THE COMPLEX RELATION BETWEEN
DIRECTOR INDEPENDENCE AND BOARD EFFECTIVENESS

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Abstract

Throughout the world, reform initiatives have been set up to fix perceived and actual corporate governance shortcomings. One of the proposed remedies has been to improve the independence of the board of directors. The main purpose of this paper is to examine the issue of independence as one element to improve board effectiveness. In doing this, the focus is mainly on the monitoring role, and to a lesser extent on the strategic role of the board of directors, without denying however, the importance of other functions.

A comparison of the definitions of independence provided by the corporate governance codes and recommendations reveals that they approach the concept of independence mainly from a formal point of view, where independence equals being in a position free of any possible conflicts of interest. It is stated that this approach does not capture all the aspects of independence and that independence can not be an end in itself. Instead of emphasising independence, we hypothesise that to ensure board effectiveness, a board of directors is needed which, among other things, vigilantly monitors the company and pursues an objective decision-making process.

Without neglecting the importance of other elements in achieving this two-fold goal, we highlight the need for directors to have the “right attitude” and discuss the issue of “complementarity”. The first element implies that each director should be a critical thinker, with an independent mind so that he is able to exercise an objective judgement. The second element refers to the facilitating role of a complementary board of directors in reaching an objective decision-making and monitoring process. Evidence based on 60 in-depth interviews with Belgian directors points to the importance of this latter element.
1. “Independence” increasingly seen as a crucial corporate governance component

In response to the burst of the Internet bubble and the wave of scandals in both the US and Europe, there has been quite a lot of interest in corporate governance. World-wide, initiatives have been taken to improve corporate governance, as one of the remedies to rebuild trust. Even for the mass media, corporate governance has become a headline topic.

Undoubtedly, this increased attention is justified, as some of the recent American and European corporate scandals contain shortcomings of corporate governance. In the case of Enron for instance, the role of the board of directors in the energy provider’s collapse has been thoroughly examined by the US Senate Permanent Subcommittee on Investigations. In its conclusion, the Subcommittee states that it “identified more than a dozen red flags that should have [alarmed] the Enron Board to ask hard questions, examine Enron policies, and consider changing course. Those red flags were not heeded. In too many instances, by going along with questionable practices and relying on management and auditor representations, the Enron Board failed to provide the prudent oversight and checks and balances that its fiduciary obligations required and a company like Enron needed” (United States Senate, 2002, p.59). Surprisingly however, some of those companies, like Enron, were at first sight good adherents of the basic principles of corporate governance.

One of the main issues that have been addressed by recent reform initiatives, is the independence of the board of directors. There is little doubt about the primacy of this condition. It is commonly accepted that a ‘lack of monitoring by independent, disinterested non-executive directors […] has been a major cause for the various corporate scandals that we have witnessed.

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3 This is not to say that those meltdowns were only a board failure. Other market players are certainly to blame too. John C. Coffee (2002) for instance, argues in this respect that the Enron debacle was more about gatekeeper failure (the “reputational capital” of some intermediaries no longer served as a guarantee for effective monitoring) than board failure.
(High Level Group, 2002, p.60)”. However, there exists a lot of disagreement on what constitutes an independent board.

The main purpose of this paper lays in the demystification of the concept of independence in order to understand its real foundations and importance. In doing so, we will come up with an alternative approach towards board effectiveness which integrates both “hard” and “soft” elements. The structure of the paper is as follows. In section 2, we present the policy changes of the recent reform initiatives with respect to the number or proportion of independent directors sitting on the board and its committees. This is followed then, in section 3, by an extensive analysis of existing as well as recently proposed definitions of independence. Based upon this analysis, it will be made clear that these definitions do not grasp the full story of what constitutes independence (section 4).

The main hypothesis of this paper will be presented in section 5. Limited to the board’s monitoring and service task, it will be argued that board effectiveness can only be obtained by a board of directors which pursues an objective decision-making process and monitors the company vigilantly. Without neglecting the importance of other elements to achieve this goal, the rest of the paper will then focus on two aspects. The first of it, the need for having directors on board with the right attitude will be presented in section 6, followed by a discussion of its relation to the concept of (formal) independence (section 7) and some tentative remarks with respect to measuring and evaluating its application (section 8). The second element, the importance of having a complementary board, will be discussed in section 9. Finally, we end this paper with a conclusion and discussion (section 10) and some proposals for further research (section 11).
2. Scandalitis reaction 1: increasing the number of independent directors

A first vital remedy put forward was an increase in the number of independent directors.\(^4\) In the US, the proposed new listing requirements of the NYSE (2003) and NASDAQ (2003, p.2) stipulate that, with the exception of controlled companies,\(^5\) a majority of the board must be independent. The Business Roundtable (2002, p. 12) and the Conference Board Commission on Public Trust and Private Enterprise (2003, p.16) go even further and recommend that every board should be composed of a substantial majority of independent directors. In the UK, the Combined Code on Corporate Governance of July 2003 provides that, “except for smaller companies,\(^6\) at least half of the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent (Financial Reporting Council, 2003, provision A.3.2)”. Before, the Combined Code (Financial Reporting Council, 2002) only stipulated implicitly that at least one third of the board be comprised of independent directors. In the Netherlands, the recent preliminary code of the Commission Tabaksblat recommends as best practice that all members of the supervisory board, with the exception of maximum one person, be independent (Commissie Corporate Governance, 2003).\(^7\)

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\(^4\) This issue has certainly been addressed by previous corporate governance codes too (e.g. the Viénot II Report in France, or the Nørby Report & Recommendations in Denmark). For an extensive review of the existing European codes up till 2001, see Weil, Gotshal & Manges (2002, p.53-55 and annex V). The focus here, however, is on the recent reform initiatives after the corporate scandals as there are: the Sarbanes-Oxley Act of 2002, the new corporate governance listing requirements of the NYSE and NASDAQ, the report of the High Level Group of Company Law Experts, the revised UK Combined Code on Corporate Governance and the concept code of the Dutch Commission on Corporate Governance.

\(^5\) A controlled company is a company in which 50% of the voting power is held by an individual, group or another company.

\(^6\) According to the definition adopted in the Combined Code, a smaller company is one that is below the FTSE 350 throughout the year immediately prior to the reporting year.

\(^7\) Of course, this is to be seen from the perspective that it mainly relates to two-tier boards where the supervisory board is composed of only outsiders.
At EU level, the High Level Group of Company Law Experts (2002, p.60) did not express a view as to how the full board (be it a one-tier or two-tier board) should be constituted. Instead, they only recommend that “listed companies should be required to ensure that the nomination and remuneration of directors and the audit of the accounting for the company’s performance within the board are decided upon by exclusively non-executive or supervisory directors who are in the majority independent” (High Level Group, 2002, recommendation III.10, p.11). As was already observed by Fama & Jensen (1983), non-executive directors have especially an important monitoring role with respect to those areas, where executive directors clearly have conflicts of interest.

Similar measures have therefore been taken or proposed by the other reform initiatives too. United States Congress (2002, p.32) adopted the most sweeping approach, by mandating by law that every public company installs an audit committee comprised of solely independent directors. The NYSE proposals require the same with respect to nominating and compensation committees\(^8\), again with an exception for controlled companies. In the UK, the revised Combined Code also recommends listed companies to establish an audit and remuneration committee composed of only independent non-executive directors (Financial Reporting Council, 2003, provision B.2.1 and C.3.1). With respect to nomination committees, it is less strict. These committees should only consist of a majority of independent non-executive directors (Financial Reporting Council, 2003, provision A.4.1). Finally, the concept code of the Commission Tabaksblat (Commissie Corporate Governance, 2003, p.17) considers as best practice the establishment, within the supervisory board, of separate audit, remuneration and nomination committees.

\(^8\) The NASDAQ proposals (2003, p.3) differ in this matter. Under the proposed rules, approval of director nominations and CEO compensation should either be done by independent nominating, respectively compensation committees (with the possibility of one non-independent director being member of these committees under special conditions) or by a majority of the independent directors. Here too, controlled companies are exempt.
committees, consisting of at least three directors, with a maximum of one non-independent member.  

These recommendations have gained widespread support, although the empirical evidence on the impact of independent directors on firm performance is not conclusive. Bhagat & Black (1999) for instance, found in their survey on the relationship between board composition and firm performance that boards of large US listed companies with a majority of independent directors behave differently in a number of ways, but that this not always increases firm value. Overall, “there is no convincing evidence that greater board independence correlates with greater firm profitability or faster growth” (Bhagat & Black, 1999, p.1). Neither do the meta-analyses of Daily et al. (1998) provide evidence of a substantive relationship. Finally, a very recent study of Victor Dulewicz and Peter Herbert (2003) comes to the conclusion that there is no relationship between company performance and the proportion (be it 33% or 50%) of non-executive directors on UK PLC boards.  

3. Scandalitis reaction 2: tougher requirements to qualify as independent director

Together with an increase in the proportion of independent directors on the board and its committees, the list of demands to qualify as independent director is getting bigger and more

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9 Again, we should be aware of the different role independent directors have when sitting on a one-tier or two-tier board. From an agency theory perspective, the rationale for independent separate board committees is much higher in a one-tier board, because of the schizophrenic position (being principal and agent) of the internal directors. In a two-tier board, the focus of the supervisory board is naturally much more on control. There exist however other reasons (independence from the reference shareholder, presence of former executives in the supervisory board, board efficiency) that justify the establishment of separate board committees. As we will see in section 4, this difference will also have its consequences on how independence is defined.

10 It should be noted however that most of these studies use performance data from the nineties, an era in which there were still more insider-dominated boards. It can therefore be dangerous to link those data to current code provisions and recommendations.
stringent too. Most of the recent proposals pay a lot of attention to this issue and adopt a more extensive and restrictive definition of independence. This seems to express a belief, present throughout the business community, in the potential of independent directors to prevent future scandals. As a result, expectations with regard to independent directors are soaring, although it is still a question mark whether they will be able to live up to these expectations.

As a first step in our exposition, we compare some of the proposed definitions of independence. For the purpose of this comparison, we will rely on several sources: on the one hand, the Weil, Gotshal & Manges study (2002), which covers the European corporate governance codes until 2001 (see Appendix 1); on the other hand, some recent definitions, adopted or proposed by the High Level Group of Company Law Experts (2002), the revised UK Combined Code (Financial Reporting Council, 2003), based on the Higgs report (Derek Higgs, 2003), the Commission Tabaksblat in the Netherlands (Commissie Corporate Governance, 2003), the Sarbanes-Oxley Act (2002), the NYSE (2003) and NASDAQ (2003). An overview of these latter definitions can be found in Appendix 2. On the basis of these data the following observations can be made:

**Observation 1:** Almost all definitions are formulated in a negative way and list elements that disqualify a director of being considered independent.

Except for one, all of the documents that treat the issue of independence focus on those elements that prevent a director from being independent. Instead of giving a positive definition of what constitutes independence, they mostly try to define those circumstances or relationships that imply non-independence. One of the most comprehensive definitions in this respect is the definition adopted by the PIRC Shareholder Voting Guidelines, which includes up to 16 elements that disqualify a director of being considered independent. Additionally, it can be observed that the more recent definitions (those devised after the scandals) treat those elements in much more detail.
Observation 2: Almost all definitions approach the concept of independence from a formal, structural point of view, in a sense that independence seems to equal being constantly in a position free of any possible conflict of interest.

This characteristic tends to go hand in hand with the previous observation. Most of the elements of each definition, and certainly those presented as part of a list, seem to be formal in essence. There is a clear lack of attention for, what we could call, “soft” factors of independence, like character, attitude, etc. Instead, the main focus is on the requirements that an independent director cannot be an active or former employee or member of the management, a (representative of a) reference shareholder, a professional adviser, a supplier, customer or other business relation, or closely related to any of the previous parties, etc. In fact, what these definitions try to do, is to make sure that any conflict between the personal interests of an independent director and those of the company is avoided. Hence for instance, the comprehensiveness of the PIRC definition.

Two remarks should be made. First of all, it should be noted that most of these documents do not blindly advocate a formal definition of independence. In fact, 20 of the 36 definitions under consideration do make reference, be it explicit or implicit, to their belief that independence cannot be grasped by a formal definition alone, by giving a list of elements that disqualify a director of being considered independent. These references, which mention “the ability to make an independent or objective judgement” or “to exercise their duty in an independent manner”, are however limited. The prime focus remains on the formal definition.

Secondly, we would like to note that the current approach towards independence differs from the earlier adopted approach of situational independence. In Belgium for instance, Company Law prescribed in the past (article 524) that a board of directors faced with a conflict of interest had to appoint three directors, who were considered independent with regard to that particular situation. For each subsequent situation, this could lead to the appointment of different
independent directors. The new Corporate Governance Law of August 2\textsuperscript{nd} of 2002, however, changed this practice in favour of the appointment of several structurally independent directors, who can be considered to be independent in all situations. In practice, many Belgian companies had already opted for this solution. For matters of simplicity, we will use the term \textit{formal independence} to refer to both, the situational approach as well as its structural variant, because they both have the formal characteristic in common.

\textbf{Observation 3:} Differences exist between the definitions of independence adopted in the Anglo-Saxon system and in the continental European corporate governance system. In the first one, independence is especially defined as being independent from management, whereas the continental European system emphasises equally (or more) the independence from the reference shareholder.

Of course, these differences do not come as a surprise, as it can easily be understood how each system pays special attention to avoiding those conflicts of interest that are the most relevant and dangerous. In the managerial capitalism, which is inherent to the Anglo-Saxon system, the most obvious threat is the pursuit of self-interest by the management. On the contrary, in the reference shareholder model, often found in the Continental European system, the perils related to the presence of a majority shareholder can take the form of harmful intra-group transactions, a restrain on growth, etc. (Van den Berghe & De Ridder, 1999). Nonetheless, whatever the corporate governance situation, independence has always to do with the concentration of power, because this can lead to abusive power in order to capture private benefits at the detriment of corporate benefits and benefits to other parties.

Related to this issue, it should be noted that the role of independent directors is different in a one-tier board, which has a strategic priority, than in a two-tier board, where the priority is foremost monitoring. It is especially in the one-tier board that independent directors are very important because there, the schizophrenic position (being agent as well as principal) of the
executive directors could well jeopardise decision-making and control. A two-tier board automatically eliminates these conflicts of interest. Nevertheless, other possible conflicts of interest – between the reference shareholder and the minority shareholder for instance, or between the shareholder and the other stakeholders (cf. the French and Dutch model) – do still mandate the presence of independent directors in both models.

4. Independence is not enough

Minimising the potential occurrence of conflicts of interest as much as possible is certainly a first step towards rebuilding trust. More than one year after the corporate meltdowns of Enron, Worldcom and others, in-depth analysis has revealed that one of the key issues in the corporate breakdown was the occurrence of conflicts of interest throughout the chain of monitoring. Not only at board or corporate level, but also at the level of the external monitors (auditors, information brokers, regulators, short-term shareholders, …) conflicts of interest seemed to have flourished, leading to situations wherein the personal interests of the parties involved prevailed over corporate and social interests (Van den Berghe & Baelden, 2003). At the same time, the corporate scandals have demonstrated that good governance will not come by writing codes of best practice and monitoring the formal application of these recommendations. Some of these companies complied with all the necessary regulations, but yet, it went wrong.

Nevertheless, the recent reform initiatives still address independence mainly from a box-ticking approach. As was observed in section 3, formal “hard” elements form the basis of these definitions, whereas little attention is being paid to “soft” elements, like character, attitude, independence of mind, etc. This does not mean these reform initiatives have it all wrong. To the contrary, as will be discussed in section 7, this formal approach has its value, certainly as a preliminary step. Besides, given the fact that a more refined definition may not be feasible for the moment, it is understandable that those “soft” elements are not yet incorporated into the corporate
governance codes and laws. However, one should guard against expecting too much of these stricter definitions and requirements. These new proposals alone will not prevent future scandals from happening. Minimising any possible conflicts of interest is an important first step, but is no sufficient condition or guarantee against future corporate breakdown. Investors should therefore, as Nell Minow, co-founder of the Corporate Library, puts it, “be less concerned [about] what the governance policies say, or what [she calls] “résumé independence”, than they are with the practice of independent judgement” (Richards, 2003).

In fact, there are a lot of corporate governance advocates who state the opinion that an independent director should not only find himself formally in the right position, but needs also “something more” than the characteristics determined in the corporate governance codes and recommendations. The terms used to denote this “extra quality” are so divers, that a short overview is appropriate before continuing.

One of the most used terms is independence of mind. This concept clearly captures the idea that independence, rather than being a structural formal concept, is about the character and the spirit of the person under consideration. A good definition of it can be found in the Code of Ethics of the International Federation of Accountants (IFAC). They define independence of mind as “the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism” (IFAC, 2003, p. 9). Essentially, it is about the ability and willingness to make an independent judgement, which is not guaranteed by the definitions of the corporate governance codes and recommendations.

11 We will at several occasions make use of the insights already obtained in the debate about auditor independence, and insert them, whenever useful, to our research about board and director independence.
A similar opinion can be found in the special report of the Conference Board on Corporate Governance Best Practices (Brancato & Plath, 2003, p.18): “[…] directors must not only be independent according to evolving legislative and stock exchange listing standards but also independent in thought and action – qualitatively independent. […] In considering independence, it is necessary to focus not only on whether a director’s background and current activities qualify him or her as independent, but also whether that director can act independently of management.”\footnote{Given that this definition is originated in a US setting, it is clear that the focus is on acting independently from management. (cf. supra, observation 3)} In their opinion, those qualitative aspects of director independence should include the will and the ability to ask the hard questions, and character and integrity in dealing with potential conflict of interest situations (Brancato & Plath, 2003, p. 18).

William T. Allen, former Chancellor of the Delaware Court of Chancery, makes a distinction between objective and subjective independence. Objective independence is defined as having “no objective circumstances that would or might affect the judgement of an ordinary person” (Allen, 1998, p. 4). Subjective independence is seen as a mental state or attitude characterised by “internal fortitude and independence of view that will lead to an evaluation and judgement unaffected by any irrelevant or inappropriate considerations” (Allen, 1998, p. 4).

Other terms used to denote the same concept are: independence of spirit, independence of thought, etc. These terms are then often confronted with what is called structural independence, formal independence, independence of position, etc.

In section 3, we pointed out that most of the corporate governance codes do not pay a lot of attention to these latter aspects of independence. There are however some codes, like the Belgian Recommendations of the Federation of Companies, the Director’s Charter of the Belgian FDA, the Greek Mertzanis Report, the Swedish Shareholders Association Policy and the UK Combined Code (see Appendix 1), who mention that some or all directors must have the capacity
to make independent judgements. The recently developed guidelines for non-executive directors of the Belgian Directors’ Institute (2003) recommend that a good (non-executive) director strives constantly for an independent attitude. The Italian Preda Report states that directors shall act and decide autonomously, which means that their decisions are taken in the light of their unbiased assessment of the facts in the interest of the generality of shareholders. Finally, the ISC Statement of Best Practice explicitly defines independent as being free from bias, involvement or partiality, etc. 13

Whether these aspects constitute the “real” independence or whether they refer to something already beyond independence and should be denoted with another term, is open for discussion. The conclusion up till now is that there exists an expectation gap between what is expected of these new independence requirements and their practical relevance. Formal independence is no sufficient condition to guarantee that directors, and boards as a whole, will do the job they are supposed to do. Hence, it is wrong to think of it as a goal in itself. But independence of mind can neither be the goal, because it is just a state of mind, which has no use, unless it serves something else. So, before continuing, we have to ask ourselves the question: what is the goal? What do we expect from a board of directors? And why do we care about independence?

5. Vigilant monitoring and objective decision-making as the keys to board performance

In general terms, you could say the goal is board effectiveness. However, this is a rather unpractical concept, which simply refers to the degree in which a board reaches its objectives. Therefore, the concept of board effectiveness will need further elaboration according to the role each board plays within its organisation. Because of the diversity in these roles this may be

13 As we saw in section 3, this is however not the ground tone of the independence debate in the corporate governance codes and recommendations. Such stipulations are rather exceptional.
extremely complicated. Humphry Hung (1998) for instance identifies six different roles and consequently suggests that the measurement of board effectiveness should be reconsidered in line with these roles. Further more, the relative weight of each role will vary according to the structure of the board. One-tier and two-tier boards clearly have a different combination of roles. In this paper we will focus on those roles for which the issue of independence seems most relevant. This is the case mainly for the monitoring role and to a lesser extent for the strategic role of the board. With respect to these two central tasks, we will argue in favour of the following hypothesis:

**Hypothesis 1**: To ensure board effectiveness, a board of directors is needed which pursues an objective decision-making process and monitors the company vigilantly.

Boards of directors have to make all kind of decisions, be it with regard to an investment decision, a decision to dismiss the CEO, etc., or be it in the form of a judgement or advice. Each of these decisions or judgements implies trading-off different alternative courses or strategies for action in order to achieve an objective consensus. However, in the corporate governance literature, not much attention has been paid to the board of directors as a decision-making group. The study by Forbes & Milliken (1999) is one of the first that used this approach explicitly. They characterise boards of directors as “large, elite, and episodic decision-making groups that face complex tasks pertaining to strategic-issue processing” (Forbes & Milliken, 1999, p. 492). Nor is the concept of objectivity treated much. Consequently, we will also search for clues in other disciplines, like science, (legal) philosophy, psychology, … .

In legal philosophy for example, the issue of objective decision-making has been an important issue with respect to a judge’s ability to make truly objective decisions. For a judge, this means his or her decision is not influenced by some personal characteristics, such as political persuasion, race, ideology, gender, or economic background (Hanson, 2003). Further, in the field of the media, objectivity involves seeking all sides of a story (Davis, 2002). Finally, for a
scientist, to be objective means he has to check the circumstances of his experiment accurately and describe his findings in a reliable matter (Rip & Dijs, 1996).

In the mind of most, objectivity has to do with observing things from an outside, undetached, impartial, unbiased, neutral … position. Thomas Nagel, a renowned philosopher who wrote extensively on the subject, calls it “the view from nowhere” (Nagel, 1986). But at the same time, it is commonly acknowledged that real objectivity does not exist. In the end, total detachment is not reachable, in part because we all have our own particular view of the world, which is influenced by the person we are and the place we live. Beyond, the human mind itself restrains us from achieving full objectivity. Human beings have only a limited cognitive capacity. Some of our innate mental processes systematically lead us to make irrational decisions. Sometimes we see patterns in the world when in fact no pattern exists (Dawes, 1988, p. 140). These has led some people, like the philosopher Karl Popper, to attack the traditional notion of objectivity, which is based on the assumption that there exists an outside, objective world waiting to be discovered (Popper, 1959). Instead, they specify independence as the degree to which a proposition is shared by a group of people (= intersubjective agreement).

In sum, these different perspectives demonstrate that objectivity is hard to define. Nonetheless, in an attempt to apply this concept on the functioning of a board of directors, we suggest the following definition. A board decision or judgement is objective if all relevant issues have been considered so that it can be taken in the interest of the corporation and if the decision or judgement is not biased by emotions, personal prejudices, special interests or any other possible influence. We do acknowledge that full objectivity can never be reached, but we belief the pursuit of it is, for a board who has to make trade-offs, a desirable goal. Instead of emphasising formal independence, the focus should be on pursuing objective decision-making.

A first tentative support in favour of the need for objective decision-making can be found in some of the analysed corporate governance codes and recommendations. According to the
OECD-principles, for instance, “the board should be able to exercise objective judgement on corporate affairs” (principle V.E.). The Swedish Shareholders Association Policy includes a similar statement and expects the members of the board to have “the capacity to make independent and objective judgements of the company’s operations” (1999, Guideline 2.2). Further, the Italian Preda Report emphasises that the “directors shall act and decide autonomously”, which means their decisions “are taken in the light of his or her unbiased assessment of the facts” (Comitato per la Corporate Governance delle Società Quotate, 1999, paragraph 1.3). Finally, the recent Higgs Report also underlines this point. It recommends “that it should be a provision of the [UK Combined] Code that all directors have to take decisions objectively in the interests of the company […] (Higgs, 2003, p.36)”. “Requiring some board members to be more obviously free from other connections with the company [=formal independence] would thus not be seen as reducing the need for independence of mind from all of them. (Higgs, 2003, p. 36)”

Secondly, some of the definitions about independence of mind (cf. supra) give also supplementary support for our hypothesis. It seems that, in the end, independence of mind, or whatever term is used to denote the same concept, is often correlated with the ability to make an unbiased, impartial, neutral, or objective judgement or decision.

Thirdly, the debate in the field of audit about the independence of the auditor is again a valuable source. The definition of auditor independence adopted by the Exposure Draft of the Independence Standards Board (2000, paragraph 4), which can easily be applied to directors too, does perfectly match our opinion. Independence is there defined as “freedom from those pressures and other factors that compromise, or can reasonably be expected to compromise, an auditor’s [director's] ability to make unbiased audit [board] decisions”. This means an auditor [director] must be free from “those factors that are so significant that they rise to a level where they compromise, or can reasonably be expected to compromise, the auditor’s [director's] ability to make audit [board] decisions without bias – that is, that the pressures and other factors
compromise, or can reasonably be expected to compromise, the auditor’s [director’s] objectivity” (Independence Standards Board, 2000, paragraph 4). Although this is a definition about independence, it does endorse the fact that the purpose is eventually not independence, but objectivity. Independence is only a prerogative in order to facilitate the person or entity in question (be it an auditor, a director, an analyst, ...) to make a judgement or decision as objective as possible.

The pursuit of an objective decision-making process is both with respect to the board’s monitoring role as to its strategic role essential. The recent wave of scandals have revealed, however, that given the risk that the management or other employees of the company pursue their own interests, there is a clear need to stress that a board of directors should especially be vigilant in its monitoring task. “To ensure maximum board effectiveness, boards need to shift their entire emphasis – they can no longer be just “advisors” who wait for management to come to them (Brancato & Plath, 2002, p. 11).” “An independent, effective, vigorous, and diligent board of directors is the key to a corporation’s corporate governance. (Brancato & Plath, 2002, p.18).”

Because of its importance, we did stress this factor separately in our hypothesis. Besides, it is not clear whether the pursuit of an objective decision-making process alone will activate directors sufficiently to be vigilant monitors. Objectivity does imply that the decision is based on all the relevant facts, but the question is whether this characterisation also includes that the decision-maker himself has to make sure he has all the information at his disposal. When the directors of Enron and other collapsed companies were questioned about their role in the breakdown, they often responded that they felt no responsibility because management had not given them all the necessary information. Hence, they did not know about the problems or fraud. Because of the schizophrenic position of the management, however, it should be clear that this responsibility can not be fully delegated to the management. At least, this should be a shared responsibility. This does not mean a director has to collect personally all the necessary data. It
only means that all directors, and the board as a whole, are (also) responsible for making sure they receive them.

6. No vigilant monitoring and objective decision-making without the right attitude

Undoubtedly, realising this two-fold goal of vigilant monitoring and objective decision-making is a complex task, for which no easy solutions are available. It can rightfully be expected that only an optimal combination of different elements will result in a high level of board effectiveness. Some of these elements are obvious. For example, it is rather clear that a board cannot monitor the company or achieve a reasonable objective decision without the right information (cf. supra). But, in order to judge appropriate on the basis of all this information, a director shall also need to be competent and have the necessary skills. Other examples include the role of the chairman, the need for a regular board evaluation, etc.

Without neglecting the importance of these elements, we will focus in this paper on two elements, whose importance we would like to emphasise. The first is the need for individual directors to have the right attitude. The second, which we will discuss later on, is the issue of complementarity.

Hypothesis 2: In order to achieve vigilant monitoring and objective decision-making, the members of a board of directors do not (only) need to be formally independent, but need to have the right attitude. They should be critical thinkers, with an independent mind, who are able to exercise an objective judgement on corporate affairs.

The basic idea of this hypothesis is that an independent director without the right attitude to think and act independently will not be an effective independent director. William T. Allen acknowledges this point when stating that, “in theory, our interest in the independent character of a decision maker is really concerned with his or her true mental state or attitude when the
decision is weighed and made” (Allen, 1998, p. 4). In order to contribute to an objective decision-making process and vigilant monitoring, an (independent) director will need to have the ability and willingness to ask the hard questions, to be critical, and to be as objective as possible.

Both factors, ability and willingness, are important to achieve this right attitude. Without the ability, a director will not know when to object and ask the hard questions. This implies he needs to be competent and should have knowledge of the issue under discussion. But apart from that, he should also possess some general skills that enable him to form an opinion on his own and to communicate it appropriately to the other board members. The Expert Consensus on what constitutes critical thinking (Facione, 1990) found in this respect that the cognitive skills that are at the core of critical thinking include the ability to interpret, analyse, evaluate and infer, the ability to explain what you think and how you arrived at that judgement, and the skill of self-regulation.14

On the other hand, without the willingness, it does not matter whether a director is “able to exercise an objective judgement” (OECD, 1999, principle V.E). A company can have the most competent and experienced people on its board, if they do not have the willingness to use their skills, their contribution will only be minimal. Eventually, it is the character and the critical spirit of the person that leads him to be committed, to allot sufficient time for attending and preparing the meetings, to be alert and ask the hard questions, etc. In the opinion of the Expert Consensus “an ideal critical thinker is habitually inquisitive, well-informed, trustful of reason, open-minded, flexible, fair-minded in evaluation, honest in facing personal biases, prudent in making judgements, willing to reconsider, clear about issues, orderly in complex matters, diligent in seeking relevant information, reasonable in the selection of criteria, focused in inquiry, and persistent in seeking results which are as precise as the subject and the circumstances of inquiry permit (Facione, 1990, p. 14)”. Do these characteristics sound familiar? No wonder, they could

14 A detailed definition of these cognitive skills can be found in Appendix 3.
easily be collected from one of the many listings of director qualifications or guidelines for (non-executive) directors. These so-called affective dispositions are of course only part of any list of director qualifications, but together with the necessary cognitive skills they do provide already a starting point in our search for what constitutes the “right attitude”. Further research will need to refine this issue.

There is however a third factor that should be taken into account, namely the context or environment in which a director has to display this attitude. This factor is equally important because outside factors can block (or stimulate) the personal ability or willingness to think and act independently. In order to understand real-world board behaviour, one should be fully conscious of the fact that a board is composed of human beings that work together as a social system. Without a minimum level of cohesiveness a board can not function. On the other hand, a high level of cohesiveness, accompanied by an absence of cognitive conflict (or task-oriented disagreement) can lead to groupthink, “a dysfunctional mode of group decision making characterised by a reduction in independent thinking and a relentless striving for unanimity among members” (Forbes & Milliken, 1999, p. 496). It is in this respect that Jeffrey Sonnenfeld (2002) stresses the social aspect as the key towards an effective board. In order to build such a board, one should in his opinion: a) create a climate of trust and candour; b) foster a culture of open dissent; c) utilise a fluid portfolio of roles; d) ensure individual accountability; and e) evaluate the board’s performance (Sonnenfeld, 2002, p. 110).

In creating such a facilitating environment where open dissent or cognitive conflict is nurtured and where directors are motivated to challenge management as well as each other, the role of the chairman is extremely important. The latest book of Sir Adrian Cadbury (2002) is completely devoted to the subject and underlines the responsibility of the chairmen in reaching board effectiveness. “They are the connecting link between governance principles and the turning of those principles into action (Cadbury, 2002, p. xvii).” It is the chairman who leads the
discussions and who influences board practices the most. Consequently, it is foremost the chairman who should have this right attitude of critical thinking and independence of mind. Beyond that, there exist also a rationale for having several of these “independent” directors on a board. Alone, one director will not have enough influence on board functioning and board decision-making. Furthermore, that person’s willingness to ask the hard questions will rapidly sink into oblivion when he or she is the only one really doing so.

7. Does one need to be formally independent in order to have the right attitude?

In the previous section, we described three conditions – the ability, the willingness and the presence of a facilitating environment – which are necessary so that individual directors have an attitude of critical thinking, independence of mind and objectivity. Until now, these conditions did not include one has to be formally independent. Moreover, in hypothesis 2, we explicitly placed between brackets the word only in the statement that directors “need to (only) to be independent” to open up the possibility for formally non-independent directors to have such an attitude. The question whether this is possible has however not been answered. While in section 4 it was stated already that formal independence is no sufficient condition to guarantee the “right attitude” and board effectiveness, the question at hand in this section is whether formal independence is even a necessary condition for board effectiveness.

In short, the answer to this question can be summarised as follows. In theory, formal independence is no necessary condition to have the “right attitude”, but in practice, it can be a very important indicator and a provisional assurance. Theoretically, being free from any possible conflicts of interest is not needed in order to display a vigilant, critical attitude or to reach an objective decision. Ideally, a really self-critical person is able to identify and transcend his own dependencies to make an objective decision in the interest of the company and its mission (cf. the skill of self-regulation). “An extraordinary person may have this characteristic [of internal
fortitude and independence of view] even when required to decide matters affecting his own
important interests (Allen, 1998, p. 4).”

However, as the former Chancellor of the Delaware Court of Chancery continues, “we
design legal systems not with extraordinary persons in mind, but for people with average moral
character and diligence” (Allen, 1998, p. 4). In dealing with such people it would not be
appropriate to assume that conflicts of interest will not influence their independent, objective
attitude. Formally independent directors, with no material conflict of interest with regard to the
subject at hand, will have an easier job to reach an objective judgement. Their distance to the
subject is naturally greater. And although formal independence is not a sufficient guarantee, it
does provide a provisional assurance. The change that an independent director will make an
independent or objective judgement will not be a 100%, but will nonetheless be greater than the
change that a non-independent director will reach it. However, this does not mean that non-
independent directors can not be independent of mind at all. There are in fact a lot of matters
where objective decision-making is in their interest. But there will certainly be situations too
where their judgement can be biased by personal interests or the interests of the people they
represent. For that reason, external parties will be reluctant to give non-independent directors a
big change of being independent of mind. It is the task of the non-independent directors
themselves to make extra efforts in order to show external parties their objective attitude.

Secondly, independence of mind, objectivity, critical thinking, etc. are concepts that
denote a mental state or attitude. Such a mental state is difficult to observe or measure, especially
for external parties who have no direct contact with the directors themselves. Therefore, these
features do not have much practical use for designing our legal systems, which we basically try to
build “in a way in which observable features are employed rather than unobservable ones (Allen,
1998, p.4)” . This might also be the reason why the corporate governance codes and laws do not
address or stress this issue extensively (cf. section 3).
Based on the two previous arguments, there exists a strong case in favour of not abandoning the concept of formal independence, despite its weaknesses and insufficiency. Though it should not be seen as an end in itself, it should remain – especially with respect to the monitoring task of the board of directors – an important feature of any corporate governance system. The reason for this can be found in the fact that it is an observable criterion of independence that can be used as an a-priori indicator of an independent attitude. For practical matters, it can be resorted under the factor context from the previous section, because conflicting interests can be seen as outside factors influencing the personal ability and willingness of the person involved to display an independent, critical attitude. Consequently, in accordance with the requirements of the previous section, a sufficient number of (formally) independent directors and the presence of an independent chairman are important conditions for creating an environment of open dissent. Interested parties (an investor, a monitor, etc.) can never be sure that a board of directors will vigilantly monitor the company and pursue an objective decision-making process, but the fact that a substantial part of the board is comprised of independent directors, including the chairman of the board, does add some assurance that this will be the case.

8. In search for a reference framework to measure independence of mind

By now, it seems the circle is closed. We started with questioning the usefulness of the concept of formal independence. At the end, however, our analysis reconfirmed the importance of having independent directors on a board, be it not as a direct necessary condition for board effectiveness, but as an indicative element of good governance. Nevertheless, this does not mean one should advocate the standstill. To the contrary, the opportunity is now to complement the formal, “hard” approach with a focus on the social, attitudinal, “soft” elements of board effectiveness. Corporate governance codes and recommendations should further stress – as they are starting to do – the importance of those qualitative, soft aspects and further research will have
to bring light to those aspects of board functioning that are not yet known very well. Boards of directors, finally, should go beyond compliance in order to build a truly effective board. In sum, the emphasis should be on *substance over form*.

One of the challenges ahead is how to bridge the gap between evaluating formal independence and evaluating a genuine independent attitude of vigilant monitoring and objective decision-making. As was remarked earlier, unobservable features do not have much practical use. So could it not be possible to come up with a framework to measure and evaluate the independence of mind, the objectivity, …, in short, the mental attitude of a director? At first, this seems extremely difficult because we can not observe this feature directly and may easily disagree whether it is present in a particular person. Moreover, measuring the a priori intention of someone does not give any guarantee with respect to the future behaviour of that person. Consequently, the only practical way to observe directly the presence of this right attitude within a director may be through an ex post evaluation. This is exactly what Nell Minow of the Corporate Library does: “We do not evaluate directors on what they say they do; we evaluate them on what they actually do. We grade them on how well they handle the toughest calls” (Richards, 2003).” It seems that because the actual behaviour of directors can only be observed after the facts, that an ex post evaluation, and the outlook of such a thorough evaluation, is our best shot for success.

Nevertheless, it may be possible to have some assurances beforehand about the change that a specific director will display a critical attitude and contribute to the effectiveness of the board. We stressed already the importance of formal independence as an ex ante indicator and the need for a facilitating environment. In case a company would be sufficiently transparent with respect to these issues – by putting forward the measures it takes to create such a facilitating environment for instance –, this could provide a supplementary assurance for external parties.
At board level, the most obvious issue that deserves special attention is the selection process. If an external party could be assured that the board of directors will (try to) select only the right people, with the appropriate competencies, experience, skills and moral character that makes them able and willing critical thinkers, this would be a big step forward. At least with respect to evaluating the cognitive skills of someone, there seems room for creating specific selection techniques. Doing this would suppose however that the selection process for non-executive directors be as professional as it is for executives, which is at this point far from true. On the other hand, with regard to the affective dispositions that influence the willingness to take a though stance, it is even more difficult to device an effective and practical evaluation tool. Here, a good starting point seems to imply one verifies the intention of the candidate and looks for signs in his personal track record of integrity and moral character. The fact that the person under consideration seems to care a lot about his or her own reputation will also influence his willingness to do the job right. Especially if the ex post evaluation is taken seriously, this mechanism, based upon the ‘reputational capital’ of the directors, may be an effective tool to realise the “right” attitude. Further research with respect to these issues is however needed, which will probably require insights from the fields of psychology and group dynamics to be incorporated in the corporate governance debate.

In figure 1, all proposed elements for evaluating independence of mind are summarised. Of course, this is only a provisional scheme in an attempt to device a framework for evaluating the “right” attitude. The most important conclusion is perhaps the observed difference between those features that are a priori verifiable and those that can only be checked a posteriori. Independence of mind is clearly a feature that can only be verified a posteriori, notwithstanding the fact that some assuring indications can be found a priori. This difference may even be generalised to encompass most of the elements of good corporate governance. “Hard”, formal elements, like the number of independent directors on the board, can then be seen as a priori
verifiable, whereas the “soft” elements of board effectiveness, like board culture, directors’ attitudes, etc., are rather a posteriori verifiable. The general challenge consists then of searching for ways to put these “soft” factors into practice.

9. The importance of a complementary board

Notwithstanding the emphasis on a facilitating environment, the focus in the previous sections was mainly on the individual director and the contribution his attitude can make in achieving a vigilant monitoring stance and an objective decision-making process. In this section however, we would like to discuss an aspect with respect to the board as a whole. By doing this, we would like to stress that it is eventually the board as group that has to monitor the company and has to come to a decision which is as objective as possible. In the end, a board acts as a collegial body where decisions are generally taken by consensus, preceded by a discussion to centralise the different opinions if necessary. We will therefore defend the following hypothesis.

Hypothesis 3: A complementary board of directors facilitates objective decision-making and vigilant monitoring.

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The basic assumption of this hypothesis is that if a sufficient number of different points of view are put together with the goal of reaching a consensus decision, this decision will be more objective. In a similar way, the presence of different perspectives will increase the monitoring quality. The reason for this lays in the fact that – notwithstanding the personal efforts of a director to pursue an objective judgement – personal background and affinities can still influence his perspective. Bringing together individuals with divers – or better complementary – competencies, background and affinities, can eliminate these idiosyncratic subjective to a certain extent. Besides, the presence of a variety of perspectives will naturally help to create an environment of cognitive conflict. Bringing together a group of “clones”, to the contrary, will not contribute much to board performance.

The importance of this factor was recently confirmed during 60 in-depth interviews with board members of 30 Belgian listed companies. In one of the questions they were asked to sum up elements of a good board of directors. Appendix 4 gives an overview of the findings. For a detailed discussion of them, we refer to Van den Berghe & Levrau (2003). They show that, in general, the directors themselves pay most attention to the quality of the board meetings, followed by the composition of the board of directors. Within this last group, the sub-elements diversity and complementarity clearly take the lead. Taken together, they are even the second most reported answer, equally cited as the quality of the discussion/debate and only preceded by the aspect of information. Although it is not possible to provide any conclusive evidence on the basis of this qualitative research, this does gives some indications of the importance Belgian directors attach to the issue of diversity and complementarity.

The presence of different perspectives, competencies and skills does however not guarantee that they will also be used effectively. Forbes & Milliken (1999, p. 495) refer to this as “the board’s ability to tap the knowledge and skills available to it and then apply them to its tasks”. In order to achieve this “board members must elicit and respect each others’ expertise,
build upon each other’s contributions, and seek to combine their insights in creative, synergistic ways (Forbes & Milliken, 1999, p. 496). This demonstrates again the importance “soft” factors play in creating an effective board. Without the chemistry to combine the knowledge of all directors into one, the quality of the board’s decisions will not benefit much from the available complementarity. Again however, this feature is difficult to evaluate ex ante.

10. Conclusion, discussion and further research

The aim of this paper was to provide an initial step to demystify the concept of independence. Our analysis of about 40 corporate governance codes and recommendations with respect to the definition of independence has revealed two common characteristics. Firstly, these definitions formulate independence mainly in a negative way by listing those elements that disqualify a director of being considered independent. Secondly, almost all definitions approach the concept of independence from a formal, structural point of view, in a sense that independence seems to equal being in a position free of any possible conflicts of interest, at all times. Although this structural requirement contrasts with the earlier adopted approach in Belgium of situational independence – where independent directors were each time indicated depending on the particular situation at hand – both approaches emphasise the formal aspects. Neither of them pays much attention to so-called “soft” aspects of independence, like attitude and character, which resort more under independence of mind. As some of the recent scandals have shown, without these “soft” elements, the mere presence of formally independent directors will not prevent future breaches of corporate governance and corporate success. Minimising the potential occurrence of conflicts of interest is certainly a first step towards rebuilding trust but is no guarantee for board effectiveness. In other words, it is questionable whether there exists a direct relation between formal independence and board effectiveness.
Finding the true nature of the relation between formal independence and board effectiveness is however not easy, because this depends to a great extent on the specific roles of a board. These roles can be so divers that it is difficult to give a standard description of board effectiveness. Moreover, the relevance of each role will vary according to the structure of the corporate governance model. In a one-tier board, the priority is rather strategic, whereas in a two-tier board, the priority of the supervisory board is foremost monitoring. Not surprisingly, our analysis of the corporate governance codes and recommendations revealed a similar difference between the definitions of independence adopted in the Anglo-Saxon system, which focus on independence from management, and in the Continental European system, which equally emphasise the independence from the reference shareholder(s). Without neglecting the diversity in roles, the focus in this study was on the monitoring and in a lesser extent on the strategic role of the board.

Based upon a qualitative analysis of the most cited “soft” aspects of independence and after careful consultation of similar approaches in other disciplines (philosophy, psychology, auditing, …) we stated the hypothesis that to ensure board effectiveness with respect to these two functions, a board of directors needs to pursue an objective decision-making process. Although full objectivity can never be reached, this means a board should try to take a decision (or make a judgement) unbiased by emotions, personal prejudices, special interests or any other possible influence, and only after all relevant issues have been considered in order for it to be taken in the interest of the company.

Of course, good governance will not come by pursuing an objective decision-making process alone. For many decisions, certainly those where sufficient information is available, this may be a good approach, but for other decisions other elements may be of equal or superior importance. It was discussed for example, that with respect to the monitoring task of the board, it is above all important that the directors are vigilant. Because of the schizophrenic position of the
executive directors (being principal and agent), the non-executives themselves have to verify whether they have all the relevant information at their disposal. When this is not the case or when they have doubts, they themselves should make sure they receive it. Other elements, like the need for vision and entrepreneurial guts, were however not discussed in this paper. Nonetheless, these might be important in case the board of directors has to decide upon entering a new market for instance. In this situation, pursuing an objective decision will initially be useful to delimit uncertainty as much as possible (by asking a market study, etc.). But when, in the end, there is still doubt about the feasibility of the project, only the presence of some directors with vision and entrepreneurial guts will contribute to making the right decision.

To reach such an objective decision-making process and a vigilant monitoring process, many conditions have to be conjointly fulfilled. This requires for instance that the directors receive timely and reliable information and that they are competent to understand that information. In this paper, the focus was on two additional aspects. First of all, it was argued that board effectiveness can not be achieved if the directors do not have the right attitude. They should be critical thinkers, with an independent mind, able to exercise an objective judgement on corporate affairs. In order to reach such an attitude, the directors themselves do not only need to have the ability and willingness to be independent of mind, but the environment in which they have to display this attitude should be facilitating and stimulating too. It is for example much easier to be independent of mind when there exists a culture of open dissent. In this respect, the role of the chairman is extremely important.

Another element relates to the question whether a director needs to be formally independent in order to reach an independent, objective attitude. In theory, this does not seem necessary because a really self-critical person may even be able to identify and transcend his own dependencies. In practice, however, it is appropriate to accept as a general assumption that a non-independent director will have a smaller change of being independent of mind. In some
occasions, he or she may be independent of mind, but at other times, the possible conflicts of interest a non-independent director might have, can be seen as outside factors blocking his or her ability and willingness to think and act independently. Besides, our legal systems are not designed with extraordinary persons in mind, but for people with average moral character.

In addition, it is very difficult, certainly for external parties, to judge the attitude or mental state of a particular person. The a priori intention of a director to be independent of mind does not give any guarantee with respect to his actual behaviour. Three consequences stem from this. Firstly, this strengthens the case in favour of using formal independence as an ex ante indicator of an independent attitude. Although it does not give any guarantee, it is at least an observable feature and it does add an element of assurance to our judgement of a person’s attitude. Secondly, this increases the need for a facilitating environment in which directors are stimulated to be independent of mind. We referred to the role of the chairman of the board in this respect, but also the presence of a substantial number of (formally) independent directors is an important element. One independent director alone will not have much influence on board practices and board decision-making. Finally, it seems that some elements of board effectiveness are not observable a priori whereas others are. This is an important conclusion because it points to the difficulties one can expect when complementing the formal “hard” approach towards board effectiveness with a focus on the social, attitudinal, “soft” elements.

Notwithstanding the previous conclusion, we tried to come up with a preliminary framework for judging and evaluating independence of mind. Because this feature is a priori unobservable, the only practical way to observe this directly is after the facts, through an ex post evaluation. Nonetheless, we argued that it is possible to find some underlying indicators and drivers, who can give an assurance ex ante. Apart from the issue of formal independence, we made reference to the importance of the selection process. During this process it is possible to judge the candidate’s cognitive skills and affective dispositions, his personal track record and moral intention to display an independent attitude, and the level of importance he or she attaches
to preservation of his or her own reputation. Coupled with the outlook of an ex post evaluation, these elements can figure as important a priori indicators, especially for internal use. External parties, however, can not make that judgement themselves and have to rely on the information they receive. A large degree of transparency with regard to these issues, together with the presence of a substantial number of formally independent directors, is the best signal they can rely on. Further research is however needed to refine this framework into an interesting instrument for pre-nomination discussions and post-nomination evaluations.

A second element that was emphasised with respect to achieving the proposed goal of objective decision-making and vigilant monitoring, was the issue of complementarity. Both theoretically as empirically, we argued that a complementary board of directors, composed of directors with distinct background, competencies and experiences, helps to eliminate the idiosyncratic subjective perspectives each director will always have. In a similar way, the presence of a variety of perspectives will naturally create an environment of cognitive conflict, under the condition however that the board succeeds in using this diversity effectively.

Finally, emphasising the “right” attitude and the issue of complementarity does not imply that other factors can not influence the degree in which a board of directors will achieve an objective decision-making process and a vigilant monitoring process. Consequently, further research is not only necessary to examine the two previously discussed elements in much more detail, but should also try to bring together all elements that have an impact on the degree in which a board of directors reaches these goals. Equally important however, is the restriction on future research projects to differentiate the concept of board effectiveness in line with the respective roles of the board. The relevance of a particular criterion for board effectiveness will vary according to each role. After all, it is clear that the relation between independence and board effectiveness is more complex than it may seem.

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