly reliant on them could success simply be not having failed in this ruthless competitive environment where commercial adjustment is ongoing and the lifespan of most business is not that long anyway. Are the pressures and tensions nothing other than normal and when we talk of the evolution of co-operatives is it as other businesses go through. There is however one difference and it is that co-operatives really are special organisational systems with their owners as users and commercial change and tension puts pressure on this "organisation". It must at times re-align, reorganise itself. It is the duties of the directors, though good governance to get this evolutionary response to market tension right in the commercial and organisational (ownership) sense to ensure that the co-operative is enduring. *Good governance means the right directors*.

References

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