An International Comparison of Corporate Governance Models

Gregory Francesco Maassen

SpencerStuart

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A Study on the Formal Independence and Convergence of One-tier and Two-tier Corporate Boards of Directors in the United States of America, the United Kingdom and the Netherlands

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Acknowledgements

This dissertation is all about corporate governance and corporate boards of directors in listed corporations. It has been written for scholars as well as practitioners interested in the international aspects of corporate governance. Some chapters are particularly of interest to readers who are interested in the practical aspects of corporate governance. Chapters five and nine concentrate on the role stock exchanges, legislators and institutional investors play in the international corporate governance arena. Developments in the organization and the composition of boards of directors of listed corporations in the United States, the United Kingdom and the Netherlands are presented in chapters six to eight. The remaining chapters of this study are of interest to scholars who are interested in conflict and consensus perspectives on corporate governance.

During the last four years, I have had the pleasure to become deeply involved in the international discussion on the role of corporate boards of directors in major corporations in the United States, the United Kingdom and several continental European countries. Many things have changed in the field of corporate governance. At the start of this research project, the recommendations of the Cadbury Report were actually just published in England. Several initiatives followed, including those of Greenbury and Hampel in England, Viénot in France and the Peters committee in the Netherlands. It has not always been easy to digest all international developments, especially when one has to describe the latest developments in governance systems on two different continents. Fortunately, I received much support from my supervisors prof. Maljers and prof. van den Bosch. They made it possible for me to work in the United States during a large part of this research. Moreover, they always emphasized the need to work closely together and they did understand my strengths and weaknesses. Their practical and theoretical experience with boards of directors strongly contributed to this research. I also would like to thank prof. Wallage for his comments on an article on audit committees in the Netherlands and prof. Moerland for his comments on an article on the convergence of one-tier and two-tier boards. This research also strongly benefited from the comments of prof. Honée on the description of the Dutch corporate governance system in this study. In addition, I'm grateful to prof. van Manen for his never ending enthusiasm and Wim Helmink of the Ministery of Economic Affairs for his support. I also would like to thank dr. Bob Tricker who accepted an article on the supposed independence of two-tier boards in his journal "International Corporate Governance" and I'm grateful to dr. Eric Gedajlovic for his contribution to new corporate governance projects at Erasmus University in the Netherlands.

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Gregory Francesco Maassen

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Chapter 1: The Introduction to This Study

"The origins of the word governance can be found in the Latin 'gubernare' meaning to rule or to steer, and the Greek Κυβερυησις which means . . . (steering, eds.). Norbert Wiener used the Greek root as the basis for cybernetics - the science of control in man and machine. The idea of steersman - the person at the helm - is a particularly helpful insight into the reality of governance."

Source: Tricker (1984:9).

1.1 Introduction

According to Cochran and Wartick (1988), corporate governance is an umbrella term that covers many aspects related to concepts, theories and practices of boards of directors and their executive and non-executive directors. It is a field that concentrates on the relationship between boards, stockholders, top management, regulators, auditors and other stakeholders. A related definition of corporate governance comes from Monks and Minow (1995). These authors state: "What is corporate governance? It is the relationship among various participants in determining the direction and performance of corporations" (Monks and Minow, 1995:1). In this definition, the group of participants includes shareholders, management, members of board of directors, employees, customers, suppliers, creditors and other interest groups. The World Bank states: "Corporate governance refers to that blend of law, regulation and appropriate voluntary private sector practices which enable the corporation to attract financial and human capital, perform efficiently, and thereby perpetuate itself by generating long-term economic value for its shareholders, while respecting the interests of stakeholders and society as a whole. The principal characteristics of effective corporate governance are: transparency (disclosure of relevant financial and operational information and internal processes of management oversight and control); protection and enforceability of the rights and prerogatives of all shareholders; and, directors capable of independently approving the corporation's strategy and major business plans and decisions, and of independently hiring management, monitoring management's performance and integrity, and replacing management when necessary" (www.worldbank.org, Jan 1999). Sheridan and Kendall (1992), suggest that " . . . different countries have different ideas as to what constitutes good corporate governance [. . .] nowhere does anyone appear to have defined corporate governance per se." These and other definitions indicate that the field of corporate governance is a rich one. As stated by Tricker (1993:2), " . . . corporate governance can mean many things to those concerned. Institutional investors have a different perspective from corporate regulators, board members from researchers. Insights can be drawn from the professional and theoretical worlds of organisational behavior, jurisprudence, financial economics, accountancy and auditing, as well as from the experiential worlds of director behaviour and board practices." See also Moerland (1997) for an overview of corporate governance definitions.

Corporate Governance and the Role of Corporate Boards of Directors

Of importance to this study is the recognition that boards of directors are essential to most definitions of corporate governance. Although Demb and Neubauer (1992a:16) explicate that it is much too narrow a focus to equate corporate governance with the role of boards of directors, these and other authors indicate that corporate boards are important to the accountability of corporations and the way corporations comply with modern ethical and economic standards. Cadbury (1993:9) states that it " . . . is the ability of boards of directors to combine leadership with control and effectiveness with accountability that will primarily determine how well . . . companies meet society's expectations of them."

Williams and Shapiro (1979) see strong and effective boards as valuable corporate assets. According to these authors, "enhancing the perception of corporate accountability and thus reducing the pressure for a government role in corporate decision making is a vital goal. However, both management and directors also share another, more fundamental, goal – to develop a board which can bring the best, most informed and most objective advice available . . ." (Williams and Shapiro, 1979:14-15). Wang and Dewhirst (1992) even proclaim that the board of directors is one of the greatest organizational innovations in the field of corporate governance. Yet, similar to the discussion on the meaning of corporate governance, it is not easy to give an unambiguous and narrow definition of the role of corporate boards of directors. Distinctive perspectives of corporate governance - such as the shareholder and stakeholder perspectives - give rise to differences in the definition of boards' roles in the governance of corporations. Seen from a shareholder perspective of corporate governance, corporate boards are understood as internal devices to align the interests of management and shareholders. In addition, boards of directors are seen as devices that alleviate agency problems associated with Berle and Means' (1932) classical dilemma of the separation of ownership from control in listed corporations (Judge, 1989; Walsh and Seward, 1990; Rediker and Seth, 1995). According to these authors, a shareholder perspective of corporate governance rests upon the assumptions that corporations are private property and that executive and non-executive directors are fiduciaries of corporations' shareholders. Moreover, Gedajlovic (1993) suggests that a shareholder perspective of corporate governance defines corporations as entities that are subordinate to the interests of shareholders (see also figure 1.1).

The stakeholder perspective of corporate governance departs from assumptions underlying a shareholder perspective of corporate governance. This perspective sees corporations as superordinate entities in which a variety of parties have vested legitimate interests. As such, this perspective also recognizes interests of stakeholders other than stockholders that need to be protected by corporate boards of directors. This also has implications for the roles of corporate boards in the governance of corporations. As stated by Gedajlovic (1993:53): "The executive (and non-executive directors, eds.) must balance the pluralistic claims of those with a vested interest in the corporation in order to secure their required contribution." Seen from a stakeholder perspective of corporate governance, these vested interests are not necessarily limited to those of shareholders.

Figure 1.1
Shareholder and Stakeholder Perspectives of Corporate Governance

Shareholder: ⟷	Stakeholder:
• executive and non-executive directors are fiduciaries of shareholders;	• executive and non-executive directors are fiduciaries of a variety of claimants;
• executive and non-executive directors should adopt policies consistent with the maximization of shareholder wealth;	• executive and non-executive directors should balance pluralistic claims;
• profitability and economic efficiency are the standards of efficacy;	• profitability and economic efficiency are important in addition to survival, long-term growth and stability;
• the corporation is subordinate to the interests of shareholders.	• the corporation is seen as a superordinate entity.

Source: based on Gedajlovic (1993:53-54).

When these competing perspectives are taken into consideration, a clear answer to what the roles of corporate directors should be in the field of corporate governance is not easily given. The roles of corporate boards may ultimately depend on specific circumstances and the way stakeholders and directors themselves define the responsibilities of boards of directors and those of affiliated corporations. Notwithstanding, this indicates that definitions of corporate governance and definitions of the roles of corporate boards can move on a continuum based on a purely economic shareholder view to a purely stakeholder view of corporate governance (see also figure 1.1).

1.2 The Organization of Corporate Boards of Directors

In addition to the diversity of board roles in the governance of corporations, differences in the leadership structure, the organization structure and the composition of boards provide a wide range of prototypes of corporate board models in Western countries. Regional and international developments have resulted in two leading approaches to the organization of corporate boards: the Anglo-Saxon one-tier board model and the continental European two-tier board model.

In general, Anglo-Saxon countries such as the US, the UK and Canada have adopted variants of the one-tier board model. In this model, executive directors and non-executive directors operate together in one organizational layer (the so-called one-tier board). Some one-tier boards are dominated by a majority of executive directors while others are composed of a majority of non-executive directors. In addition, one-tier boards can have a board leadership structure that separates the CEO and chair positions of the board. One-tier boards can also operate with a board leadership structure that combines the roles of the CEO and the chairman. This is called CEO-duality. One-tier boards also make often use of board committees like audit, remuneration and nomination committees. Continental European countries such as Germany, Finland and the Netherlands have adopted variants of the two-tier board model. In this model, an additional organizational layer has been designed to separate the executive function of the board from its monitoring function. The supervisory board (the upper layer) is entirely composed of non-executive supervisory directors who may represent labor, the government and/or institutional investors. The management board (the lower layer) is usually composed of executive managing directors. It is generally not accepted by corporation laws that corporate statutes foresee in the possibility that directors combine the CEO and chairman roles in two-tier boards. Because the CEO has no seat in the supervisory board, its board leadership structure is formally independent from the executive function of the board. This is particularly the case in two-tier boards in the Netherlands and Germany. In variants of the two-tier board model in these countries, executive managing directors are not entitled to have a position in the supervisory board of the corporation. Part II of this study presents a more detailed overview of the characteristics of one-tier boards in the US and the UK and those of two-tier boards in the Netherlands.

1.3 Alternative Approaches to the Formal Independence of Corporate Boards of Directors

To align the interests between management, shareholders and other interest groups, Guthrie and Turnbull (1995:83) conclude that " . . . various strategies are used by various cultures to bond the agents who process corporate information to those who use it." The Anglo-Saxon and continental European approaches to board organization reflect these differences. As such, one-tier and two-tier board models can be seen as alternative organizational approaches to support the role of boards of directors to align the diverging interests of managers, shareholders and other stakeholders. The effectiveness of corporate boards to align these pluralistic interests is associated with the so-called formal independence of boards. The formal independence of corporate boards of directors can be conceptualized by Fama and Jensen's (1983) distinction between the "decision management" and the "decision control" activities of corporate boards. Decision management refers to the tasks of executive directors to initiate and implement strategic decisions. Decision control refers to the tasks of non-executive directors to ratify and monitor executive decisions. An independent board structure separates the activities of executive and non-executive directors. Seen from a more practical point of view, an independent board model minimizes the role of management in the ratification and monitoring of corporate decisions. As suggested by Davis (1991:73), "an independent structure is one in which an autonomous board of directors is established to monitor organizational strategic decisions and performance. [. . .] Thus, in its purest form, management plays an extremely minor role in the independent structure." Chapter two of this study further elaborates on the distinction between decision management and decision control.

Design Strategies of Board Organization

The concept of board independence is mostly essential to the shareholder perspective of corporate governance. This perspective is based on the assumption that the more independent directors are from management, the better they will serve the interests of shareholders. The influence of management on the board of directors can be reduced by at least three design strategies. First, corporations can modify their board leadership structures by securing that CEO and chairman roles are fulfilled by different individuals. An independent board leadership structure can be also supported by the appointment of non-executive lead directors to the board (see § 6.4.3. in chapter six). Second, the formal independence of corporate boards can be supported by the appointment of non-executive directors who have not been formerly affiliated with the corporation. Third, the formal independence of boards can be facilitated by the formation of board committees and the formal division of board roles through one or more hierarchical layers in the organization of the board (see also table 1.1).

Table 1.1
Design Strategies and the Formal Independence of Corporate Boards

• Board leadership:	• the separation of CEO and chair positions; • the appointment of lead directors.
• Composition:	• the appointment of a majority of non-executive directors; • the appointment of a majority of non-formerly affiliated non-executive directors.
• Structure:	• the separation of directors in management and supervisory boards; • the formation of independent oversight board committees.

The international corporate governance debate largely builds on the assumption that these design strategies improve the formal independence of boards. In addition, design strategies give rise to differences in the way one-tier and two-tier board models facilitate the formal independence of boards of directors. The next two paragraphs further elaborate on the formal independence of one-tier and two-tier boards.

The Formal Independence of One-Tier Boards

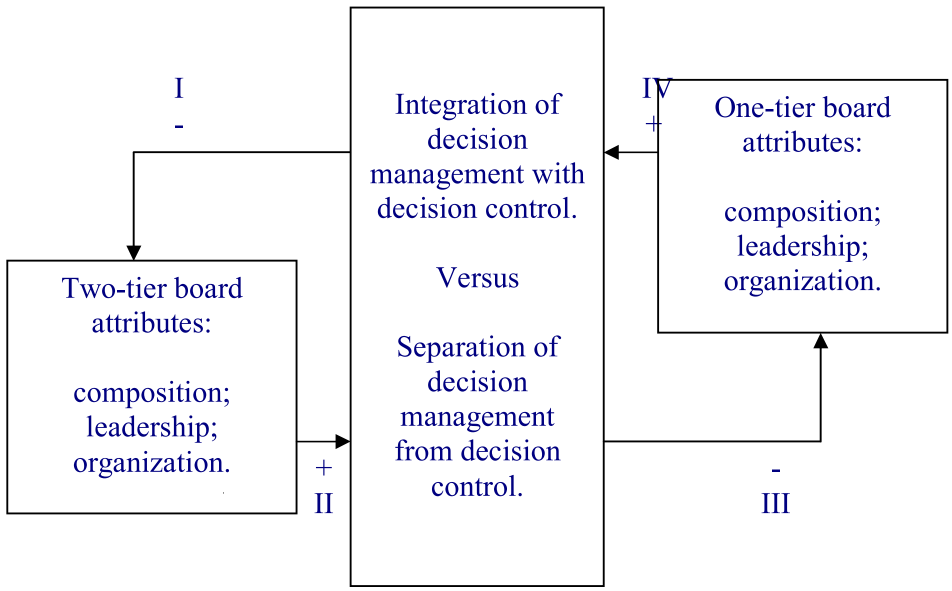
Directors who operate in Anglo-Saxon countries have been targeted by commentators, financial analysts, environmentalists, employees and investors to apply design strategies that improve the formal independence of one-tier boards. In practice, business failures and excessive directors' pay have put pressures on corporate boards to become more independently structured and composed of management. For example, stock exchanges that are fighting for a piece of the international financial pie are flexing their muscles to alter listing requirements that aim at changes in the formal organization of one-tier boards. Regulators are continuously amending voluntary codes of best practices as well and are introducing guidelines to improve the formal independence of one-tier corporate boards. Especially one-tier boards with a majority of executive directors have been put under pressure to increase the number of independent non-executive directors. Another criticism is related to the practice of directors to combine the influential position of the CEO with the leadership of the board in one-tier boards (Boyd, 1995). According to Sheridan and Kendall (1992:161): "There is an uncomfortable untidiness in having one group of directors supervising or controlling another group on the same board, which is meant to be the collective for managing the company." Consequently, directors who operate with a board that is composed of a majority of executive directors who are also chaired by the CEO are under pressure to modify the composition and the structure of their boards in Anglo-Saxon countries.

The Formal Independence of Two-Tier Boards

A relatively new development in the debate on the formal independence of one-tier boards is the recognition that two-tier boards represent a board model that clearly separates executive directors' management tasks from supervisory directors' monitoring tasks. According to Tricker (1984) and Cadbury (1995), the two-tier board model represents a board structure in which the three design strategies are formally applied (see also table 1.1). First, as previously noted, the two-tier board model has two organizational layers that separate the executive function of the management board from the monitoring function of the supervisory board. It is suggested by Sheridan and Kendall (1992) that the formal separation of these boards transparently defines responsibilities of executive managing directors and non-executive supervisory directors. Second, the supervisory board (the upper layer of the two-tier board) is entirely composed of non-executive supervisory directors, which secures an independent composition of the board (Pic, 1995). The management board is entirely composed of executive managing directors. Third, two-tier boards also provide a formal separation of CEO and chairman roles (Demb and Neubauer, 1992a). As such, decision management and decision control are formally separated in the two-tier board model.

The formal independence of one-tier and two-tier boards is indicated by figure 1.2. Arrow I in this figure suggests that the integration of decision management with decision control is negatively associated with design strategies applied to the composition, the leadership structure and the organization structure of two-tier boards. These board attributes are positively associated with the separation of decision management from decision control (arrow II). Figure 1.2 suggests also an opposite theoretical train of thought on the organization of one-tier boards.

Figure 1.2
The Formal Independence of Board Models



Arrow III suggests that common design strategies related to the attributes of one-tier boards are negatively associated with the formal independence of one-tier boards. In other words, while reformers seek independent board structures that clearly separate management tasks from boards' monitoring tasks, design strategies related to the composition, the leadership and the structure of one-tier boards may facilitate the integration of decision management with decision control. This is indicated by arrow IV in figure 1.2.

These observations raise research questions on the formal independence of one-tier and two-tier board models. These are explored in more detail in paragraph 1.4.

1.4 Research Questions on the Formal Independence of Corporate Board Models

A comparative approach to the organization of corporate boards gives rise to a number of practical and theoretical research questions that are related to the formal independence of one-tier and two-tier boards in Anglo-Saxon and continental European countries. The central research questions in this study can be divided into three interrelated topics. The first group of research questions concentrates on the separation of decision management from decision control in one-tier and two-tier boards. The second group of research questions concentrates on the integration of these steps in decision making in one-tier and two-tier boards. The third group of research questions focuses on the transformation and convergence of board models.

Research Questions Related to the Separation of Decision Management From Decision Control in Corporate Boards

The first group of research questions concentrates on design strategies that separate decision management from decision control in boards of directors in listed corporations. Related to one-tier boards, this study explores how corporate boards of directors are organized in the US and the UK. It seeks to find what design strategies are used by boards of directors to separate decision management from decision control in these countries. More specifically stated, what types of board leadership structures are established by directors? How are one-tier boards composed and structured? Does the formal organization of boards in the US and the UK hinder the separation of decision management from decision control? In a similar way, the following research questions explore the formal organization of two-tier boards of listed corporations in the Netherlands: what design strategies are used by boards of directors that separate decision management from decision control in the Netherlands? How are supervisory boards composed and structured? How is board leadership organized in Dutch two-tier boards? Does the formal structure of two-tier boards enhance board independence in practice? And, are two-tier board structures an answer to the supposed concentration of power in the hands of executive directors who operate in one-tier boards in the US and the UK?

Research Questions Related to the Integration of Decision Management With Decision Control in Corporate Boards

Although a majority of reformers advocate independent board structures that separate decision management from decision control, others urge the formation of dual board structures that empower management (Donaldson and Davis, 1991, 1994). This approach to board organization opposes the notion that corporate boards can be mainly seen as devices that align the interests of shareholders and management. As indicated in the introduction to this research (paragraph 1.1), a stakeholder perspective of corporate governance sees the corporation as a coalition of vested interests in which executive and non-executive directors balance the pluralistic claims of management, shareholders and other interest groups (Gedajlovic, 1993). In line with this perspective, a relatively new approach to the organization of corporate boards - the stewardship theory - also understands the corporation as coalition of vested interests. Proponents of the stewardship theory oppose the notion that conflicts of interests exist between management, directors and shareholders (Donaldson and Davis, 1991, 1994; Davis et al., 1997; Hung, 1998). The three key actors are seen as a coalition, willing to co-operate and to bargain to achieve long-term growth, stability and profitability. If one assumes that there are no conflicts of interests between these key actors, than there is also no need to establish corporate boards to monitor management and to secure the maximization of shareholder wealth. Instead, the stewardship theory sees corporate boards as valuable strategic devices to maximize shareholder wealth when authority structures are unified and when boards are composed of experienced executive directors who do not suffer from information asymmetries and unnecessary bureaucratic structures that may paralyze the strategic decision making processes of corporations. This opposing point of view may raise a dilemma for reformers and academics who seek to establish formal board structures that maximize shareholder wealth. Finkelstein and D'Aveni (1994:1080) refer to board independence as a "double-edged sword." The detachment and distance required to assure that board judgment is independent and critical may be hindered by directors' responsibility to be closely involved in the initiation and implementation of critical strategic decisions (Demb and Neubauer, 1992a). We call this dilemma the paradox of board involvement. This paradox suggests that design strategies that support the formal independence of corporate boards may hinder the involvement of non-executive directors in the initiation and implementation of decisions.

The second group of research questions further elaborates on the paradox of board involvement. The research questions concentrate on the formal organization of boards and design strategies that integrate decision management with decision control in one-tier and two-tier boards (the so-called duality of corporate boards). Applied to one-tier boards in the US and the UK, this research seeks to find an answer to the following questions: what design strategies are used by directors that integrate decision management with decision control in one-tier boards? What types of board leadership structures are established by boards of directors? Does the composition, the organization and the leadership structure of one-tier boards contribute to the integration of decision management with decision control? Related to the Dutch two-tier board, this study seeks to find an answer to the following questions: what design strategies are used by directors to integrate decision management with decision control in two-tier boards in the Netherlands? What types of board leadership structures are established by supervisory directors in Dutch two-tier boards? Does the composition, the organization and the leadership structure of two-tier boards contribute to the integration of decision management with decision control or does the formal organization of Dutch two-tier boards hinder the integration of decision management with decision control?

Research Questions Related to the Transformation and Convergence of Corporate Boards

The third group of research questions in this study focuses on changes in the formal organization of one-tier and two-tier boards in the US, the UK and the Netherlands. As indicated above, the international call for boardroom reform is strongly reflected by a fierce and ongoing discussion on the formal independence of one-tier boards in Anglo-Saxon countries (Demb and Neubauer, 1992a; Charkham, 1994; Tricker, 1994). Worldwide, one-tier corporate boards of listed corporations are under pressure to change towards an "ideal" independent board type. Stock exchanges play a dominant role in this process by enforcing changes in the attributes of one-tier corporate boards through new listing requirements and more disclosure of board practices. Reform proposals and guidelines include the application of design strategies related to the separation of chief executive and chairman roles and the introduction of senior non-executive directors (lead directors) to corporate boards. The formation of committees by corporate boards is another development that receives much attention from stock exchanges. New listing requirements and voluntary guidelines promote independent audit, remuneration and nomination committees composed partly or entirely of non-executive directors to establish a system of checks and balances in the boardroom. Other changes aim at directors' constituent responsibilities and a reduction of the number of executive directors in the board. These developments indicate that directors who operate in one-tier boards are under pressure to restructure and to reconsider the composition and structure of their boards.

It has been suggested that pressures from regulators, legislators and investigators may result to the transformation of the formal organization of one-tier boards into a more independent structure (Pahn, 1998; Rubach and Sebora, 1998; Maassen and van den Bosch, 1999b). This development raises important research questions. Are recent boardroom reform proposals indicating a process of transformation of one-tier board models towards an independent board model, i.e. the Dutch two-tier model? Are one-tier boards becoming more independently composed and structured as suggested by reformers? Is this process unidirectional or are two-tier boards also influenced by corporate governance developments in Anglo-Saxon countries? In other words, can we discern a process of transformation and convergence of corporate boards in the US, the UK and the Netherlands?

1.5 The Organization of This Study

In summary, the first group of research questions in this study concentrates on design strategies that separate decision management from decision control in boards of listed corporations in the US, the UK and the Netherlands. The second group of questions concentrates on design strategies that integrate decision management with decision control in boards in these countries. The third group of questions focuses on the transformation and convergence of corporate boards. To find answers to the interrelated central research questions, this study is organized as follows (see also table 1.2 for an overview of the organization of this research). Chapter two first elaborates on the diversity of board roles indicated by the literature. This chapter conceptualizes the service roles, the control roles and the strategic roles of boards of directors. These board roles are considered to be part of boards' decision management and decision control activities. The formal independence of corporate boards is understood by a structure that separates decision management from decision control. In addition to a description of the formal independence of board models, chapter two also presents an overview of corporate governance literature and builds on an integrative research framework to capture the complex literature on board involvement in decision making. Based on the literature review, chapter two also distinguishes two competing perspectives of board organization: the conflict and the consensus perspectives of board organization.

Table 1.2
The Organization of This Study

Introduction:	• acknowledgements; • table of contents; • list of tables and figures.
Chapter 1:	• introduction to central research questions, methodology and organization of this research.
Part I: A Theoretical Approach to Board Organization	
Chapter 2:	• literature review of board involvement in decision making and the formal independence of corporate board models.
Chapter 3:	• the independence of corporate boards: a conflict perspective of board organization.
Chapter 4:	• the duality of corporate boards: a consensus perspective of board organization.
Chapter 5:	• the transformation and convergence of one-tier and two-tier board models.
Part II: Empirical Analyses of Changing Board Attributes	
Chapter 6:	• one-tier board attributes in the US.
Chapter 7:	• one-tier board attributes in the UK.
Chapter 8:	• two-tier board attributes in the Netherlands.
Part III: Confronting the Theoretical Model with the Analyses of Changing Board Attributes	
Chapter 9:	• comparing changing board attributes. Reflection on theoretical framework and propositions. Summary, conclusions and recommendations. • references; • curriculum vitae; • publications derived from this research; • summary in Dutch.

These perspectives are applied to build a theoretical framework on the transformation and convergence of board model attributes. Chapter three elaborates on a conflict perspective of board organization to explore the association between board model design strategies and the separation of boards' decision management and decision control roles (board independence). To formalize this approach, chapter three presents assumptions related to the relationship between board model attributes and the formal independence of one-tier and two-tier boards. In sharp contrast to the conventional wisdom on boardroom reform (Walsh and Seward, 1990; Donaldson and Davis, 1994), chapter four elaborates on a consensus perspective of board organization. This chapter presents several assumptions related to the relationship between board model attributes of one-tier and two-tier boards and the integration of decision management with decision control (board duality). Chapter five further builds on chapters three and four. Seen from both conflict and consensus perspectives of board organization, this chapter suggests three propositions on the transformation and convergence of board models. Chapter five concludes Part I of this research with a theoretical framework on the transformation and convergence of board models.

Part II of this research presents empirical findings on developments in board attributes in the US, the UK and the Netherlands. Three longitudinal descriptive studies on country level are presented to describe the formal organization of one-tier and two-tier boards. First, chapter six presents an overview of corporate governance developments in the US between 1981 and 1997. Guided by the Model Business Corporation Act and Delaware's corporation law, this chapter explores changes in one-tier board attributes and the formal independence of boards of directors. An analysis of the governance structure of the largest corporations further completes the study of corporate governance developments in the US. In a similar vein, chapter seven presents an overview of developments in one-tier boards in the UK. Due to the limited availability of data, this research could only reveal information on changes in board attributes between 1992 and 1997. The analyses is based on LSE-corporations. In addition, reports from the Cadbury, Greenbury and Hampel Committees are used to portray developments in the formal structure of one-tier boards of listed corporations in the UK. Chapter eight of this research presents developments in the attributes of two-tier boards of listed corporations in the Netherlands between 1987 and 1998. In addition to the analysis of the governance structure of these corporations, chapter eight also refers to the recommendations of the Peters Committee and other recent corporate governance developments in the Netherlands. Chapter eight concludes part II of this research.

Part III reflects on the theoretical and empirical analyses of board model design in Part II of this study. Chapter nine presents a comparison of changing board attributes and their consequences for the independence of one-tier and two-tier board models in the US, the UK and the Netherlands. This chapter also presents a confrontation between the theoretical model with the analyses of changing board attributes in this study and concludes with a summary, conclusions and recommendations on both theoretical and practical perspectives of board model design.

1.6 The Research Approach of This Study

Although there is an enormous body of prescriptive literature available on how directors should govern corporations and while there is a growing interest in the formal independence of boards from practitioners as well as academics, there are several factors that challenge the research agenda on corporate boards of directors. Zahra and Pearce (1989) conclude that there is still a pressing need to document what boards actually do. Judge (1989) and Judge and Zeithaml (1992) report that researchers simply do not know what boards' roles are in decision making. The factors that challenge the research agenda on boards of directors are discussed in more detail in the following paragraphs.

The Availability of Data

The limited availability of meaningful data makes a study on the formal independence of boards a challenging endeavor. Boards of directors are hard to study, there is a scarcity of data, directors are difficult to approach, are always busy and often conduct their business behind closed boardroom doors. Although stringent disclosure regulations provide detailed information on board practices in annual reports and proxy statements of listed corporations in the US and the UK, information on board practices in these and other countries is still rarely systematically collected for comparative international research purposes. Most databases concentrate on financial data of corporations. When available, corporate governance data is fragmented or difficult to access. The SEC Edgar database - for example - has reported on individual corporations in the format of separate proxy statements and Forms 10K in the US. The database is not designed for comparative, longitudinal research purposes. Fortunately, executive search firms have taken the lead to provide their clientele with detailed information on board practices. Material from Heidrick and Struggles, Korn Ferry International and Spencer Stuart has been used in this study to collect detailed information on corporate governance practices in listed corporations in the US (between 1981 and 1997) and the UK (between 1992 and 1997). Data on board attributes of boards in these countries are presented in chapter six and chapter seven of this research.

The disclosure of board practices is much less developed in (continental) European countries. Due to limited board disclosure regulations in the Netherlands - certainly compared to disclosure standards in the US and the UK - this study relied on a questionnaire sent to fifty chairmen of the largest Dutch corporations in 1996 and fifty chairmen in 1997 to reveal information on the Dutch two-tier board model. The surveys resulted in positive response rates of 60 percent in 1996 (n=30) and 64 percent in 1997 (n=32). In addition to the surveys, information on board composition and board structure has been culled from 1987-1997 annual financial reports of one hundred of the country’s largest listed corporations. These corporations also verified the information on the composition and the structure of their management and supervisory boards. The results of the surveys are presented in chapter eight of this study. The database of the research project in the Netherlands currently contains information on some 14,000 management and supervisory board positions. This study also initiated a survey, sent to all leading stock exchanges in Europe, North- and South-America and Asia in 1997. Stock exchanges were asked to indicate the latest developments in listings rules, codes of best practices and other self-regulatory initiatives in their financial regions. The results of this survey are presented in chapter five of this study.

The Selection of Countries

The corporate governance literature is strongly dominated by research on one-tier corporate boards in the US and the UK. Second in prevalence, but much more less available, are studies on corporate governance models in Germany and Japan. With the exception of a few studies, comparative research on governance systems and board models in (continental) European countries is hardly existent (Charkham, 1994; ICA, 1995; Pic, 1995; Maassen and van den Bosch, 1999a). Although some progress has recently been made to understand the differences between the formal independence of one-tier and two-tier boards, the body of knowledge in this particular field of interest is still limited. Demb and Neubauer (1992a, 1992b) were among the first scholars to publish a comparative study on corporate boards in the US and Europe. Sheridan and Kendall (1992) reported on governance systems in several European countries. Charkham (1994) wrote an influential book on corporate governance in five countries. More recently, the International Capital Markets Group (1995) and Pic (1995) systematically reviewed corporate governance issues from an international perspective. The limited number of comparative studies can be explained by the relative importance of economies in the US, the UK, Japan and Germany. Another reason could be the availability of data and research resources and the unfamiliarity of scholars with corporate governance systems in Europe and other financial regions. In addition to the analysis of board models in the US and the UK, the limited body of research on international corporate governance has stimulated this research project to explore developments in two-tier boards in the Netherlands - a country previously ignored in the internationally oriented corporate governance literature.

The Domination of Anglo-Saxon Perspectives of Corporate Governance Research

The third challenge relates to the magnitude of Anglo-Saxon views of corporate governance in the literature. The existing body of knowledge is dominated by researchers who concentrate on the formal independence of one-tier boards in the US and the UK and who most often apply a shareholder perspective on corporate governance. These studies often concentrate on quantitative research methods to understand the relationship between attributes of boards and firm performance. Placed in the context of the one-tier corporate board model, this stream of research assumes that the structure of the board determines board behavior and therefore leads to changes in organizational performance (Judge, 1989). Interestingly, Pearce and Zahra (1992:417) conclude that the " . . . web of associations among organizational variables is so complex that unidirectional, causal relationships can not be claimed and defended reliably.” In addition, Pettigrew (1992a:178) suggests that “ . . . progress in . . . the study of boards and their directors, has not been helped by over-ambitious attempts to link independent variables such as board composition to outcome variables such as board and firm performance. The research agenda here need not be guided just by studies testing the relative explanatory power of the agency theory or theories of managerial hegemony.” Pettigrew (1992a:178) concludes that the task is perhaps a simpler one to “ . . . redress the overwhelmingly prescriptive bias in this literature, and (to, eds.) begin to provide some basic descriptive findings about boards and their directors.”

The Case Study Approach of This Research

In response to these observations, this study relies on a research method that concentrates on the exploration and classification of corporate governance models, i.e. a case study approach. According to Yin (1989:14), “ . . . the distinctive need for case studies arises out of the desire to understand complex social phenomena . . . real life interventions that are too complex for the survey or experimental strategies.” More specifically, Thurman (1990) indicates the following characteristics of case studies that make the use of this research design particularly useful for this study:

- the phenomena are examined in a natural setting;
- data are collected by multiple means;
- one or few entities (person, group, organization or country) are examined;
- the complexity of the unit is studied intensively;
- case studies are more suitable for the exploration, classification and hypothesis development stages of the knowledge building process; the investigator should have a receptive attitude toward exploration;
- no experimental controls or manipulation are involved;
- the investigator may not specify the set of independent and dependent variables in advance;
- the results derived depend heavily on the integrative powers of the investigator;
- changes in site selection and data collection methods could take place as the investigator develops new hypotheses;
- case research is useful in the study of “why” and “how” questions because these deal with operational links to be traced over time rather than with frequency or incidence;
- the focus is on contemporary events.

Sources: based on Benbasat (1987), quoted in Thurman (1990:54).

The complexity of board independence, the limited body of knowledge on one-tier boards and the fact that the organization and the composition of two-tier boards are relatively unexplored in the literature suggest that there is an ideal match between the characteristics of case study research and the complexity of the central research questions of this study (Eisenhardt, 1989b). As indicated above, case studies are suitable for the exploration, clarification, classification and hypothesis development stages of the knowledge building process (Yin, 1989). In this study, the formal independence of one-tier and two-tier boards is explored in more detail both theoretically as well as empirically in the US, the UK and the Netherlands. The case studies in this research are based on the description and the analyses of board models in these countries. The three studies in this study focus on contemporary events while supporting data for the description of board models is collected by multiple means and the web of associations between board structure and firm performance is understood to be too complex to predefine causal relationships. To explore differences between one-tier and two-tier boards, this research - for example - relies on a combination of previously published board indexes, surveys, archival records and direct observations. It is also important to understand that research findings of this study are method bound. The research findings can only be generalized to the corporations that are included in this study and the findings should primarily be used to clarify and to compare the empirical results with the theoretical framework of this research. As such, the theory developed in part I of this research is used as a template to interpret and to understand the empirical results of this study in parts II and III of this study (Yin, 1989).

The Reliability of Data

Yin (1989) indicates that the goal of a reliability test is to minimize errors and biases in a study. Essential to the reliability of research findings is the accuracy of the data. When possible, this research relies on primary data sources. Information on corporate boards in the US and the UK is culled from publications from executive search firms. The data in these publications is mainly derived from proxy statements and annual reports. This research project did not influence nor control the research methods used by executive search firms that collect information on boards in the US and the UK. As part of the research tradition in these firms, corporations are generally requested to verify the information on their boards before the information is published by executive search firms.

This research project directly controlled the accuracy and reliability of data on corporate boards in the Netherlands. Annual reports and surveys have been used as a primary source of information. To assure the accuracy of data, a summary of findings was sent to the investor relation departments of corporations for verification in 1998. These findings were based on annual reports published between 1987 and 1998. When necessary, adjustments were made to the data set. The fact that the information would be published in booklets and that these would be sent to directors of corporations involved, acted as a strong incentive for representatives of investor relation departments of listed corporations to verify the accuracy of the project’s data files.

1.7 Conclusion

The independence of corporate boards is an important corporate governance issue. To empower non-executive directors, stock exchanges, legislators and other commentators promote changes to existing board structures in Anglo-Saxon countries. The international debate on boardroom reform suggests that the Dutch board model is an interesting alternative governance model to common one-tier board structures in the US and the UK.

Despite these developments and while researchers have made progress in understanding the differences between one-tier and two-tier boards, continental European forms of board organization are still rarely recognized by both reformers as well as researchers in the field of corporate governance (Demb and Neubauer, 1992a, 1992b; Kendall and Sheridan, 1992; Charkham, 1994). This "gap of interest" in the literature, the limited body of knowledge on board models and the contemporary discussion on boardroom reform have stimulated the comparison of one-tier and two-tier boards in this study. This study has several practical and theoretical implications. Seen from a theoretical point of view, this study seeks to explore the relationship between the characteristics of board models and the formal independence of corporate boards. Seen from a more practical point of view, this research also hopes to contribute to the international discussion on board independence by comparing governance systems in Anglo-Saxon and continental European countries, i.e. the US, the UK and the Netherlands. Consistent with Boyd (1995), the comparative focus of this research may generate new insights in the characteristics of the organization of corporate boards and it may offer insights to both practitioners as well as to public policy makers in their effort to reform current board practices (Judge, 1989).

Chapter 2: Literature Review of Board Involvement in Decision Making

2.1 Introduction

The premise that corporate boards are important mechanisms to improve the performance and competitiveness of corporations is receiving support from an increasing number of different and even competing practical and theoretical perspectives on corporate governance. The enormous multi-disciplinary body of prescriptive literature and the growing interest of academics, regulators, institutional investors and others exemplify the diversity of boards' roles in the governance of corporations. As one of the leading theoretical approaches, the agency theory is frequently applied to understand the role of corporate boards to mitigate agency problems. Another leading theory, the resource dependence theory, emphasizes the resource allocation role of corporate boards. The involvement of directors in the strategic course of the corporation is mainly understood in the relatively new stewardship theory. Consistent with the recommendations of Judge (1989) and Hung (1998), these multiple perspectives of board involvement in decision making are presented in this chapter to yield a better understanding of the roles of corporate boards of directors.

Outline

As a means to conceptualize the involvement of boards of directors in the decision making processes of large publicly held corporations, this chapter builds on Fama and Jensen's (1983) decision making model. Paragraph 2.2 presents four steps in this widely applied model and introduces the concepts of decision management and decision control. Based on an overview of the corporate governance literature, paragraph 2.3 relates board roles to the four steps in Fama and Jensen's decision making model. The service roles of directors are associated with decision management. The control roles of directors are associated with decision control. The strategic roles of boards are related to the integration of decision management with decision control. Paragraph 2.3 also presents an integrative model to synthesize the corporate governance literature on board role typologies. Furthermore, this paragraph suggests that the literature on board involvement can be classified in terms of conflict and consensus perspectives of board organization. These theoretical perspectives are examined in chapters three and four of this study to explore the association between board model attributes and the separation and integration of decision management and decision control activities of boards of directors in listed corporations.

Paragraph 2.4 briefly reviews general models of board involvement and presents an integrative research model to capture the complexity of the literature. Another purpose of this integrative model is to guide the focus of this research with respect to the roles of corporate boards, the attributes of one-tier and two-tier boards and the context in which directors operate. This chapter ends with a summary in paragraph 2.5.

2.2 Board Involvement in Decision Making

The introduction in chapter one of this research indicates that corporate governance is a concept that covers many aspects related to the distribution of rights, wealth and power between corporations, directors, regulatory agencies, legislators, employees, suppliers, and other corporate stakeholders. Central to most corporate governance definitions are the roles directors have in the governance and the decision making processes of corporations. The literature suggests that ideas about boards' roles in decision making have changed over time. Initially, the roles of corporate boards were mainly understood in the tradition of the agency theory and its emphasis on the control of power and authority in organizations. More recent definitions of corporate governance and boards' roles reflect on changes in expectations about the roles of corporations in modern society. Stakeholders from a wide array of internal and external interest groups have launched initiatives to make corporations more responsive to stakeholders' rights and wishes. These initiatives range from enhancing shareholder participation in corporate decision making and the alignment of interests of management with the interests of shareholders, to the opposing stakeholder view on industrial democracy, sustainability and corporate social responsibility. As such, constituency groups are continuously challenging the assumption that shareholders are the sole legitimate claimants of (listed) corporations. Green activists mobilize the general public to make corporations aware of the environmental risks associated with corporate activities. Human rights organizations defend guidelines on corporate social standards and corporate investments in politically unstable regions. Employees increasingly demand a bigger voice in corporate decision making. Consequently, stakeholders - and not only shareholders - claim to have legitimate rights to affect corporate outcomes. Corporate boards of directors are responding to these external pressures by the way they are involved in the decision making processes of the corporation and the way they organize their work. As suggested by Steiner (1988:28), "boards are far more involved in company strategic planning, are concerned about how the company is affecting its environment, and how management is reacting to all important environmental forces." The next sections of this paragraph further explore the roles boards of directors can have in the top decision making structure of corporations.

Board Roles in Decision Making

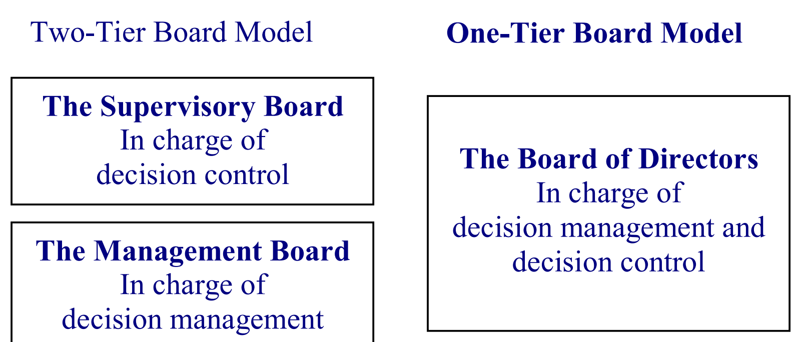
Through the identification of problems and opportunities, the development of alternatives and the execution of corrective actions, boards of directors can respond to pressures from various stakeholders. To formalize boards' involvement in these activities, theoretical models on corporate decision making processes generally identify a sequence of decision making steps. In general, these steps concentrate on the formulation, the implementation and the evaluation/monitoring of decisions (Judge, 1989). The widely applied model of Fama and Jensen (1983) recognizes the following four steps in decision making:

- initiation - the generation of proposals for resource utilization and structuring of contracts;
- ratification - the choice of the decision initiatives to be implemented;
- implementation - the execution of ratified decisions, and;
- monitoring - the measurement of the performance of decision agents and implementation of rewards.

Source: Fama and Jensen (1983:278).

Fama and Jensen (1983) use the term decision management to refer to the combination of the initiation and implementation steps in decision making (steps one and three). The authors use the term decision control to describe the combination of the ratification and monitoring steps in the process of decision making (steps two and four). The recognition that these steps in decision making can be combined into decision management and decision control is of particular interest to this study. Not only does the model recognize that these four steps are particularly found in the formal decision making processes of large listed corporations (Mintzberg, 1973; Fama and Jensen, 1983; Boal and Bryson, 1987). The model is also useful to describe the formal independence of corporate boards of directors. Basically, design strategies that are applied to enhance the formal independence of corporate boards seek to separate decision management from decision control in decision making.

Figure 2.1
The Formal Separation and Integration of Decision Making Steps in Board Model Prototypes



The introduction in chapter one of this research suggests that the two-tier board model is based on a structure that separates these steps in decision making. Decision management is delegated to the managing directors in the executive management board. Decision control lies in the hands of the non-executive supervisory directors in the supervisory board. One-tier boards are formally based on a structure that integrates the four steps in decision making. In other words, one-tier boards formally combine decision management with decision control (see also figure 2.1). Moreover, the distinction between decision management and decision control is useful to understand the roles of boards in decision making. Both the formal independence of boards and the roles of boards of directors are explored in more detail in this chapter.

2.3 The Roles of Corporate Boards of Directors: A Theoretical Classification

The corporate governance literature recognizes different roles of boards of directors in decision making (Gopinath et al., 1994; McNulty and Pettigrew, 1996; Hung, 1998). The resource dependence theory and the stakeholder theory emphasize the resource allocation and boundary spanning roles of corporate boards. Theories originating from organizational economics, such as the agency theory and the legalistic approach, focus on boards' roles to mitigate agency problems and to monitor management. The involvement of directors in the strategic course of the corporation is mainly understood by the stewardship theory.

Zahra and Pearce (1989), Gopinath et al. (1994) and Jonnergård et al. (1997) suggest that these theoretical schools recognize three generally accepted board role categories. These are the service roles, the control roles and the strategic roles of corporate boards of directors. The roles show similarities with the four decision making steps identified by Fama and Jensen (1983). The service roles, derived from the resource dependence theory and stakeholder theory, can be related to the decision management activities of the board. The control roles, as suggested by proponents of the agency theory and the legalistic approach to board organization, strongly focus on the decision control activities of the board. Daily (1991) indicates that these perspectives are not necessarily mutually exclusive. This is also indicated by table 2.1. This table shows that the strategic roles of corporate boards combine boards' decision management and decision control activities. The integration of these roles is mainly understood by the stewardship theory.

Table 2.1
Examples of Theoretical Schools of Board Involvement

Decision management	Decision control	Decision management + decision control
resource dependence theory; stakeholder theory.	agency theory; legalistic approach.	stewardship theory.
Service Roles	Control Roles	Strategic Roles

The relationship between the service, control and strategic roles of boards of directors and the four steps in decision making are explored in more detail in the next sections of this paragraph.

Decision Management and the Service Roles of Boards of Directors

The service roles of boards of directors are predominantly recognized by the resource dependence theory and the stakeholder theory (Pfeffer 1972, 1973; Pfeffer and Salancik, 1978; Freeman and Reed, 1983; Kriger 1988; Boyd 1990; Boeker and Goodstein 1991; Wang, 1991). Within the context of these theories, corporate boards can perform at least the following four service roles:

- the co-opting of external influencers;
- the establishment of contacts (and the raising of funds);
- the enhancement of the organization's reputation, and;
- the giving of advice to organizations.

Source: Mintzberg (1983:81-86).

(1) Central to the first service role is what is called the formal co-optation of organizations. According to Selznick (1966:13), co-optation is ". . . the process of absorbing new elements into the leadership or policy-determining structure of an organization as a means of averting threats to its stability or existence." In their service role of co-opting external influencers, the board is seen as a device for corporations to secure linkages to various stakeholders in their business environments. The role of a co-opting board is one in which the organization uses the status of a board membership of the corporation. Its main purpose is to diffuse the power of important external influencers (Mintzberg, 1983). (2) The second service role of boards of directors concentrates on the control corporations have over the availability of important external resources. Zald (1969:102) indicates that " . . . a major source of board member control and influence stems from their control of crucial inputs of capital, raw materials or 'market'." Mintzberg (1983) suggests that this service role is all about making contacts between directors and the people they know to obtain and to secure critical resources of the corporation. Fund raising - for example - is an important function of corporate boards that coincides with the

second service role of boards of directors. (3) The third service role refers to boards of directors that play a role in enhancing or maintaining the reputation of corporations (Mintzberg, 1983; Demb and Neubauer, 1990). In this service role, boards of directors represent the firm's interest in the community and perform ceremonial functions. The board - for example - presides over shareholders' annual meetings and represents the corporation at press meetings and during other public activities (Pearce and Zahra, 1992). (4) The fourth service role suggests that boards of directors can also be actively involved in the formulation and implementation steps in decision making. According to Zahra (1990:109), "boards are expected to review and evaluate analyses and proposed changes. Specifically, boards may not develop new strategies but they may recommend making changes in company strategies. Thus, directors may contribute to strategy development through careful refinements of strategic plans, by probing managerial assumptions about the firm and its environment, and by ensuring that agreement exists among executives on the strategic direction of the firm. (Accordingly, eds.) . . . strategy review represents the forum through which boards may influence the strategic process." As such, the fourth service role of boards of directors may resemble the concept of decision management. Although the development of new strategies is the direct responsibility of management, the fourth service role may suggest that boards can serve management with their expertise through their involvement in the initiation and implementation steps in decision making.

Decision Control and the Control Roles of Boards of Directors

In contrast to theories on boards' service roles, proponents of the legalistic perspective and the agency theory strongly emphasize the roles of corporate boards to monitor management and to represent the interests of shareholders. These perspectives of board involvement stress the responsibility of corporate boards to perform control roles as "independent sources of discipline" to align the interests of management with shareholders (Williams, 1979:15). In addition to other control agencies, the board is seen as a governance mechanism that can add value to a corporation by serving as an auditor or monitor of management (Demb and Neubauer, 1990). According to Johnson et al. (1993:35), control roles of boards concentrate on the control of agency problems and the promotion " . . . of firm efficiency in order to maintain high levels of shareholder value." Gopinath et al. (1994:177) define boards' control roles as inwardly focused roles " . . . wherein boards are expected to be watchdogs over management." Weisbach (1988) - for example - emphasizes that corporate boards are the shareholders' first line of defense against incompetent management. In extreme cases, it is the role of the board to replace the CEO and other executives to safeguard the interests of shareholders. The control roles of boards also include the responsibility of directors to select the CEO, to monitor his or her performance, to review CEO analyses and to ratify executive decisions (Tricker, 1984; Zahra and Pearce, 1989).

Mintzberg (1983) distinguishes the following roles boards can play in a control capacity:

- selecting the chief executive officer;
- exercising direct control during periods of crises;
- reviewing managerial decisions and performance.

Source: Mintzberg (1983:70-81).

Boards' control roles are rather reactive in nature and imply post-factum assessment of management behavior (Demb and Neubauer, 1992b). According to Zahra (1990:109), this means that "the board should not be involved in developing or implementing strategy unless it firmly believes that the proposed strategy or its execution is wrong." Of importance to this study is the observation that the control roles of boards of directors correspond with the concept of decision control. As suggested by Fama and Jensen (1983), the board of directors is the common apex of decision control to ensure the separation of decision management from decision control. As such, boards' involvement strongly focuses on the independent ratification and monitoring of the initiation and implementation steps in decision making, the general supervision of management and the disclosure of information. Not surprisingly, the control roles of boards of directors are particularly advocated by proponents of independent board structures (Davis, 1991).

The Integration of Decision Management With Decision Control and the Strategic Roles of Boards of Directors

Proponents of the stewardship theory also recognize boards' role in strategy (Donaldson and Davis, 1991; Gopinath et al. 1994; Boyd, 1995; Davis et al. 1997; Hung 1998). According to Zahra (1990:110), " . . . boards need to go beyond their service and control function to participate actively in strategy." Zahra's observation suggests that boards' strategic roles combine the service/decision management roles with control/decision control roles of boards of directors. As such, it can be observed that directors are far more actively involved in the initiation and implementation of decisions in addition to the ratification and monitoring of decisions when they perform a strategic role. The integration of board roles is also observed by Mintzberg (1983) who states that it is not easy to untangle the service and control roles of boards in practice. He states: " . . . how is one to know which role is really operative? Indeed, how can one distinguish, say, control from co-optation, or advice from contacts, when two or more roles can very well operate concurrently. In other words, at the margins the real purposes of the directors can be very subtly intertwined, discernible if at all only through intensive study of the actual behavior of board members" (Mintzberg, 1983:86).

As one of the strongest proponents of the strategic roles of directors, Andrews (1980:30) states that "a responsible and effective board should require of its management a unique and durable corporate strategy, review it periodically for its validity, use it as the reference point for all other board decisions, and share with management the risks associated with its adoption." More authors have recognized the importance of the strategic roles of boards of directors. According to Sadtler (1993:113), "the board has a vital role in ensuring that corporate strategy is properly thought out and executed. It is a question that should be on every board agenda." In essence, Gopinath et al., (1994:177) indicate that " . . . when boards adopt a strategic role, the directors guide the definition of the corporate mission and are called upon to assist in the development, implementation and monitoring of the firm's strategies." Demb and Neubauer (1990:157) observe that "primarily through involvement in corporate strategy, boards can play a forward-looking role, adding value by utilizing its breath of experience." These authors suggest that the involvement of directors in the formulation of strategy serves the following purposes:

- it helps non-executive directors to move along the learning curve regarding the industry – competitors, and the market – and technology;
- it subjects management proposals to the scrutiny of a broader-based set of perspectives. Questions posed by those with outside perspectives can lead to important modifications of corporate strategies;
- it prepares the board for implementation actions which might arise quickly. Without the anticipation provided through boards' involvement in strategy, a promising acquisition which comes to the board as a surprise, might meet a cold response;
- it helps develop commitment and a sense of ownership of the corporate strategy among board members. The more the board understands management logic regarding the strategy, the more likely are discussions to be robust, constructive exchanges - rather than perfunctory sessions, or worse;
- a board which has been fully involved in the strategy process has much greater ability to play a critical role in top management succession than one which has been kept at greater distance.

Source: Demb and Neubauer (1990:158).

It can be observed that research on the strategic roles of boards mainly has focused on the context of overseeing or ratifying strategy, ignoring the possibility that boards can also be actively involved in the formulation of strategies. Yet, new evidence indicates that beyond acquiring resources through service roles and resolving or avoiding conflicts of interests through control roles, boards are increasingly involved in important decisions on strategy development, implementation and communication. Demb and Neubauer (1992) found in a European survey among 71 directors an increasing emphasis on the formation of strategy in corporate boards. Stiles and Taylor (1996) indicate that boards take a larger role in the development of strategy and in the discussion of competing choices in the UK. In a recent study in nine countries, the Conference Board revealed that directors are spending more time on discussing their involvement in strategic assessment. Sixty percent of 82 participating corporations indicated that directors devote more time to strategy discussion. A greater role in strategy formulation was indicated by more than half the respondents while 49 percent described boards' role as "actively engaged in the choice of strategic options" (Conference Board, 1996:7). According to Judge and Zeithaml (1992), the involvement of boards in strategic decision making is a result of the institutional response of corporations to external pressures. The authors indicate three "forces as catalysts for change": litigation, pension funds and the market for corporate control (hostile takeovers). In addition, Zahra (1990) identifies five factors that call for more involvement of boards in the strategic area:

- boards play an important role as boundary spanners to link the corporation and its environment. Thus, they are in the position to gather relevant data that is vital to effective strategic actions by the corporation;
- directors' expertise as managers in other corporations may prepare them to participate actively in the strategic process. Thus directors are often well acquainted with the demands of developing, changing or implementing strategies;
- rising shareholders' activism compels directors to pay attention to strategy issues. Directors can no longer perform their fiduciary responsibilities without reflecting on the strategy in place;
- the complexity of the strategic process urges directors to participate. Armed with experience, a unique perspective, and a mandate to represent shareholders, directors must aid the CEO and top management in developing strategies that will maximize shareholders' wealth;
- the complex competitive conditions companies face need to be recognized. Corporations are facing competition that is increasingly global in scope. Serious social problems are commanding the attention of executives. As a result, boards - through their total membership or specialized committees - can offer the CEO guidance on how to deal with these competitive and social conditions.

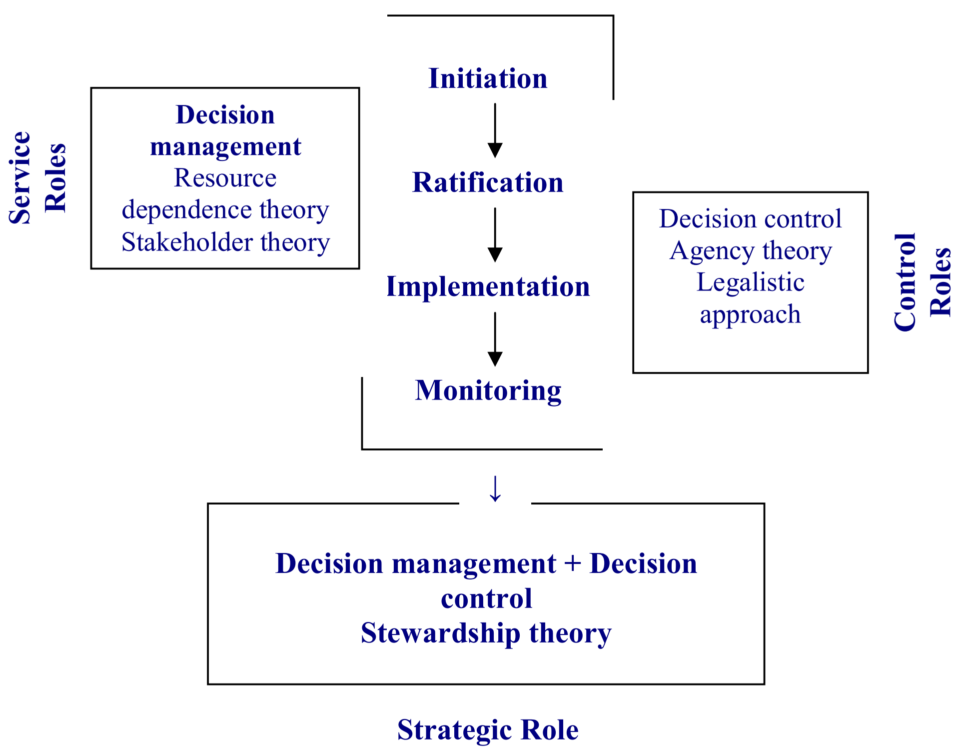
Source: Zahra (1990:111).

Competing Theoretical Perspectives of Board Involvement

The theoretical perspectives of board involvement in decision management and decision control are summarized in figure 2.2. The figure indicates that boards' service roles have been recognized by proponents of the stakeholder theory and the resource dependence theory. Related to the fours steps in decision making (Fama and Jensen, 1983), it is suggested that the service roles of boards concentrate on activities related to the support of management and the initiation and the implementation of strategic decisions (decision management). The control roles of corporate boards of directors are mainly understood by theories originating from the organizational economics school, i.e. the agency theory and the legalistic approach to board organization. Boards' control roles are mainly associated with the ratification and monitoring steps of the strategic decision making process (decision control). Figure 2.2 also indicates that the strategic roles of boards are recognized by the stewardship theory. The strategic roles focus on boards' involvement in the initiation and implementation steps as well as the ratification and monitoring steps in the process of strategic decision making.

It is suggested that these theoretical perspectives of board involvement in strategic decision making can be divided in terms of conflict and consensus theories (Lammers, 1989; Bettis and Donaldson 1990; Jonnergård and Svensson, 1995). Conflict and consensus theories reflect on contrasting philosophies of management. According to Davis (1991), a conflict perspective of board involvement sees executive directors as self-serving agents who should be monitored. To support non-executive directors' control roles, a conflict perspective of board involvement suggests that the formal organization of corporate boards should be designed in such a way that it clearly separates executive directors' involvement in strategic decision making from non-executive directors' involvement in monitoring. The agency theory is an example of a theory that is based on a conflict perspective of board involvement. Seen from this point of view, the debate on the separation of the CEO from the chairman of the board, the increasing appearance of non-executive directors in corporate boards and the formation of audit, remuneration and nomination committees with a majority of non-executive directors indicate the predominance of a conflict perspective of board involvement in the current corporate governance debate in Anglo-Saxon countries.

Figure 2.2
Theoretical Support of Board Roles in Decision Making



Consensus theories propose an opposite train of thought related to the roles and the organization of corporate boards. The stewardship theory represents a consensus perspective of board involvement. According to the stewardship theory, executive directors do not intentionally shirk and exert moral hazard (Jonnergård and Svensson, 1995). As such, it is a theory that strongly focuses on the empowerment of executive directors who are seen as honorable wealth builders. It is also a theory that seeks the integration of decision management with decision control through boards' strategic roles (Donaldson and Davis, 1994). Seen from this point of view, the stewardship theory opposes the notion that boards are devices to align conflicts of interest between shareholders and management. Boards are mainly seen as valuable strategic devices which should be built on integrative board structures that integrate decision management with decision control.

The Dilemma of Board Involvement

While the stewardship theory addresses the integration of board roles, proponents of a conflict perspective of board involvement foresee a potential conflict of interest when the four steps in decision making are put in the hands of directors (Charkham, 1986; Sheridan and Kendall, 1992). According to a conflict perspective of board involvement, non-executive directors should critically judge executive directors' performance as part of the decision control role. Yet, the detachment and distance required to ensure that this judgment is independent and critical could be hindered by the integration of board roles (Demb and Neubauer, 1992a). As such, the integration of board roles could result in the dilemma of directors marking their own examination papers (Tricker, 1984). This dilemma is called the paradox of board involvement. As previously indicated in chapter one of this study, design strategies that support the formal independence of corporate boards may hinder the strategic roles of boards; board roles that imply that directors are strongly involved in the initiation and implementation of strategic decisions besides the ratification and monitoring of strategic decisions. On the other hand, a formal board organization that supports the integration of decision management with decision control may hinder the control roles of directors. These are board roles that mainly concentrate on the ratification and supervision of corporate decisions. The next paragraph further reviews the literature on variables that may have a direct or an indirect effect on the involvement of directors in decision making and the way directors execute their service, control and strategic roles.

2.4 General Models of Board Involvement in Strategic Decision Making

A rich body of literature exists in which board attributes, like the composition and the structure of corporate boards, are related to the roles of directors and ultimately the financial performance of corporations. Zahra and Pearce (1989) developed a model based on four theoretical perspectives that integrate board attributes, board roles, contingencies and indicators of firm performance. Judge (1989) developed a multidisciplinary model based on contextual antecedents like the institutional context, process predictors (board size and CEO decision style) and several interrelated outcome variables. Jonnergård and Svensson (1995) and Jonnergård et al. (1997) have introduced a model in which several "influences" (input), "lines of reasoning" (process) and output variables (firm performance, etc.) are identified.

Through the use of multiple theoretical perspectives, these models have in common the integration of four components or so-called building blocs. (1) First, the models recognize board attributes such as the composition and the structure of corporate boards of directors. (2) Not surprisingly, the models also recognize board roles such as the service, control and strategic roles. (3) In addition, the models recognize external pressures or so-called contingencies (Boal and Bryson, 1987; Judge, 1989) and (4) output variables to measure the financial performance of corporations. According to Zahra and Pearce (1989:306): "In combination, internal and external contingencies determine the mix of the board attributes and, in turn, a board's performance of its three roles and, ultimately, on company performance." Figure 2.3 at the end of this chapter summarizes the four building blocs. In addition to the analyses of board roles in paragraph 2.3, the next sections of this paragraph briefly review the building blocs of the general models of board involvement in decision making.

Board Attributes

The first category of variables in general models of board involvement are board attributes. Board attributes include variables on the composition, the characteristics and the structure of corporate boards (Zahra and Pearce, 1989). Research on board <u>composition</u> variables mainly concentrates on the size of the board, the distinction between executive and non-executive directors and the degree of affiliations directors have with their corporations. Board <u>characteristics</u> refer to the background, the gender and the age of directors. Other characteristics of directors are their social and educational backgrounds, tenure and work experience. Board <u>structure</u> refers to board committees, the role of subsidiary boards in holding corporations, the formal independence of one-tier and two-tier boards, the leadership of boards and the flow of information between board structures. In addition, board <u>process</u> variables are related to the decision making activities and styles of the board, the frequency and length of board meetings, the formality of board proceedings and boards' culture on the evaluation of directors' performance. Studies on the association between board attributes and the formal independence of corporate boards are reviewed in more detail in chapters three and four of this study.

Firm Performance

Another component of general models of board involvement relates to the measurement of firm performance. According to Judge (1989), research on the association between board attributes and the performance of corporations is generally based on two methodological approaches. First, a majority of the literature examines direct relationships between board attributes and firm performance. These studies are based on the assumption that board attributes such as the composition, the structure and other variables directly influence firm performance criteria.

According to Judge (1989:24), board behavior is often treated as a “black box” in these studies and researches can only “ . . . speculate on actual board behavior.” Zahra and Pearce (1989) state: ” . . . without sufficient attention to board process variables, little progress can be made in understanding how boards affect corporate performance [. . .] There are countless lists of what boards should do. Yet, evidence on what boards actually do is not well documented.” These authors also indicate that structure research widely ignores contextual forces on board variables, that research samples are not always adequately composed and that structure research has failed to operationalize board variables in a consistent manner. Studies that relate the formal organization of corporate boards to output variables are reviewed in more detail in chapters three and four of this study.

The second category of research collects and analyzes data on actual board structures and behavior through surveys, observations, action research and interviews. These so-called process studies are descriptive in nature and do not directly associate board attributes with firm performance criteria. Board behavior in these studies is conceptualized through board roles and board attributes, and contingencies are understood as influential factors that shape the composition and structure of corporate boards. Surveys and interviews are predominantly used to collect information in these studies. Examples of process studies are Pettigrew’s (1985a) case study on ICI and Thurman’s (1990) doctoral study of corporate governance processes behind boardroom doors. In line with these studies, this research does not seek to reveal a direct association between board model attributes and financial performance criteria. As such, it does respect the criticism on structure research that the web of causalities is too complex to reveal unidirectional causal relationships between board model attributes and financial performance criteria (Pearce and Zahra, 1992). Seen from this point of view, this research can be classified as an explorative study on the formal independence of one-tier and two-tier board models. This research also follows the rationale that first there is a need to document what boards actually do and how they have organized their structures under different jurisdictions, market regulations and other external pressures.

Board Contingencies

According to Judge (1989:29), board contingencies are “ . . . fundamental or initiating influences on the strategic role of the board, and includes relevant factors in the task environment (e.g., social pressures) and organizational performance.” According to Zahra and Pearce (1989), contingencies influence board attributes, the way corporate boards of directors conduct their roles and contingencies can ultimately influence the contribution of boards of directors to the performance of corporations. The authors recognize environmental variables, the types of industries and legal requirements as external contingencies. Judge and Zeithaml (1992) also distinguish institutional forces that may influence the involvement of corporate boards of directors in decision making. The authors distinguish court systems and legislation, pressures from institutional investors (shareholder activism) and the market for corporate control in financial regions as important institutional forces that may have an impact on the performance of corporate boards and the way directors organize their boards. Demb and Neubauer (1992a, 1992b) found that societal pressures, regulatory systems and ownership patterns are important elements of national governance systems. Lo (1994) identifies that these patterns of corporate governance and control differ significantly across countries because of the national differences in structures of ownership and the composition of boards of directors. An example of differt patterns of corporate governance has been indicated by Sheridan and Kendall (1992). These authors distinguish insider bank-based and outsider market-based financial systems (see also table 2.2).

Table 2.2
An Example of External Board Contingencies:
The Distinction Between Insider and Outsider Systems

• outsider system (Anglo-Saxon countries);	• insider system (continental Europe and Japan);
• dispersed ownership and control;	• concentrated ownership;
• separation of ownership from control;	• the association of ownership with control;
• little incentive for outside investors to participate in corporate control;	• control by related parties such as banks, partners and employees;
• a climate where hostile takeovers are not unusual, and they can be costly and antagonistic;	• absence of hostile takeovers; in fact, an aversion to them;
• the interests of other stakeholders are not represented;	• the interests of other stakeholders are represented;
• low commitment of outside investors (whatever they may say in public!) to the long-term financial strategies of the company;	• the intervention of the outside investor is limited to periods of clear financial failure;
• takeovers may create monopolies.	• insider systems may create collusion and cartels.

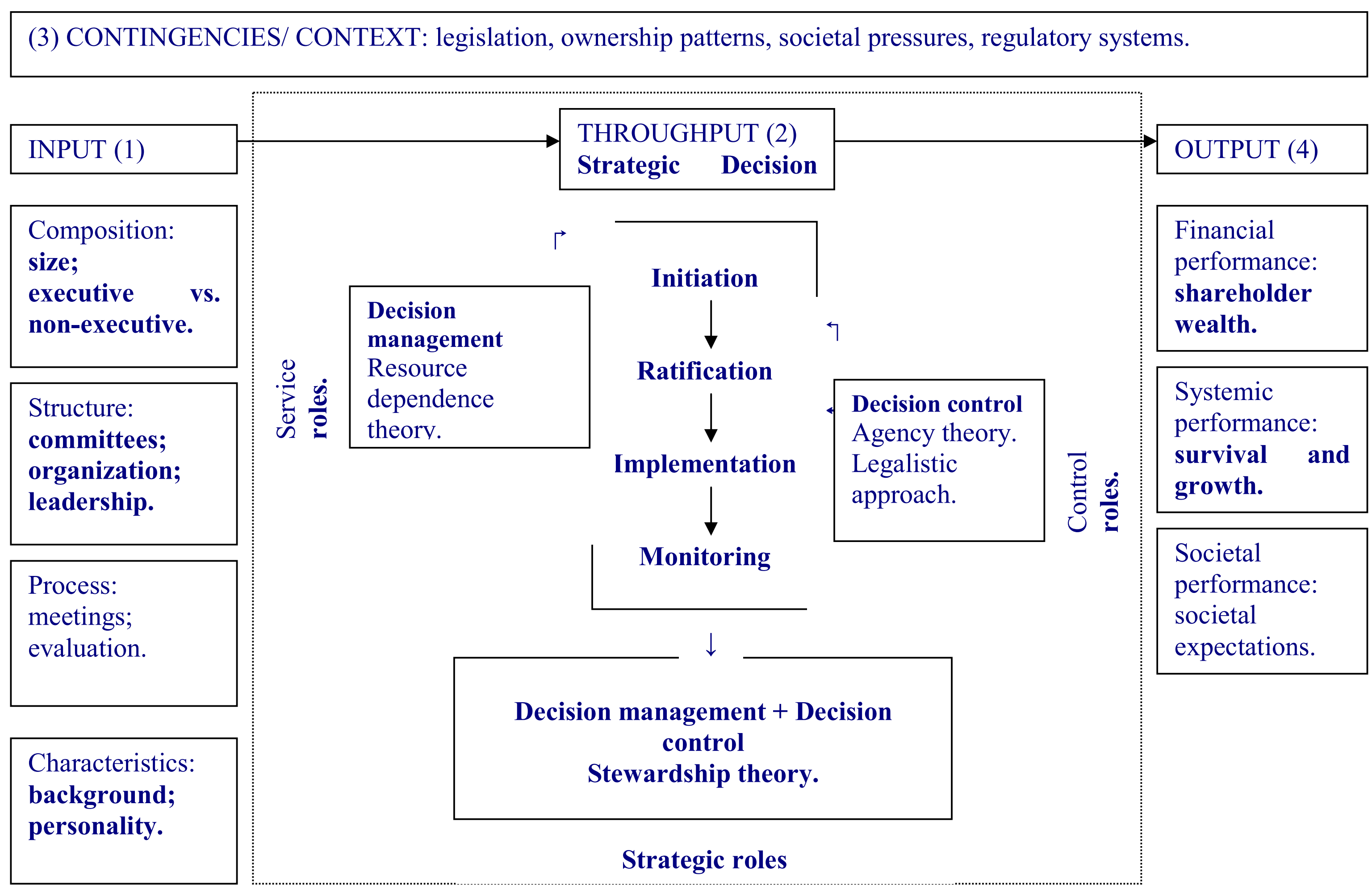
Source: Sheridan and Kendall (1992:53-55).

Contingencies are not necessarily limited to external variables. General models of board involvement also recognize internal variables as well, such as the phases of product life cycles and the size of corporations. Of importance to this study is the recognition that contingencies can influence the formal organization of corporate boards. Chapter five of this research further explores pressures from regulators, legislators and boardroom reformers on the formal independence corporate boards of directors.

2.5 Summary

The presumption that corporate boards do matter can be approached from multiple theoretical perspectives. The resource dependence theory and stakeholder theory emphasize board involvement in decision management through boards' service roles. The agency theory and the legalistic perspective accentuate the involvement of boards of directors in decision control through the execution of control roles. The stewardship theory recognizes the involvement of corporate boards in both decision management and decision control through boards' strategic roles. These theoretical schools can be defined in terms of conflict and consensus perspectives of board involvement. Proponents of a conflict perspective seek to apply board model design strategies that clearly separate decision management from decision control. Proponents of a consensus perspective seek to apply board model design strategies that integrate boards' decision management with boards' decision control tasks. Clearly, no theoretical perspective and research methodology can fully capture, describe and explain board involvement in decision making and the way directors organize their corporate boards (Judge and Zeithaml, 1992). As suggested by Zahra and Pearce (1989), the web of associations between the components that can influence the involvement of directors and the organization of their boards is so complex that it is impossible to study all possible and relevant relationships in the context of a single research project. Moreover, seen from a theoretical point of view, it has been suggested that there is a need to first synthesize the literature on corporate governance and to understand more about the actual behavior of directors and their involvement in decision making (Judge, 1989; Pettigrew, 1992a). Interestingly, general models of board involvement recognize the need to synthesize the complex and contingent nature of associations between the context, board attributes, board roles and the effects of board behavior on firm performance. The integration of multiple perspectives of board involvement and the recognition of contingencies, board attributes, and the effects of board behavior make the general models helpful tools to explore the complexity of board involvement in decision making. The general integrative models are also helpful to organize and to classify fragmented research on board involvement. For the purposes of this research, the model presented in figure 2.3 guides the description of one-tier and two-tier board models. In chapters three and four of this research, the attributes of these board models are further associated with the formal independence of corporate boards of directors. Seen from a conflict perspective of board organization, chapter three elaborates on board model design strategies that focus on the separation of decision management from decision control. Chapter four presents a consensus perspective of board organization to associate board model design strategies with the integration of the steps in decision making. Chapter five investigates the organization of corporate boards and pressures from boardroom reformers and regulators. Part II of this research explores the legal context in which corporate boards of directors operate in the US, the UK and the Netherlands.

Figure 2.3
An Integrative Model of Board Involvement in Decision Making



Chapter 3: A Conflict Perspective of Board Organization

3.1 Introduction

The previous chapter indicates that the roles of boards of directors can be analyzed from both a conflict perspective as well as a consensus perspective of board involvement. In a similar way, these perspectives can also be applied to understand the formal organization of boards. Consistent with a conflict perspective of board organization, corporate boards of directors are internal control devices that align the interests of management with those of the owners of the corporation (Judge, 1989; Walsh and Seward, 1990; Rediker and Seth, 1995). To reduce the danger of managerial opportunism and to mitigate agency problems, corporate boards are understood to be most effective when they operate independently of management when they perform their control roles (Jensen and Meckling, 1976; Fama and Jensen, 1983; Boyd, 1995). In theory, one-tier and two-tier boards provide different structures that may facilitate the independence of boards through the separation of decision management from decision control. In practice, one-tier and two-tier boards differ in the way boards organize the leadership structure of the board, the way boards make use of oversight board committees and how boards are composed. This chapter further elaborates on the observation that one-tier and two-tier board models provide distinctive organizational approaches to the formal independence of boards.

Outline

3.1 Introduction to chapter three.
3.2 Theoretical review of a conflict perspective of board organization.
3.3 One-tier board attributes and formal board independence.
3.4 Two-tier board attributes and formal board independence.

Seen from a conflict perspective of board organization, this chapter focuses on the first group of central research questions of this study. These research questions concentrate on design strategies related to the separation of decision management from decision control in corporate boards in the US, the UK and the Netherlands. The organization of this chapter is as follows. First, paragraph 3.2 briefly reviews the theoretical base of a conflict perspective of board organization, the underlying assumptions with respect to the economic model of managerial behavior and the implications of these assumptions for the formal organization of corporate boards. Second, paragraph 3.3 addresses the formal independence of one-tier boards. This paragraph investigates the theoretical assumption that board attributes of one-tier boards are negatively associated with the separation of decision management from decision control. Based on a conflict perspective of board organization, four assumptions are presented related to the association between board attributes and the formal independence of one-tier boards. In a similar vein, key board attributes are associated with the formal independence of two-tier boards in paragraph 3.4. This paragraph also presents four assumptions related to the formal separation of decision management from decision control in two-tier boards. This chapter concludes with a summary in paragraph 3.5.

3.2 A Conflict Perspective of Board Organization

The agency theory and other conflict perspectives of board organization principally focus on the diverging interests of shareholders and managers of publicly held corporations (Alchian and Demsetz, 1972; Jensen and Meckling, 1976; Fama, 1980; Fama and Jensen, 1983). Berle and Means (quoted in Mintzberg, 1983:35) already observed in the early 1930s that the ownership of large public corporations is so " . . . widely distributed that no individual or small group has even a minority interest large enough to dominate the affairs of the company." As a result, managers are free to maximize their interests that may not necessarily coincide with the interests of shareholders (Mulick, 1993). According to Hill and Jones (1992), stockholders act as wealth maximizers while managers seek to maximize a utility function that includes job security, power, remuneration and status. As indicated by Hoskisson and Turk (1990:462), "managers who pursue their own best interests may select different strategies than managers who pursue the interests of shareholders . . ." Due to the separation of ownership from managerial control and differences in the utility functions of principals and agents, conflicts of interests can exist between shareholders and managers in public corporations. As such, a distribution or agency problem may occur in the exchange relationship between principals and agents in their roles of financiers, monitors and managers of listed corporations. According to Gedajlovic (1993:16), the " . . . basic agency problem stems from the fact that the possessors of decision rights (managers) can adopt strategies or policies which negatively impact upon the wealth of residual claimants (shareholders)." This problem still has proven to be central to theories in the field of organizational economics (Wang, 1991). Although agency theory emphasizes that the separation of ownership from managerial control can be economically efficient, parties involved are also recognized to have different utility functions that may lead to conflicts of interests between owners and managers (Hoskisson and Turk, 1990).

The Model of Managerial Behavior

Jensen and Meckling (1976:308) define the principal-agent relationship as " . . . a contract under which one or more persons (the principal(s)) engage another person (agent) to perform some services on their behalf which involves delegating some decision making authority to the agent." These contracts include (in)formal agreements in which parties define contractual guarantees and obligations. Fama and Jensen (1983) indicate that agency problems can arise because contracts cannot be written and enforced costlessly. Shleifer and Vishny (1997:741) indicate that a contract " . . . specifies exactly what the manager does in all states of the world, and how the profits are allocated. The trouble is, most future contingencies are hard to describe and foresee, and as a result, complete contracts are technologically infeasible." The costs associated with contracts between principals and agents - the agency costs - ". . . include the costs of structuring, monitoring, and bonding a set of contracts among agents with conflicting interests. Agency costs also include the value of output loss because the costs of full enforcement of contracts exceed the benefits" (Fama and Jensen, 1983:279). The design of contracts is complicated by perhaps the most uncertain factor in the relationship between principals and agents: the behavior of agents. Shleifer and Vishny (1997:737) state: "How do the suppliers of finance get managers to return some of the profits to them? How do they make sure that managers do not steal the capital they supply or invest it in bad projects? How do suppliers of finance control managers?" As such, a conflict perspective of board organization assumes that agents cannot always be trusted to maximize the utility function of principals. Instead, it is assumed that managers will use their powers to pursue personal interests such as empire building, excessive remuneration, job security and other forms of self-interest orientation. Fundamental to this "model of man" is the assumption that individuals choose actions that maximize their welfare (Williamson, 1985; Maassen and van Montfort, 1997). Seen from this point of view, an agent is understood to be a rational single utility maximizer (Swedberg et al. 1990). This implies that every individual involved in the process of decision making recognizes self-interested motivations of other participants (Band, 1992).

The Corporate Board of Directors as a Mechanism to Alleviate Agency Problems

The agency theory treats managerial behavior as a potential source of opportunistic behavior unless this behavior is bounded by contracts, incentives and bonding mechanisms including the external threat of takeovers, competition in product-markets and competition in managerial labor markets. Agents can only be "trusted" after they have been put firmly under the control of principals with mechanisms that aim at the reduction of agency problems (Donaldson, 1990). Within the context of the agency theory, the corporate board of directors is seen as an important mechanism to alleviate agency problems in principal-agent relationships. According to Walsh and Seward (1990), the board of directors is responsible for the development and the implementation of internal control mechanisms that align the interests of management with the owners of the corporation. Fama (1980:294) sees the board as the ultimate internal monitor which " . . . most important role is to scrutinize the highest decision-makers within the firm." Fama and Jensen (1983) also see the board of directors as a critical internal governance mechanism. According to these authors, " . . . management and control functions are delegated by the residual claimants to the board. The board then delegates most decision management functions and many decision control functions to internal agents, but it retains ultimate control over internal agents – including the rights to ratify and monitor major policy initiatives and to hire, fire, and set the compensation of top level decision managers" (Fama and Jensen, 1983:287). The formation of corporate boards results to what Coleman (1990:162) calls a "complex authority structure." This is an authority relation " . . . in which there is both a transfer (from the prospective subordinate to the prospective superordinate) of the right to control and a transfer of the right to transfer that right of control to another (a lieutenant)." With the creation of such a complex authority structure, " . . . a division of labor emerges in the management and control of organizational decision making. The managers initiate and implement their decisions, while the board ratifies them and, in general, monitors the conduct of the firm's top managers" (Walsh and Seward, 1990:424). The next paragraph concentrates on the attributes of one-tier boards and the way these attributes facilitate the control roles of boards.

3.3 A Conflict Perspective of One-Tier Board Model Attributes

Not all scholars are sympathetic to the view that corporate boards effectively monitor managerial behavior (Mace, 1971; Herman, 1981; Vance, 1983; Daily, 1991). Given the international call for reform, proponents of a conflict perspective of board organization strongly emphasize that one-tier boards are not independent enough. As indicated by Zald (1969:98): " . . . some scholars have doubted whether the formal system of board control does any more than provide lip service to the law. Those who argue that boards of directors are merely a legal and co-opted appendage believe organizations are controlled by the full-time managers . . . They believe boards are at the mercy of the managers who control information, definitions of alternatives, the nominating process, and, indeed, the very agenda of decision making." Sundaramurthy et al. (1996) indicate that corporate boards historically have been relatively ineffective and passive. Some authors even indicate that ineffective boards are no more than ceremonial rubber-stamping devices to support the objectives of management (Rechner and Dalton, 1991). The observation that directors not always act in the best interests of shareholders has resulted to many initiatives from legislators, exchanges, institutional investors and other boardroom reformers who recommend changes in the formal structure of one-tier boards in the US and the UK. As summarized by Wang (1991:3): "Over the years, numerous recommendations of boardroom reform have been proposed. Some of the recommendations call for separating the position of the CEO and chairman, redefining directors' constituent responsibilities, reducing the number of directors, asking all insiders on the board other than the CEO to resign, requiring directors to own a substantial amount of stocks relative to their compensation, and redefining precisely what directors should or should not do as well as establishing criteria for board evaluations . . ." That does not mean that all one-tier boards are associated with ineffective boards. Yet, related to the formal organization of one-tier boards, criticism is particularly addressed to the composition of boards when these are dominated by executive directors and when directors combine board leadership positions with executive responsibilities in one-tier boards. The criticism related to these attributes of board organization and the formal independence of one-tier boards are discussed in more detail in the remaining parts of this paragraph.

One-Tier Board Composition

It is suggested that the division of board roles between executive and non-executive directors is troubled in one-tier boards models due to the diffusion of tasks and responsibilities of directors (Sheridan and Kendall, 1992). In the US and

UK, corporation laws - for example - do not make a distinction between the role and position of executive and non-executive directors. Non-executive directors have the same legal responsibilities and are confronted with the same legal liabilities as their executive colleagues. The division of board roles in one-tier boards is further troubled by the common practice of directors to compose their boards with a majority of executive directors. Corporate boards composed of a majority of executive directors are frequently associated with structures in which potential conflicts of interest can arise between management and shareholders. Sheridan and Kendall (1992:161) indicate that there ” . . . is an uncomfortable untidiness in having one group of directors supervising or controlling another group on the same board, which is meant to be the collective for managing the company.” Charkham (1994:334) concludes: ”If it is desired to put and end to fudge, the logic is to differentiate between the duties of supervisors and the managers.” As such, proponents of a conflict perspective of board organization indicate three main reasons why one-tier boards should be composed of a majority of non-executive directors. Corporate boards should be predominantly composed of non-executive directors because of:

- the breadth of their experience and knowledge;
- the contacts they have which may enhance management’s ability to secure external resources;
- the independence they have from the CEO. Non-executive directors are considered better able to provide independent assessment of actions taken by the firm and insure that there are proper checks and balances on management.

Source: Kesner and Johnson (1990:328).

These observations suggest that one-tier boards, dominated by executive directors, are negatively associated with the formal independence of corporate boards. This observation is formalized by the following assumption on one-tier board model composition and the formal independence of corporate boards:

Based on a conflict perspective of board organization, assumption 1a reads:

Assumption 1a: one-tier boards composed of a majority of executive directors are negatively associated with the separation of decision management from decision control.

Empirical evidence suggests support for the wide-spread belief that one-tier boards dominated by executive directors are negatively associated with the independence of corporate boards and ultimately with the performance of corporations. Kosnik (1987) investigated 53 greenmail-paying corporations and 57 corporations that resisted the payment of greenmail between 1979 and 1983. The author found that corporate boards that resisted the payment of greenmail (the private repurchase of company stock at a premium above the market price to secure its control position when faced with a raider – Kosnik, 1987) have a higher proportion of non-executive directors than boards that did not resist the payment of greenmail. Weisbach (1988) investigated 367 corporations listed on the New York Stock Exchange between 1974 and 1983. The author found that "outsider-dominated" boards tended to add firm value through CEO changes. Boards with at least 60 percent of nonaffiliated non-executive directors were significantly more likely to remove the CEO when the corporation was confronted with a poor performance than corporations that did not have a board dominated by non-executive directors. A study of Schellenger et al. (1989) indicated a positive relationship between the proportion of non-executive directors in boards and the financial performance of 526 corporations. Rosenstein and Watt (1990) found in a sample of 1251 appointments of non-executive directors a significantly positive stock price reaction after corporations announced the appointment of non-executive directors. Kesner and Johnson (1990) investigated a total of 53 Delaware corporations that were sued by their shareholders between 1975 and 1986. Compared to a control group of 53 other Delaware corporations, the results of the study indicate that boards that were sued for violation of their fiduciary duties had a greater number of executive directors than boards that were not sued for these violations. Yet, the authors did not reveal a significant relationship between the composition of the board and suit outcomes. Beasley (1994) examined the relationship between the composition of boards of directors and the occurrence of management fraud. Based on a sample of 150 publicly traded corporations in the US, the author found that in the period between 1980 and 1991 board composition significantly affected the likelihood of financial statement fraud. Firms that experienced no management fraud were significantly more likely to have higher percentages of non-executive directors on their boards than corporations that were confronted with fraud. Baysinger and Butler (1985) indicated in their study of 266 corporations that nonaffiliated non-executive directors had a positive effect on the average return on equity. Yet, the authors found a lagged effect of board composition on firm performance. Pearce and Zahra (1992) also found a positive association between board composition (the high representation of non-executive directors) and future measurements of corporate financial performance.

One-Tier Board Leadership Structure

In addition to the composition of corporate boards, another central topic in the discussion on the formal independence of corporate boards is the leadership structure of one-tier boards. Seen from both practical and theoretical perspectives of board organization, it is suggested that the decision control task of the board to monitor and to discipline management is weakened when the CEO and the chairman positions of the board are combined (Mulick, 1993). As suggested by Kesner and Dalton (1986, quoted in: Rechner and Dalton, 1989:141): "A potential threat to the independence of the board is the dual role of CEO as chairperson . . . The top managerial officer in the corporation . . . is also the chairperson of the group that is chartered, among other things, to monitor and evaluate the top managerial officer. Isn't reasonable to expect that, as board chairperson, the CEO would attempt to influence other board members? . . . An analogous potential for abuse would exist if the President of the United States served simultaneously as Chief Justice of the Supreme Court." According to Sheridan and Kendall (1992), CEO-duality (the combination of chairman and CEO roles) creates a diffusion of board roles and an erosion of the non-executive directors' decision control role. Dalton and Kesner (1987:35) also state: "A very real threat to the exercise of independent judgement by the board of directors is the dual role of CEO as board chairperson." Dahya et al. (1996) indicate that a dual board leadership structure may even eliminate systems of checks and balances in the boardroom. According to these authors, there are five main arguments in favor of separating the roles of chairmen from the CEO in one-tier boards:

- there is said to be a conventional belief - well supported in the literature on corporate governance - that the chairman should be independent and that his independence will help to provide a measure of balance to the board and also supply a useful check on the possibly over-ambitious plans of the CEO;
- a move to a dual CEO top management structure is likely to be interpreted by investors as an adverse signal and may result in a fall of the share price of the corporation. Stock market reactions of this nature are likely to be significant if it is believed that someone who holds the two top positions is likely to pursue strategies which advance their personal interests to the detriment of those of the firm as a whole;
- a move to a dual CEO structure may eliminate an important check on the actions of the chief executive which could place the corporation at risk;
- an independent chairman may provide a valuable "outside" perspective, perhaps has contacts in government or finance which are useful to the corporation and, if a member of other boards - as is often the case - can offer insights or comparisons derived from personal knowledge of other organizations;
- studies present evidence that the profitability of corporations is significantly enhanced when there is an independent chairman.

Source: Dahya et al. (1996:72-73).

The agency theory suggests that due to the assumed opportunistic behavior of the CEO and other executives, a concentration of power and strong leadership is expected to result to sub-optimal top management behavior. As such, there is a strong consensus in the agency literature that one-tier boards should be directed by independent non-executive chairmen. According to Dalton et al. (1998:271): " . . . there is a strong sentiment among board reform advocates, most notably public pension funds and shareholder activists groups, that the CEO should not serve simultaneously as chairperson of the board . . ." The following assumption reflects the idea that CEO-duality in one-tier boards does not support the formal independence of the board:

Based on a conflict perspective of board organization, assumption 1b suggests:

Assumption 1b: CEO-duality in one-tier boards is negatively associated with the separation of decision management from decision control.

Rechner and Dalton (1991) examined the relationship between the existence of CEO-duality and the financial performance of 250 randomly selected Fortune 500 corporations between 1978 and 1983. The study indicates that firms, opting for independent leadership, outperform firms relying on CEO-duality in terms of return of equity, return on investment and profit margin. Mallette and Fowler (1992) found an association between CEO-duality and the incidence of poison pill adoption in a sample of 673 manufacturing firms (poison pills are contingent securities that impose financial burdens on acquirers when triggered by change of control events – Malec, 1995). The study indicated that corporations with a dual board leadership structure are more likely to pass poison pills than corporations that have the CEO and chair positions formally separated. Daily and Dalton (1994) also revealed an association between the combination of CEO-duality, low proportions of independent directors and the likeliness of corporations to file Chapter 11 bankruptcy. The authors stated that " . . . the bankrupt firms were found to rely more heavily on the dual leadership structure and fewer independent directors than their survivor counterparts" (Daily and Dalton, 1994:649). A recent study of Dahya et al. (1996) also found support for the assumption that corporate boards of directors are more effective when CEO and chair positions are not simultaneously occupied by one director. The study indicated that the separation of the responsibilities of chairman and CEO in a sample of 124 corporations was followed by significant and positive market reactions in the UK. This reaction was accompanied by enhanced performances of corporations according to accounting measures in the year following the change.

One-Tier Board Committees

Another attribute that receives much attention from boardroom reformers is the formation of board committees in one-tier boards. Harrison (1987) distinguishes two generic types of board committees. The first type is called the management support or operating committee. The primary function of these board committees is to integrate decision management with decision control in boards of directors. This is also reflected by the composition of operating committees. Most often, the composition of these board committees is dominated by executive directors. Examples of operating committees are the executive committee, the strategy committee and the finance committee.

As suggested by table 3.1, the second type of committee is concerned with the control roles of boards. These so-called monitoring or oversight committees aim at the protection of shareholders' interests by providing objective, independent review of corporate decisions. The primary function of these committees is to separate decision management from decision control. Examples of oversight committees are the audit, compensation and nominating committees. Seen from a conflict perspective of board organization, oversight board committees can be effective mechanisms to separate decision management from decision control when these committees are composed primarily of non-executive directors who are independent of senior management (Verschoor, 1993).

Table 3.1
Generic Types of Board Committees

Attributes	Operating Committees	Monitoring Committees
Composition:	• insider dominated.	• outsider dominated.
Purpose:	• advice to management.	• accountability and legitimacy.
Function:	• integration of decision management with decision control.	• separation of decision management from decision control.
Examples:	• executive committee; • finance committee; • strategy committee.	• audit committee; • compensation committee; • nominating committee.

Source: based on Harrison (1987).

According to Davis (1991:77): "Management participation on these committees has been thought of as tantamount to allowing the 'fox in the henhouse'." Compared to other oversight committees, the audit committee has been studied most notably in the literature. As stated by Beasley (1994:33): "Audit committees can be viewed as monitoring mechanisms that are voluntarily employed in high agency cost situations to improve the quality of information flows between principal and agent." Todd DeZoort (1997) sees audit committees as corporate governance mechanisms to protect the interests of shareholders by monitoring management and the external and internal auditors. Seen from another practical point of view, " . . . definitions broadly agree that the audit committee is a board sub-committee of (predominantly) non-executive directors . . . concerned with audit, internal control and financial reporting matters" (Spira, 1998:30). Comprised predominantly of independent non-executives, these and other oversight committees are accepted by reformers as valuable means to improve the independence of one-tier boards. As such, the following assumption suggests a positive association between independent oversight board committees and the independence of one-tier boards:

Based on a conflict perspective of board organization, assumption 1c suggests:

Assumption 1c: independent oversight board committees of one-tier boards are positively associated with the separation of decision management from decision control.

Of importance to this study is the practical belief of boardroom reformers that oversight committees support the formal independence of one-tier boards. In line with agency theoretical assumptions, independent audit and compensation committees are required for corporations with a listing on the New York Stock Exchange and NASDAQ. Independent board committees are also recommended by the SEC and introduced through state legislation in the US. In England, a similar development can be observed in the formation of oversight board committees. According to Demb and Neubauer (1992b) one-tier boards tend to overcome the imbalance in the board by relying heavily on those committees. This imbalance derives from the unitary structure of one-tier boards. It can be therefore suggested that oversight board committees seem to act as additional structures in one-tier boards to facilitate a formal separation of decision management from decision control. Based on a conflict perspective of board organization, assumption 1d suggests:

Assumption 1d: the unitary structure of one-tier boards is negatively associated with the separation of decision management from decision control.

So far, very little work has been done in examining the effectiveness of oversight board committees as monitoring devices that support the formal independence of corporate boards and the financial performance of corporations (Cobb, 1993; McMullen, 1996; Todd DeZoort, 1997). Some authors have found support for the agency-theoretical assumption that audit committees composed of non-executives directors improve the independence of corporate boards and other measures that safeguard the interests of shareholders. Cobb (1993) found an association between the likelihood of court filings for fraudulent financial reporting and the existence of audit committees. Based on a sample of 96 corporations in the US, the study indicates that when the composition of audit committees does not adhere to the stringent definition of board independence (meaning that non of the members of the audit committee have ever had employment status with the corporation), the likelihood of fraudulent financial reporting increased. In a recent study, Beasley (1994) observed that "no-fraud firms" have more active audit committees than "fraud firms." The author found support for the assumption that audit committees may enhance " . . . the board of director's capacity to act as a management control by providing the board of directors with more detailed knowledge and complete understanding of financial statements and other financial information issued by the company" (Beasley, 1994:34). McMullen (1996) investigated the relationship between the presence of audit committees and the reliability of corporate financial reporting. The author selected 376 corporations that were confronted with shareholder litigation due to allegations of fraud, mistakes and errors in the financial statements of the corporations and with allegations of inadequate disclosure of financial information. The control sample in the study consisted of some 500 corporations. In line with the assumptions of a conflict perspective of board organization, the results of the study indicated that the existence audit committees is associated with a lower number of shareholder lawsuits. Corporations with unreliable financial reporting were less likely to have audit committees than those not confronted with lawsuits. The study also suggested that the quality of financial statements improves when audit committees are established. In a similar vein, McMullen and Raghunandan (1996) found that corporations confronted with SEC enforcement actions and material restatements of quarterly earnings were much less likely to have audit committees consisting solely of non-executive directors than corporations that did not experience these enforcement actions.

3.4 A Conflict Perspective of Two-Tier Board Model Attributes

In strong contrast to the discussion on the organization and composition of one-tier boards, the independence of two-tier boards has hardly been disputed in the international corporate governance debate. Bacon and Brown of The Conference Board distinguish the following four characteristics of two-tier boards:

- two-tier structures separate in a tangible way the direct management of a company and the function of supervising and overseeing the management function. In countries with a single board, these functions are perceived as separate and to some extent are carried out separately. But since some individuals bear the responsibility for both they can become muddled and the supervisory function may become weakened in the process;
- the physical separation into two bodies not only results in delineating and defining the two functions of management and supervision, but assures that one person is not asked or expected to do both;
- the two-tier structure changes – and to an important degree diminishes – the role of the traditional director. The supervisory body is not granted direct managerial authority over company affairs;
- a two-tier structure may insulate supervisory directors from the degree of liability that, in some countries at least, is attached to serving as a director on a single board.

Source: The Conference Board (1977:8).

In some way similar to the definition of The Conference Board (1977), Cadbury (1995) identifies three main differences between one-tier and two-tier boards:

- the unitary board, however many outsiders it has on it, remains in full control of every aspect of the company's activities. It initiates action and it sees that the action which it has initiated is carried out. All its directors, whether executive or non-executive, share the same aims and the same responsibilities. The supervisory board, on the other hand, may have to approve management action, but it is primarily a monitoring body, not an initiatory one. The tasks and duties of the two boards are different as are their legal responsibilities;
- the chief executive at least will be on a unitary board, so the board combines non-executive and executive directors whereas the supervisory board does not;

- the kind of people who are non-executive members of a unitary board will not be precisely the same as the members of a supervisory board; this is leaving on one side the possibility that some supervisory board members may have been appointed by the employees. This distinction arises because being a non-executive member of an operating board may require a different set of attributes from that of being a member of a strictly supervisory body.

Source: Cadbury (1995).

In summary, the composition of two-tier boards seems to be strictly divided in executive and non-executive directors who have different legal responsibilities. Executive managing directors are seated in the management board. The separate supervisory board is composed entirely of non-executive supervisory directors. Board leadership is also formally separated from executive board responsibilities. This means that CEO-duality is not possible in two-tier boards. The formation of board committees in two-tier boards is not enforced by legislation or stock exchanges. Supervisory boards are also not necessarily co-determinated. The supervisory board in Germany has directors representing employees while the Dutch two-tier board operates without employee representatives. The differences between the attributes of one-tier and two-tier boards are summarized in table 3.2.

Table 3.2
Board Model Attributes of One-Tier and Two-Tier Corporate Boards

Attributes	One-tier boards	Two-tier boards
Composition:	Executive and non-executive directors operate in one board.	Executive and non-executive directors operate in separate boards.
Committees:	Mandatory or recommended.	Recommended.
Organization:	Unitary.	Binary.
CEO-duality:	Admitted.	Impossible.

Source: based on Maassen and van den Bosch (1997b).

These differences give rise to the comparison of one-tier and two-tier boards in this study. As recognized previously in this chapter, board composition and board leadership structures may account for problems associated with the independence of one-tier boards. Assumptions 1a and 1b indicate that one-tier boards composed of a majority of executive directors and one-tier boards that are directed by a CEO who also holds the position of chair are negatively associated with the separation of decision management from decision control. In contrast, the description of two-tier board models may suggest a positive association between the composition and the leadership structure and the separation of decision management from decision control in two-tier boards. Seen from a conflict perspective of board organization, the characteristics of the two-tier board model suggest that the formal division of board roles between executive and non-executive directors may reduce agency costs and may simplify directors' duties and liabilities (Guthrie and Turnbull, 1995). The attributes of two-tier boards are further explored in the following paragraphs.

Two-Tier Board Composition

Based on the fundamental belief that boards composed of a majority of non-executive directors are more effective in protecting shareholder interests than those dominated by executive directors, proponents of a conflict perspective of board organization advocate the strong representation of independent non-executive directors at corporate boards (Mallette and Fowler, 1992; Sundaramurthy et al., 1996). The previous description of two-tier boards suggests that the supervisory board is entirely composed of non-executive directors. The management board is entirely composed of executive managing directors. Based on a conflict perspective of board organization, assumption 2a suggests:

Assumption 2a: the composition of supervisory boards in two-tier boards is positively associated with the separation of decision management from decision control.

This study could not find evidence in the literature that supports this assumption. To fill this gap in the literature, chapter eight and nine of this study further investigate this assumption in more detail.

Two-Tier Board Leadership Structure

One-tier boards provide the possibility that the CEO acts as an executive director who is responsible for the daily management of the firm. The CEO can also be held responsible for the overall governance of the corporation. In other words, dual leadership structures in one-tier boards can formally put the tasks of decision management and decision control in the hands of a powerful and influential member of the board. Seen from a conflict perspective of board organization, such a concentration of power may result in agency problems. An independent board leadership structure may effectively reduce agency problems due to the separation of decision management from decision control. The integration of CEO and chairman roles is not possible in two-tier boards because a member of the management board may not simultaneously act as a member of the supervisory board. As a result, an executive managing director can not act as chairman of the supervisory board. Such an independent board leadership structure may effectively avert the “two hats problem” of the CEO when he or she also holds the position of chairman of the board (Tricker, 1984). Based on a conflict perspective of board organization, assumption 2b suggests:

Assumption 2b: the board leadership structure of two-tier boards is positively associated with the separation of decision management from decision control.

The literature review of this study could not find research that has investigated this assumption. To enrich our understanding of board leadership structures and the formal independence of two-tier boards, this assumption is further investigated in chapters eight and nine of this research.

Two-Tier Board Committees

As previously noted, oversight board committees are balancing devices to secure the independence of one-tier boards of directors (Davis, 1991). Demb and Neubauer (1992b:29) suggest that board committees appear to be used in one-tier boards to " . . . accomplish to some degree a purpose similar to the legal separation between the management and the supervisory board . . . " in two-tier boards. Listing requirements and corporations laws do not call for oversight board committee structures that support the independence of supervisory directors who operate in two-tier boards. Although audit, remuneration and nominating committees are becoming more universal in countries with a two-tier board model (Pic, 1995), they are not necessarily formed to improve the independence of the board. Maassen and van den Bosch (1999a) suggest that board committees such as the audit and nomination committees of Dutch supervisory boards may serve as integrative devices by means of a mixed composition of both executive managing directors and non-executive supervisory directors. As such, the function of audit and other oversight board committees in two-tier boards may differ from those in one-tier boards. As integrative devices, these committees may support the integration of decision management with decision control. Based on this observation, a conflict perspective of board organization may support the following assumption:

Assumption 2c: oversight supervisory board committees of two-tier boards that are composed of both executive directors and non-executive directors are negatively associated with the separation of decision management from decision control.

This assumption is further investigated in chapters eight and nine of this study.

Two-Tier Board Organization

Sheridan and Kendall (1992) acknowledge that two-tier boards clearly separate the legal obligations of executive and non-executive directors. Tricker (1984:198-197) sees two-tier boards as structures " . . . with an absolute separation of supervision from executive management." Cadbury (1995:66) indicates that supervisory boards are in the position " . . . to take an entirely independent view of the actions of management, since there is no overlap of membership between the two boards." Seen in light of a theoretical conflict perspective of board organization, the management board is in charge of the initiation and implementation of strategic decisions (decision management). The independent supervisory board ratifies and monitors the conduct of the members of management board (decision control). The separation of board roles in one-tier and two-tier boards is presented in table 3.3. The table indicates that one-tier boards combine several board functions such as the supervisory function and the management function of the board (Demb and Neubauer, 1992b), the service, the strategic and control roles of directors (Zahra and Pearce, 1989) and the performance enhancement role and the monitoring role (Hilmer, 1993).

Table 3.3
Formal Board Structure and the Division of Board Roles

One-Tier Board	Two-Tier Board		Authors
	Management board.	Supervisory board.	
Supervisory function and management function.	Management function.	Supervisory function.	Demb and Neubauer (1992b).
Accountability, supervision, direction and executive action.	Direction and executive action.	Accountability and supervision.	Tricker (1984).
Decision management and decision control.	Decision management.	Decision control.	Fama and Jensen (1983).
Performance enhancement role and monitoring role.	Performance enhancement.	Monitoring role.	Hilmer (1993).
Decision making and decision taking.	Decision making.	Decision taking.	Pahl and Winkler (1974).
Strategic and financial control.	Not specified.	Strategic and financial control.	Baysinger and Hoskisson (1990).
Service, strategic and control roles.	Service and strategic role.	Monitoring role.	Zahra and Pearce (1989).

These roles are formally separated by the organization of two-tier boards. This observation is formalized by the following assumption on the separation of board roles in two-tier boards. Based on a conflict perspective of board organization, assumption 2d suggests:

Assumption 2d: the binary structure of two-tier boards is positively associated with the separation of decision management from decision control.

This assumption is further investigated in chapters eight and nine of this research.

3.5 Summary

This chapter has been largely theoretical. A conflict perspective of board organization suggests that board structures that separate decision management from decision control may effectively avert agency problems associated with the division of board roles in publicly held corporations. One-tier and two-tier board models present different routes to reduce agency problems. Three assumptions (A.1a, A.1b and A.1d) suggest a negative association between the attributes of one-tier boards and the formal independence of these boards. Assumption A.1c suggests a positive association between the formation of independent oversight board committees and the independence of one-tier boards. See also figure 3.1 for an overview of assumptions on the relationship between board independence and the attributes one-tier boards.

A conflict perspective of board organization suggests a positive relationship between the attributes and the independence of two-tier boards. To formalize this observation, this chapter presents four assumptions on two-tier board attributes and the separation of decision management from decision control. The composition of the supervisory board (assumption A.2a), the absence of dual board leadership structures (assumption A.2b) and the formal division of board roles (assumption A.2d) are positively associated with board independence (see also figure 3.2). A mixed composition of supervisory board committees is negatively associated with the formal independence of two-tier boards (assumption A.2c). Part II of this research further explores the assumptions on the independence of one-tier and two-tier boards in the US, the UK and the Netherlands. The next chapter first presents an opposite train of thought on the relationship between board independence and board model attributes.

Figure 3.1
The Formal Independence of One-Tier Boards

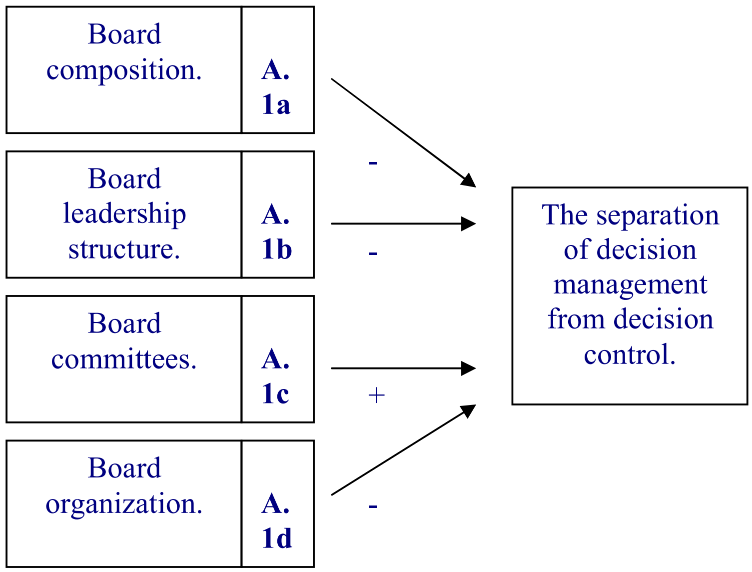
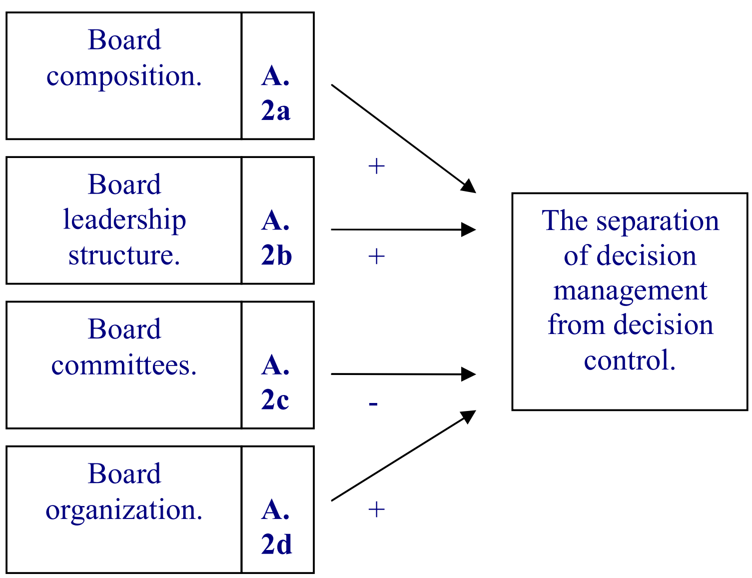


Figure 3.2
The Formal Independence of Two-Tier Boards



Chapter 4: A Consensus Perspective of Board Organization

4.1 Introduction

In contrast to the analysis based on a conflict perspective of board organization in chapter three of this study, this chapter applies a consensus perspective of board organization. The main purpose of this chapter is to understand the relationship between the attributes and the duality of boards of directors. In other words, this chapter theoretically explores the relationship between the integration of decision management with decision control and the organization and composition of one-tier and two-tier corporate boards. As such, this chapter concentrates on central theoretical research questions that focus on the integration of board roles. The organization of this chapter is as follows. Paragraph 4.2 investigates assumptions of the stewardship theory with respect to the non-economic model of managerial behavior. This paragraph also investigates the relationship between assumptions underlying this model of managerial behavior and the organization and the composition of corporate boards of directors. Paragraph 4.3 elaborates on the relationship between board attributes and the duality of one-tier boards. More specifically, this paragraph presents four assumptions that concentrate on the relationship between board composition, board leadership structures, oversight board committees and board organization and the integration of decision management with decision control in one-tier boards. In a similar vein, paragraph 4.4 presents four assumptions that concentrate on the relationship between two-tier board attributes and the integration of decision management with decision control in two-tier boards. This chapter concludes with a summary in paragraph 4.5.

4.2 A Consensus Perspective of Board Organization

In response to the popularity of the agency theory and other conflict perspectives of board organization, proponents of a consensus approach to board organization are gaining support in the corporate governance literature. An approach that is receiving attention is the stewardship theory. This relatively new theory is grounded in sociological, psychological and organizational approaches to corporate governance (Davis, 1991; Gedajlovic, 1993; Davis et al., 1997; Hung, 1998). The stewardship theory shows in principle some similarities with the agency theory. First, this theory sees corporate boards as instruments to create shareholder wealth (Davis, 1991). Second, when applied to corporate governance, the stewardship theory mainly concentrates on the relationship between shareholders, directors and management. In particular, the stewardship theory sees shareholders as important stakeholders of the corporation (Donaldson and Davis, 1994). As such, the stewardship theory departs from the literature on corporate societal responsibilities that directors are trustees of all stakeholders of the firm who should balance the interests of many diverse interest groups. Third, proponents of the stewardship theory also do not oppose the agency-theoretical notion that the separation between ownership and control in listed corporations is cost efficient and that a corporation is a nexus of contracts that specifies the relationship between principals and agents (Donaldson and Davis, 1991). Yet, the stewardship theory also differs in many ways from the agency theory. Perhaps the most striking difference lies in the way the behavior of agents is being perceived and how this behavior should be constrained. In other words, the stewardship theory is based on a model of managerial behavior that departs from theories that are based on a conflict perspective of board organization.

The Model of Managerial Behavior

Williamson (1985) indicates that alternative approaches to the organization of corporations owe their origins to differences in the underlying assumptions of the behavior of agents and principals. The agency theory and stewardship theory are good examples of theories that differentiate on assumptions with respect to the behavior of agents. As indicated previously in chapter three of this study, proponents of the agency theory see agents as potentially self-serving actors whose behavior needs to be constrained by control mechanisms such as a corporate board of directors. The stewardship theory follows a different train of thought on the model of managerial behavior. Contrary to the agency theory, stewardship theory assumes that conflicts of interests between principals and agents do not necessarily arise due to differences in utility functions. Directors and managers are seen as pro-organizational and trustworthy agents who do not act as self-serving opportunistic agents and who predominantly act in the interests of the principals of the corporation. The differences between the model of men in the agency and stewardship theory can be illustrated by the distinction between McGregor's (1960) Theory X and Theory Y. As stated by Bettis and Donaldson (1990:377): "Whereas the agency theory is derived from the economic model of man (i.e., Theory X), stewardship theory is derived from the theory Y stream of organization behavior." As such, the stewardship theory sees agents as organizational role-holders who are " . . . motivated by a need to achieve, to gain intrinsic satisfaction through successfully performing inherently challenging work, to exercise responsibility and authority, and thereby to gain recognition from peers and bosses" (Davis, 1991:83). As good stewards, they take responsibility for themselves.

Seen from this point of view, proponents of the stewardship theory oppose the "narrow" model of men in the corporate governance literature that treats human behavior as a radical simplification of social life (Perrow, 1986). This does not mean that the stewardship theory does not recognize any opportunistic behavior of agents. Yet, according to Davis et al. (1997:25), ". . . the steward's opportunity set is constrained by the perception that the utility gained from pro-organizational behavior is higher than the utility that can be gained through individualistic, self-serving behavior." This observation reflects the fact that psychologists and sociologists have identified a much larger range of human motives - than have agency theorists - such as the need for achievement, responsibility, recognition, altruism and respect for authority that aligns the interests between agents and principals (Bettis and Donaldson, 1990; Muth and Donaldson, 1998).

Models of Managerial Behavior and the Organization of Corporate Boards

Davis et al. (1997:225) indicate: "If the utility functions of self-serving agents and principals coincide, there is no agency problem: both agents and principals enjoy increases in their individual utility." The consequences of this observation are rather far-reaching when the stewardship theory is applied to the formal organization of corporate boards. To maximize the interests of shareholders, the stewardship theory strongly emphasizes management participation in board activity and the empowerment of executive directors. Based on a definition of Lorsch (1995), empowerment means that executive directors have the capability, authority and discretion to influence the strategic direction of the corporation. As indicated by Donaldson and Davis (1994:159), stewardship theory suggests that " . . . organizational financial performance and shareholder wealth will be maximized by empowering managers to exercise unencumbered authority and responsibility." In line with Finkelstein and D'Aveni (1994), the juxtaposition of conflict and consensus perspectives of board organization and their underlying theoretical assumptions make the study of board structures compelling. Based on the premise that corporate boards of directors need to direct management and represent shareholders' interests, the agency theory advocates independent formal board structures that support the control roles of boards. Grounded in a conflict perspective of board organization, the agency theory seeks a control oriented board model with independent board leadership, outsider-dominated board composition and independent oversight board committees. These specific elements of board organization are designed to constrain the behavior of agents.

In contrast to the agency theory, proponents of the stewardship theory seek formal board structures that empower managers through structures that integrate decision management with decision control (Davis et al., 1997). Based on the Theory Y view of human behavior, the stewardship theory proposes a board model that seeks to support the involvement of directors in the strategic course of the corporation through the integration of CEO and chairman roles, insider-dominated board composition and supporting board committees in so-called "participative boards" (Andrews, 1982). As such, the stewardship theory departs from the view that the behavior of agents needs to be constrained by organizational structures. As an alternative to agency theory, it holds the opposite view that board structures can ineffectively constrain the behavior of agents when they do not facilitate trust, empowerment and clear cut leadership for strategy formulation and implementation (Muth and Donaldson, 1998). The implications of the Theory Y view of human behavior on the organization and composition of one-tier and two-tier boards are explored in more detail in the remaining parts of this chapter. See also table 4.1 for the assumptions of the stewardship theory and the agency theory and the implications for board model design of these assumptions.

Table 4.1
The Comparison of Conflict and Consensus Perspectives of Board Organization

		Conflict perspective:	Consensus perspective:
Assumptions of Human Models:	Theoretical basis:	agency theory.	stewardship theory.
	Human model:	opportunism, theory X; self-serving.	altruism, theory Y; collective serving.
	Information asymmetries:	large.	small.
	Incentives:	extrinsic financial rewards. identification with individual goals.	intrinsic motivation and satisfaction identification with organizational goals.
	Time frame:	short.	long.
	Objective:	cost control.	performance enhancement.
	Control mechanism:	internal and external control mechanisms.	trust.
Implications for Board Model Design:	Board model:	control oriented; control model to alleviate agency problems;	involvement oriented; participating model to empower management.
	Leadership structure:	independent, CEO and chair positions are separated.	dual = CEO-duality: CEO and chair positions are combined.
	Composition:	outsider-dominated.	insider-dominated.
	Committees:	oversight committees.	supporting committees.
	Organization:	two-tier.	one-tier.
	Board involvement / roles:	separation of decision management from decision control; control roles.	integration of decision management with decision control; strategic roles.
	Representatives:	Williamson (1985); Kosnik (1990); Johnson et al. (1993); Fama and Jensen (1983).	Donaldson (1990); Donaldson and Davis (1991, 1994); Davis et al. (1997).

Sources: based on Davis et al. (1997:37); Jonnergård and Svensson (1995:68).

4.3 A Consensus Perspective of One-Tier Board Model Attributes

One-Tier Board Composition

In contrast to the dominant belief that corporate boards are most effective when they are comprised of non-executive directors, stewardship theorists argue that corporate boards should be composed of executive directors. The stewardship theory argues that non-executive directors do not always have the expertise and inside knowledge of executive directors to effectively contribute to strategic decision making. According to proponents of the stewardship theory, executive directors offer direct working knowledge to the board and may raise issues which might otherwise be neglected by the CEO (Davis, 1991; Kesner and Johnson, 1990). Insider-dominated boards are also favored " . . . for their depth of knowledge, access to current operating information, technical expertise and commitment to the firm" (Muth and Donaldson, 1998:6). Even strong proponents of conflict approaches to board organization have recognized the benefits of management participation in corporate boards. Williamson (1985:317) - for example - indicates that the " . . . rejection of the participating model in favor of a control model of the decision ratification and monitoring kind does not, however, imply that the management should be excluded altogether." The author indicates that management participation on corporate boards affords three benefits:

- it permits the board to observe and evaluate the process of decision making as well as the outcomes. The board thereby gains superior knowledge of management's competence that can help to avoid appointment errors or correct them more quickly;
- the board must make choices among competing investment proposals. Management's participation may elicit more and deeper information than a formal presentation would permit;
- management's participation may help safeguard the employment relation between management and the firm – an important function in view of the inadequacy of formal procedures for grievance.

Source: Williamson (1985:317).

As suggested by chapter three of this study, one-tier corporate boards are associated with insider-dominated boards (Bhagat and Black, 1997). As such, it can be suggested that one-tier boards benefit from the knowledge and expertise of executive directors when they are involved in the strategic course of corporations. Based on a consensus perspective of board organization, this observation suggests:

Assumption 3a: one-tier boards composed of a majority of executive directors are positively associated with the integration of decision management with decision control.

Interestingly, a growing body of literature challenges the assumption that boards composed of executive directors do not act in the interests of shareholders. Bhagat and Black (1997) found no convincing empirical support for a relationship between performance criteria and board composition after they had examined the composition of 934 large public corporations in the US between 1991 and 1995. Dalton et al. (1998) revealed virtually no evidence of a systematic relationship between board composition and financial performance after they reviewed a large number of studies. In another extensive review of the corporate governance literature, Donaldson and Davis (1994) also found no support for the assumption that boards composed of non-executive directors produce better outcomes than insider-dominated boards. These findings challenge the wisdom of reformers and other activists that one-tier boards should be composed of a majority of non-executive directors. In summary, research fails to prove conclusive findings on the relationship between board composition and performance criteria because:

- studies are mixed regarding whether the proportion of non-executive directors has a positive effect on overall firm performance;
- there is some support for the proposition that non-executive directors make a difference in specific transactions involving potential conflicts of interest between management and shareholders – for example, turnover due to poor firm performance, the level and structure of executive compensation, corporate acquisitions, adoption of poison pills and management buy-outs;
- certain types of non-executive directors appear to have better incentives to monitor management than others. For example, there is some evidence that directors with more additional non-executive directorships seem to act in shareholders' interests;
- certain factors appear to affect non-executive directors' ability to monitor management – for example, the length of non-executive directors' tenure on the board, non-executive directors' professional qualifications, and the length of the CEO's tenure in office;
- there is some evidence suggesting that alternative control mechanisms, such as the market for corporate control and concentration of ownership, may substitute or complement monitoring by directors.

Source: Lin (1996:964).

These findings suggests support for the stewardship theory that one-tier board structures dominated by executive directors are not necessarily dysfunctional. In response to these findings, Bhagat and Black (1997:45) propose that ." . . the burden of proof should perhaps shift to those who support the conventional wisdom that a monitoring board – composed predominantly of independent directors – is an important element of improved corporate governance." Seen from a more practical point of view, Donaldson and Davis (1994) state: "We believe that it would be unwise at the present time to go along with calls to require boards of corporations to be dominated by non-executives."

One-Tier Board Leadership Structure

While reformers and institutional investors favorably respond to the separation of CEO and chair roles, a growing number of scholars suggests that a separation of the two roles can be negatively associated with shareholder wealth. Brickley et al. (1996) state that while splitting the two titles can have potential benefits, there may be also undesirable costs associated with the separation of the roles. The authors indicate the following issues related to independent leadership structures:

- an independent chairman can monitor the CEO's actions – but who then will monitor the chairman's actions?;
- separating the titles necessitates the costly and generally incomplete transfer of critical information about the firm between the CEO and the chairman;
- withholding the title of chairman until a CEO has performed well during a probationary period gives the CEO an appropriate performance incentive. A permanent independent chairman eliminates this incentive, and;
- splitting the titles can be confusing – both internally and externally – about who is really in charge.

Source: Brickley et al. (1996:66).

In favor of dual board leadership structures, Dahya et al. (1996) indicate:

- combining the overlapping domains of chairman and CEO arguably represents a rationalization of the decision making process which should permit a sharper focus on company objectives and promote more rapid implementation of operational decisions;
- if the CEO is believed to be an individual of outstanding strategic vision, then it makes good practical sense that his vision should be permitted to shape the destiny of the firm with a minimum of board interference;
- the evidence that company performance is likely to be enhanced by an independent chairman is open to challenge;
- the fact that, as far as one can tell (for many large US corporations refuse to publish relevant data or to respond to questionnaires), the majority of the largest US companies prefer a dual CEO top management structure. This may suggest that, at the very least, they perceive no significant disadvantages in operational performance or in share performance from this concentration of responsibilities.

Source: Dahya et al. (1996:71-77).

According to Boyd (1994), proponents of the stewardship theory propose that dual board leadership structures facilitate effective actions by executive directors which are positively associated with firm performance. Due to the assumption that individuals seek intrinsic satisfaction as good stewards of the organization, the empowerment of the CEO leads to maximized financial performance and shareholder wealth (Donaldson and Davis, 1994). Finkelstein and D'aveni (1994) argue that CEO-duality facilitates decision making by establishing clear lines of authority and responsibility. Davis (1991:251) indicates that dual governance structures provide flexibility to respond rapidly to environmental changes: "In theory, the dual structure bypasses many of the complex, hierarchical decision making mechanisms found in the independent structure." As suggested by the stewardship theory, dual board leadership structures integrate decision management with decision control. With respect to one-tier boards, this assumption is formalized as follows:

Based on a consensus perspective of board organization, assumption 3b suggests:

Assumption 3b: CEO-duality in one-tier boards is positively associated with the integration of decision management with decision control.

Similar to research on the relationship between board composition and firm performance, a growing number of academic observers present inconclusive findings on the relationship between board leadership structures, board independence and firm performance. In contrast to the findings of Rechner and Dalton (1991), Mallette and Fowler (1992) and Daily and Dalton (1994), Boyd (1995) found positive effects of CEO-duality on firm performance under different levels of environmental uncertainty. Boyd (1995:309) summarizes that dual leadership structures can help firm performance. The author states that the " . . . separation of CEO and Chairman positions to appease shareholders and institutional investors may prove dysfunctional in the long term. As such, unilateral governance reform on this issue may adversely affect some firms." Donaldson and Davis (1991) found that ROE (returns on equity) positively correlated with combined board leadership roles in a sample of 321 corporations in the US. In an extensive review of literature on board leadership structures, Daily and Dalton (1997) found mixed empirical support for the relationship between independent board leadership and firm performance. Brickley et al. (1996) also concluded after a study of 661 large, publicly traded corporations in the US that they could not find systematic differences in financial performance across different board leadership structures. The authors state: "It is far from obvious whether firms would be better or worse off if they split titles. Rather, it is incumbent upon the critics of combining the titles to present a cogent explanation for how combining the titles can be wealth-decreasing and still survive in a competitive marketplace" (Brickley et al., 1996:66). Dalton et al. (1998) even conclude that there is no relationship between board leadership structure and firm performance.

The inconclusive findings may suggest support for a consensus perspective of board organization that one-tier board structures with dual board leadership structures are not necessarily dysfunctional as suggested by a conflict perspective of board organization. Baliga et al. (1996:51) report: "Our findings stand in sharp contrast to the recommendations of those who call for the abolition of duality as a primary way to improve firm governance and performance. The finding of no significant difference in the operating performance suggests that a duality status change . . . is more a variant of the 'scapegoating phenomenon' . . . and a symbolic way of 'signaling' that the board is effectively exercising its governance role . . . than an effective way of motivating fundamental change in firm performance."

Table 4.2
Competing Perspectives on Board Leadership Structures

• Joint board leadership structure: • (CEO-duality)	• Separate board leadership structure:
• strong, unambiguous leadership; • internal efficiencies through unity of command; • eliminates potential for conflict between CEO and board chair; • avoids confusion of having two public spokespersons addressing firm stakeholders.	• avoids CEO entrenchment; • increases board monitoring effectiveness; • enables board chair to function as advisor to the CEO; • Establishes independence (autonomy) between the board of directors and corporate management.

Source: Daily and Dalton (1997:13).

One-Tier Board Committees and Board Organization

Stimulated by codes of best practices and the listing requirements of the NYSE and other stock exchanges, one-tier boards often provide independent oversight committees such as audit, compensation and nominating committees. Seen from a consensus perspective of board organization, organizational structures that discourage the role of management in the governance of the corporation - such as these independent oversight board committees - may not facilitate the integration of boards' decision management roles with boards' decision control roles (Maassen and van den Bosch, 1999a). This observation is formalized by the following assumption:

Based on a consensus perspective of board organization, assumption 3c suggests:

Assumption 3c: independent oversight board committees of one-tier boards are negatively associated with the integration of decision management with decision control.

As reported previously in chapters two and three of this study, the unitary structure of one-tier boards is associated with the integration of decision management with decision control. As suggested by Rechner and Dalton (1991), Sheridan and Kendall (1992), Tricker (1984, 1994) and Cadbury (1995), the unitary structure of one-tier boards facilitates the concentration of the service and control roles of boards in the hands of executive directors. In the unitary board, executive and non-executive directors work together. According to Davis (1991), the unitary structure facilitates the exchange of information between executive and non-executive directors, may avoid unnecessary bureaucracy and may improve the quality of decision making. As such, based on a consensus perspective of board organization, assumption 3d suggests:

Assumption 3d: the unitary structure of one-tier boards is positively associated with the integration of decision management with decision control.

Research on board committees, the unitary organization of boards and board independence is limited. Most literature is anecdotal and descriptive of nature. The extensive meta-analytic reviews of Dalton et al. (1998) and Donaldson and Davis'(1994) of the corporate governance literature do not provide an overview of research on board committee composition, board independence and financial performance criteria. Yet, research on board committees shows the potential to become as inconclusive as research on board composition and board leadership structures. Recent research - for example - suggests support for a consensus perspective of board organization that insider-dominated oversight board committees are not necessarily dysfunctional as suggested by a conflict perspective of board organization. Daily et al. (1988) report that they found no evidence of a systematic relationship between the composition of compensation committees and levels of CEO compensation. According to the authors, "these results are particularly intriguing given the emphasis both academics and the institutional investment community are placing on director independence" (Daily et al., 1998:215).

4.4 A Consensus Perspective of Two-Tier Board Model Attributes

Davis (1991) suggests that independent board structures may lead to more bureaucracy and information asymmetries between executive and non-executive directors. Independent structures may also have negative effects on risk taking behavior of management, innovation of the organization, the focus for objectives and the quality of decision making processes (Davis 1991). Interestingly, proponents of the stewardship theory suggest that the alleged opportunistic behavior of executive directors proposed by the agency theory not necessarily leads to information asymmetries. According to the stewardship theory, the structure of the board itself may lead to dysfunctional information asymmetries. Or, as stated by Davis et al. (1997:25): "Stewardship theorists argue that the performance of a steward is affected by whether the structural situation in which he or she is located facilitates effective action. If the executive's motivations fit the model of man underlying the stewardship theory, empowering governance structures and mechanisms are appropriate."

Seen from this point of view, proponents of the stewardship theory suggest that the composition, the leadership structure and the organization of two-tier boards may imply disadvantages for the execution of boards' strategic roles. These are explored in more detail in the following sections of this paragraph.

Two-Tier Board Composition

The two-tier board model provides supervisory boards that are entirely composed of non-executive directors. The management board is entirely composed of executive directors. According to the stewardship theory, the formal division of board roles through separate management and supervisory boards is negatively associated with the integration of decision management with decision control. Baysinger and Hoskisson (1990) indicate that information possessed by executive directors may be superior to information possessed by non-executive directors. Moreover, non-executive directors may rely mainly on financial control strategies to understand and evaluate the outcome of the strategic decision making process: "Such controls seem attractive because they are based on easily measured data and, therefore, little information about the complex decision making process leading to performance outcomes is needed" (Baysinger and Hoskisson, 1990:74). Yet, due to information asymmetries, non-executive directors may lack the knowledge to completely understand the rationale of top management's strategic actions. The assessment of executive directors' managerial efforts can furthermore be complicated by time lags between managerial efforts and project's outcome and by difficulties of disentangling managerial and environmental origins of performance (Walsh and Seward, 1990; Baysinger and Hoskisson 1990). These observations suggest that the composition of supervisory boards in two-tier boards is negatively associated with the integration of board roles. Based on a consensus perspective of board organization, this observation may lead to the following assumption:

Assumption 4a: the composition of supervisory boards in two-tier boards is negatively associated with the integration of decision management with decision control.

Chapter eight in part II of this research further elaborates on the composition of supervisory boards in the Netherlands and the integration of decision management with decision control in two-tier boards.

Two-Tier Board Leadership Structure

The stewardship theory proposes that joint leadership structures lead to strong, unambiguous leadership of the corporation. CEO-duality also may lead to internal efficiencies through the unity of command and may eliminate potential conflicts between the CEO and the board chair. The management and supervisory boards in two-tier boards formally separate the leadership functions of the CEO and the chairman of the board. As such, the stewardship theory suggests that two-tier boards may not provide the benefits of a combined joint board leadership structure.

Based on a consensus perspective of board organization, the following assumption suggests:

Assumption 4b: the board leadership structure of two-tier boards is negatively associated with the integration of decision management with decision control.

In addition to research on the composition of two-tier boards, this study could not find research that has investigated the relationship between the formal independence of two-tier boards and the leadership structure of two-tier boards. To fill this gap in the literature, chapter eight in part II of this research further explores the composition and the board leadership structure of two-tier boards in the Netherlands.

Two-Tier Board Committees and Board Organization

Although the formation of board committees is not enforced by stock exchanges and other regulators in countries that operate with two-tier board models, the two-tier board model provides board committees as well. As previously noted in chapter three of this study, oversight supervisory board committees composed of executive and non-executive directors may support the integration of board roles (Maassen and van den Bosch, 1999a). Based on this observation, a consensus perspective of board organization may support the following assumption:

Assumption 4c: oversight supervisory board committees of two-tier boards that are composed of both executive directors and non-executive directors are positively associated with the integration of decision management with decision control.

The opposite rationale may be valid for the binary structure of two-tier boards. The organization, through separate supervisory and management boards, may facilitate the separation of board roles and responsibilities. As previously noted in chapter three of this study, the management board is in charge of decision management. The independent supervisory board is in charge of decision control. As such, based on a consensus perspective of board organization, assumption 4d suggests:

Assumption 4d: the binary structure of two-tier boards is negatively associated with the integration of decision management with decision control.

Chapter eight in part II of this research further explores the relationship between the formation of oversight board committees, the binary structure of two-tier boards and the integration of board roles.

4.5 Summary

In chapter three, the association between board attributes and board independence has been approached from a conflict perspective of board organization. Due to the assumed diverging interests of principals and agents, legislators, stock exchanges and other reformers promote independent board models that separate decision management from decision control. To formalize the independence of board models, and to build a theoretical model on board model convergence, assumptions have been introduced in chapter three on the composition, the leadership structure, the committees and the organization of one-tier and two-tier boards. In general, the assumptions suggest a negative association between one-tier board attributes and board independence (see cell A in table 4.3). This implies that the structure and the composition of one-tier boards are dual in nature. Duality means that board structures facilitate the concentration of power and authority in the hands of management through the integration of decision management with decision control (Davis, 1991; Boyd, 1995). In contrast to the duality of one-tier boards, chapter three suggests a positive relationship between two-tier board attributes and the separation of decision management from decision control (see cell B). This implies that two-tier boards are independent in nature due to the binary structure of the board (the supervisory and management boards), the formal separation of CEO and chairman roles and the absence of executive positions in supervisory boards.

Table 4.3
Conflict and Consensus Perspectives of Board Independence, Board Duality and Board Model Design

	One-tier board attributes.	Two-tier board attributes.
The separation of decision management from decision control: (independent structure).	- Agency theory. (conflict). cell A	+ Agency theory. (conflict) cell B
The integration of decision management with decision control: (dual structure).	+ Stewardship theory. (consensus) cell C	- Stewardship theory. (consensus) cell D

Chapter four further built on a consensus perspective of board organization. As part of the theoretical model on board convergence in this research, it explored assumptions related to the structure of one-tier and two-tier boards and the integration of board roles. Three assumptions (assumptions A.3a, A.3b and A.3d) suggest a positive association between the composition, the leadership structure and the organization of one-tier boards and the duality of one-tier boards. In line with the observations in chapter three, a negative association is suggested between the formation of independent oversight board committees and the duality of one-tier boards (assumption A.3c). In general, the assumptions suggest that the integration of decision management with decision control is supported by one-tier boards composed of executive directors who operate with a combined board leadership structure (see cell C in table 4.3).

This chapter also sought to find support for the assumption that a negative relationship can be found between two-tier board attributes and the integration of decision management with decision control (cell D in table 4.3). Seen from a consensus perspective of board organization, the composition of supervisory boards is negatively associated with the integration of decision management with decision control (assumption A.4a). Assumption A.4b suggests a negative relationship between the leadership structures of two-tier boards and the integration of board roles. In a similar vein, the binary structure of two-tier boards is negatively associated with the integration of decision management with decision control (assumption A.4d). Board committees of supervisory boards are positively associated with the integration of board roles (assumption A.4c). See also figures 4.1 and 4.2 for an overview of assumptions related to board model attributes and board duality.

Part II of this research further explores the organization and composition of boards in the US, the UK and the Netherlands. First, chapter five presents an integrative model on board independence, board duality and the convergence of board models based on the assumptions developed in this chapter and chapter three of this study.

Figure 4.1
The Duality of One-Tier Boards

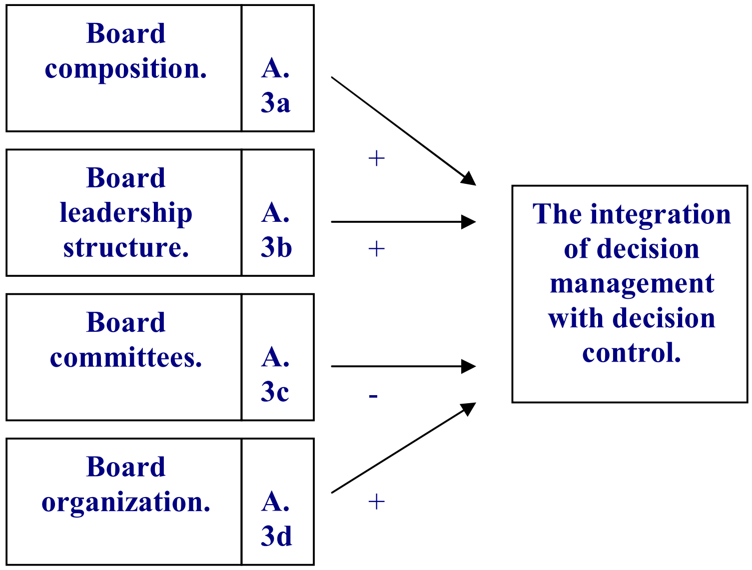
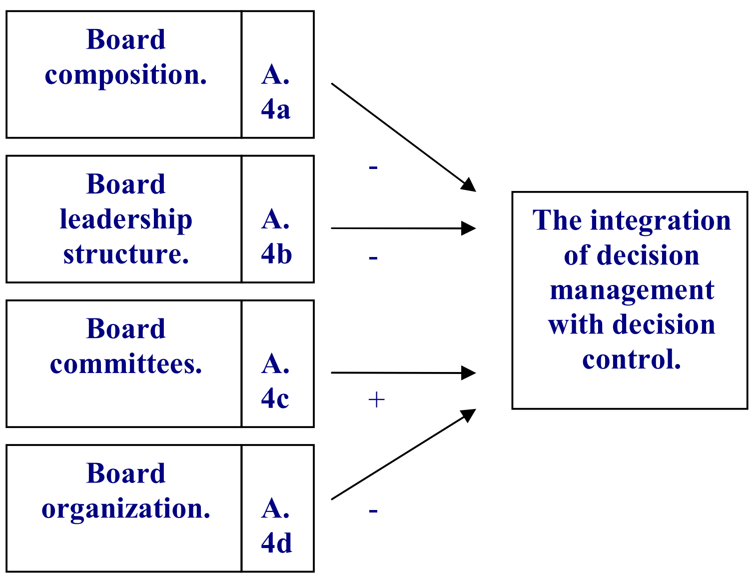


Figure 4.2
The Duality of Two-Tier Boards



Chapter 5: The Convergence of One-Tier and Two-Tier Board Models

5.1 Introduction

Although chapter four presents research that questions the assumption that dual one-tier boards are ineffective governance mechanisms, the conventional wisdom of reformers is still dominated by a conflict perspective of board organization. Developments in international corporate governance indicate a growing concern of legislators, regulators and investors with the formal independence of corporate boards in the US and the UK. The introduction of voluntary codes of best practices and new listing requirements of stock exchanges and the introduction of global corporate governance principles by institutional investors suggest that corporations are increasingly pressured by financial markets in Anglo-Saxon countries to alter the organization of their boards. In addition, pressures on the formal organization of boards of directors can be discerned in continental European countries. Even corporations in the former Soviet Union are confronted with emerging international corporate governance standards through privatization initiatives from the World Bank, the International Finance Corporation (IFC) and other internationally oriented organizations. As suggested by Maassen and van den Bosch (1997a), pressures from regulators, legislators and investors may stimulate directors to transform the formal organization of their boards into more independent board structures. This chapter further explores this process of board model transformation in listed corporations that operate with one-tier and two-tier boards of directors.

Outline

The organization of this chapter is as follows. As observed in chapter two of this research, general models of board involvement recognize external contingencies that may have an impact on the organization and composition of corporate boards. Societal pressures, regulatory systems and ownership patterns - for example - are considered to act as fundamental influences on the role and the organization of corporate boards (Judge, 1989). As indicated above, stock exchanges and institutional investors are increasingly playing a dominant role in the international discussion on board independence. This chapter further identifies the pressures from stock exchanges, legislators and institutional investors on corporate boards of directors. First, paragraph 5.2 briefly reviews the role of stock exchanges in the process of board model transformation and board model convergence. Information on these developments was not easy to obtain from the literature. When available, the literature mainly focuses on developments in the UK where the Cadbury Code and its successors have dominated the corporate governance debate. Much less is known about developments in continental European countries and other financial regions. To fill in this gap of interest, this study initiated a survey sent to all leading stock exchanges in Europe, North- and South-America and Asia in 1997. This paragraph presents the findings of the survey on the latest developments in listings rules, codes of best practices and other self-regulatory initiatives from stock exchanges that relate to the corporate governance structure of listed corporations. To illustrate the potential impact of legislation on changes in the formal organization of corporate boards, paragraph 5.3 introduces the reader to the latest developments in the draft Fifth Directive on Company Law of the European Union. Paragraph 5.4 examines the role of institutional investors in the global corporate governance debate. The literature on the role of institutional investors in the corporate governance debate is dominated by studies on shareholder activism in the US. Information on the role of institutional investors in the transformation of boards in other countries was difficult to obtain during the course of this research project.

Initiatives from legislators, regulators, exchanges and investors give rise to the development of a model on the transformation and convergence of one-tier and two-tier boards. This theoretical model is presented in paragraph 5.5. The model is based on assumptions previously developed in chapters three and four of this study. The model generates three propositions on the transformation of board models. These propositions are the building blocs of the convergence hypothesis of this study. The convergence hypothesis suggests that differences between the characteristics of board models may be reduced over time due to pressures from legislators, boardroom reformers, stock exchanges and institutional investors. Paragraph 5.6 presents a summary of this chapter.

In part II of this research, the convergence hypothesis is examined through the exploration of developments in the formal independence of one-tier boards in the US (chapter six) and the UK (chapter seven). Developments in the formal independence of Dutch two-tier boards are investigated in more detail in chapter eight of this study.

5.2 The Role of Stock Exchanges in Corporate Governance

In fostering good standards of corporate governance, stock exchanges play a "pivotal role" in the international debate on board independence (Price Waterhouse, 1997b). As second tier regulatory agencies, stock exchanges have the unique power to amend listing rules related to the governance structure of listed corporations. The New York Stock Exchange (NYSE) - for example - first started to recommend the formation of audit committees in 1939. The NYSE extended its regulatory regime when it required listed domestic corporations to establish audit committees in 1978. In response to the publication of the "Treadway Report of the National Commission on Fraudulent Financial Reporting" in the US in 1987, the London City initiated the well-known "Cadbury Committee on the Financial Aspects of Corporate Governance" in 1992 to improve corporate governance standards in the UK. The Hampel committee ("Cadbury II") was formed in 1996 to evaluate the response from the business community to the recommendations of Cadbury. Many other exchanges followed the early initiatives in the US and the UK. The Hong Kong Stock Exchange introduced the requirement to name at least two independent directors to the boards of listed corporations in 1993 (Far Eastern Economic Review, April 15, 1993). The Toronto Stock Exchange (TSE) published "Where Were the Directors? Guidelines for Improved Corporate Governance in Canada" in December 1994. Inspired by an extensive number of financial failures in Canada, the Toronto Stock Exchange Committee on Corporate Governance issued 14 recommended guidelines in the so-called Dey Report (Rosen, 1995). The committee advocated, amongst other things, that a majority of the directors should be "unrelated" to management. The committee also promoted the formation of a board committee on the nomination of directors and advocated the separation of the role of chairman of the board from the CEO role. In March 1995, the TSE adopted the recommendations of the Dey Report. Since June 30 1995, all corporations on the TSE are required to disclose their governance structures vis-à-vis the TSE guidelines (Conner, 1995).

The diffusion of self-regulation in corporate governance has also become visible in continental European countries and financial regions in Africa, Asia and the Pacific. Headed by Marc Viénot, the CNPF (Conseil National de Patronat Français) and the AFEP (Association Française des Entreprises Privées) established a committee to discuss the role, the composition and the procedures of boards of directors of listed French corporations. The 1995 "Viénot Report" stimulated directors to reduce the number of cross-directorships and stimulated the appointment of at least two independent directors to boards of listed corporations. In Australia, the 1995 Bosch Report on Corporate Practices and Conduct resulted to a new rule from the Australian Stock Exchange that requires listed corporations to include a statement on corporate governance in annual reports. Also the Johannesburg Stock Exchange revised its listing requirements in 1996. Since 1997, listed South African companies are required to disclose in annual reports the extent of compliance with the recommendations of The King Report on Corporate Governance (Chapman, 1996). The King Report of March 1996 recommends that different individuals should hold the positions of the chairman and chief executive. "The Code of Corporate Practices and Conduct" also addressed the responsibilities of executive and non-executive directors, worker participation on the board and the disclosure of board compensation in South Africa. Other corporate governance initiatives came from the Helsinki Stock Exchange Corporate Governance Committee in 1996, the Stock Exchange of Singapore in 1996 and the Botswana Stock Exchange Committee in 1997. More recently, the Brussels Stock Exchange established the Belgian Commission on Corporate Governance in 1998. As with most initiatives from stock exchanges, the Belgian commission based its code of best practices on three principles: transparency, integrity and responsibility. Directly related to the one-tier board structure of Belgian corporations, the voluntary rules recommend that when the chairman is also the CEO, a "strong and independent element" should be included in the board. The code also recommends that the board and its remuneration, nomination and audit committees, where such exist, should be composed of a majority of non-executive directors. Although not related to one-tier boards, the Amsterdam Stock Exchanges also introduced "Forty Recommendations for Corporate Governance" in the Netherlands. The guidelines were established in 1997 to start a national debate on the effectiveness of the Dutch two-tier board model.

The Unification of the European Equity Market

Another development that may have an impact on the formal independence of corporate boards is the role of stock exchanges have in the creation of a unified European equity market. The first step to a single European stock market was officially set by the London Stock Exchange and the Deutsche Börse on 7 July 1998. These two leading exchanges signed a "Memorandum of Understanding" to form a strategic alliance that undoubtedly will contribute to the development of a joint electronic trading platform in Europe and the harmonization of market rules and other conventions related to large stocks (www.stockex.co.uk, Jan. 1999). According to these exchanges, the participation of other European exchanges is welcomed to form a pan-European market for some 300 blue chip equities around the beginning of the year 2000. Especially the harmonization of market rules may have an impact on the formal independence of boards of directors of listed corporations. During the process of harmonization, exchanges will probably adapt their rules to the Combined Code in the Yellow Book of the London Stock Exchange after they have decided to participate in the pan-European project.

Self-Regulation and the Transformation of Board Models

Self-regulation is essential to the initiatives of stock exchanges that aim at the amendment of listing rules and the adoption of codes of best practices and other guidelines on the governance structure of listed corporations. According to Conner (1995:16), disclosure, and not compliance, is at the heart of these self-regulatory initiatives: "Companies are not required to structure their governance activities around the guidelines, but they will be expected to explain how their board has addressed the issues raised in the guidelines." The Cadbury Code - for example - assumes that a voluntary code coupled with disclosure is the best strategy to improve corporate governance standards in the UK (Finch, 1994). The first compliance reports indeed suggest that self-regulatory initiatives to improve corporate governance standards are increasingly being adopted by directors. In England, the Cadbury Committee published a compliance report that found that ninety percent of the top one hundred corporations had issued a statement of full compliance with the code between September 1993 and December 1994 (Samuels et al., 1996). In Canada, KPMG (www.kpmg.ca/vl/other/cgdissrv.htm, Jan. 1999) found in a survey that 64 percent of the TSE 300 corporations had made changes to their corporate governance structures by the beginning of 1997 as a result of the recommendations of the Dey Report. Other compliance reports have been initiated in the Netherlands (Maassen, 1998a, 1999a; VEB, 1998; AEX, 1998; Weimer 1998), Canada (Conner, 1995) and France (www2.atelier.fr/ciec, Jan. 1999), and more initiatives that measure the effectiveness of voluntary guidelines on corporate governance will possibly follow. Although it is too early to indicate that these self-regulatory initiatives will result in changes in the formal independence of corporate boards, the first compliance reports may indicate a positive contribution of self-regulation to the transformation of board models (Pahn, 1998).

5.3 The Draft Fifth Directive on Company Law

The Draft Fifth Directive on Company Law exemplifies legislation that may lead to the transformation of the formal structure and composition of corporate boards in public corporations in Member States of the European Union (EU). According to Du Plessis and Dine (1997:23-24), the European Economic Community was founded on the " . . . ideal that through harmonisation and co-ordination the states of Europe could be brought together into a political union as well as a single market. An important objective in achieving this goal was the harmonisation and co-ordination of the divergent company laws of the Member States, with priority given to the 'public company' because these companies, much more than others, carry on cross-frontier activities." It was against this background that the first Draft Fifth Directive on Company Law was issued by the European Commission in 1972. The main goal of the Draft Fifth Directive was - and still is - to co-ordinate the laws of the Member States in the EU that relate to the structure of public companies (www.europe.eu.int, Jan. 1999). At this moment, the Draft Fifth Directive provides the following rules:

Member States must ensure that public companies are organized according to either a two-tier board structure (management body and supervisory body) or a one-tier system (administrative body in which the actions of the executive members are supervised by the non-executive members).

The authorization of the supervisory body or non-executive members will be required by the management body or executive members for decisions relating to:

- the closure or transfer of all or part of the company;
- substantial extension or reduction in the activities of the company;
- important organizational changes; and
- the establishment or ending of long-term co-operation with other firms.

In companies with fewer than 1,000 employees, the members of the supervisory body will be appointed by the general meeting. If a company has more than 1,000 employees, Member States must provide employee participation in the appointment of:

- members of supervisory bodies in the two-tier system;
- non-executive members of boards in the one-tier system.

A maximum of two-thirds of the supervisory body or non-executive members will be appointed by the general meeting. A minimum of one-third (maximum of one-half) will be appointed by the employees. Alternatively, members of the supervisory body may be appointed by co-optation by the board itself. However, the general meeting of shareholders or the employees' representatives may object to such an appointment on certain specified grounds. Another alternative is for Member States to provide employee participation through a works council or through a collective agreement system. No person may be a member of the management body and the supervisory body at the same time. To ensure a wide measure of participation in the company's activities, it will be necessary:

- to strengthen the position of shareholders regarding the exercise of their voting rights, which should be proportionate to the shareholder's stake in the company capital;
- to impose limits on the issue of preference shares without voting rights.

There must be an annual general meeting and other general meetings can be convened by either the management body, the executive members of the administrative body or shareholders (providing the latter represent a certain minimum proportion of the share capital). The annual accounts, annual report and the auditors' report must be made available to every shareholder. Except in special circumstances, resolutions of general meetings can be passed only by absolute majority. Minutes have to be prepared of every general meeting. The memorandum or articles of association may not confer on the holders of a particular category of shares an exclusive right to put forward nominations for a majority of those members of the supervisory organ whose appointment is a matter for the general meeting.

The annual accounts are subject to several requirements. For example, 5 pecent of any profit for the year has to be put in a legal reserve until it reaches a certain minimum. The audit has to be undertaken by persons truly independent of the company, appointed by the general meeting. The auditors have to produce a detailed report of their work.

The memorandum or articles of association may not confer on the holders of a particular category of shares an exclusive right to put forward nominations for a majority of those members of the administrative organ whose appointment is a matter for the general meeting.

Certain derogations from the Directive are allowed, e.g. for companies with political, religious, charitable or educational objectives.

Source: www.europe.eu.int (Jan. 1999).

The implementation of the Draft Fifth Directive on Company Law may lead to a more harmonized and unified body of corporation laws and to changes in the formal independence of corporate boards incorporated in the European Union. Another development relates to the "Statute for a European Company." This statute makes it possible for corporations to form a holding company or joint subsidiary in the European Union while they can avoid the legal and practical constraints arising from the existence of many different legal systems. The Statute provides four ways to form a European company (Latin: "Societas Europaea", "SE"). The SE can be established through a merger, through the formation of a holding company, through the formation of a joint subsidiary or through the conversion of a public limited company previously incorporated under national law of one of the Member States (www.europe.eu.int, Jan. 1999). The statutes of a SE must provide the following governing bodies: the general meeting of shareholders and either a board of directors with a management board and a supervisory board or an administrative board based on a single-tier system.

5.4 The Role of Institutional Investors

In addition to initiatives from stock exchanges and emerging European legislation, institutional investors are increasingly putting pressure on corporations to alter the composition and structure of boards. According to McCarthy (1996), it is hard to ignore the pressures from institutional investors on corporate governance practices of listed corporations. According to the author, "there is no denying the new wave of pension fund shareholder activism" (McCarthy, 1996:16). Russell Reynolds Associates indicate: "The sudden flood of shareholder proposals that began in the United States in the late 1980s, has evolved into a steady stream of investor activism . . . investors from many different nations have strengthened their power to influence boardrooms – not only in markets where corporate governance issues have long received attention but also in those that previously might have considered themselves beyond the concern of boardroom reformers" (Russell Reynolds Associates, 1998:3). Especially institutional investors and large pension funds in the US, such as CalPERS, CalSTRS, TIAA-CREF, NYC and SWIB[1] have taken the lead in shareholder activism. According to Pomeranz (1998), institutional investors - which account for some 80 percent of all share trading in the US and which had 51.5 percent of the total market value of US equity securities in 1994 - have a potential to exert significant influence on corporations via the exercise of voting rights. As one of America's largest and most active public pension funds, with over USD 133 billion in assets, the California Public Employees' Retirement System (CalPERS) can be seen as one of the founders of the shareholder activism movement. Its famous corporate governance program in the US targeted corporations such as IBM, General Motors, American Express, Kmart and Sears. Some studies indicate that shareholder activism indeed may pay off. CalPERS - for example - claims that an investment of some USD 500,000 in shareholder activism leads to additional earnings of tens of millions US dollars annually (Pomeranz, 1998). CalPERS has also been active in building alliances

[1] Abbreviations stand for the California Public Employees' Retirement System, California State Teachers Retirement System, New York City Funds, College Retirement Equities Fund and State of Wisconsin Investment Board (Del Guercio and Hawkins, 1997).

with other pension funds through the Council of Institutional Investors to assure that public funds are becoming more actively involved in proxy voting in the US (Hemmerick, 1998).

The activities of CalPERS are not limited to financial markets in North-America. The public fund targets some 24 percent of its assets to international investments. To safeguard its investments, CalPERS has established global principles of governance with “minimum requirements” of sound corporate governance for markets throughout the world. Through its “International Corporate Governance Program”, adopted in 1996, CalPERS aims at establishing governance principles that recognize differences in markets in the UK, France, Germany and Japan. According to Kayla J. Gillan, CalPERS’ General Counsel: “CalPERS hopes that [the, eds.] international program will stimulate further debate and discussion about proper governance practices. We recognize that we cannot change corporate governance in Europe, but we can use our voice to support European investors and officials who can. By working with investors within Europe, we hope to influence all companies to focus on maximizing shareholder value” (Gillan, 1997:478). The six aspects of CalPERS’ International Corporate Governance Program are summarized in table 5.1.

Other institutional investors have followed the initiatives of the large pension funds in the US. Especially in the UK, institutional investors affiliated with the National Association of Pension Funds have become more actively involved in corporate governance. HERMES, a subsidiary of the British Telecom Pension Scheme and one of largest institutional investors in the UK, published “A Statement on Corporate Governance and Voting Policy” in July 1998. In response to the publication of the Combined Code of the LSE, this statement contains provisions on the independence of corporate boards, the separation of chairman and chief executive positions, the formation of board committees and the appointment of senior non-executive directors to boards of directors in the UK. Also in the Netherlands, the first signs are to be seen that institutional investors are gaining interest in corporate governance. The ABP, one of the largest Dutch pension funds, - for example - has drawn up corporate governance guidelines (Pension and Investments, September 1, 1997). Although it is also too early to indicate that shareholder activism has a positive impact on the formal independence of corporate boards in the US, Europe and other financial regions, and although it is also too early to discriminate fundamental changes in corporate governance systems from ceremonial and cosmetic changes, the first initiatives from institutional investors may indicate the start of an inevitable process in which listed corporations are increasingly confronted with pressures from the market place to transform their boards into more independent board structures.

Table 5.1
CalPERS' Global Corporate Governance Principles

Accountability:	**Duty to shareholders** The board of directors or the supervisory board must be accountable to shareholders; **Oversight boards** Boards should have the ability to monitor management and investors should have the ability to monitor boards; **Executive compensation** Executive compensation should be tied to company's long term performance.
Transparency:	**Openness** Globally-competitive markets depend on openness and reliability of information provided by corporations; **Accounting standards** Companies should recognize international accounting standards; **Compliance reporting** Companies should report to shareholders their compliance to Codes of Best Practices.
Equity:	**Equitable treatment** Companies should also respect minority shareholders. They should provide equitable treatment to all shareholders; **One share/one vote** Every share of stock should entitle the holder to one vote in shareholder meetings.
Voting methods:	**Proxy materials** These should be clear, concise and should provide adequate information for shareholders; **Ballot counting** All shareholder votes, whether cast in person or by proxy, should be formally counted, with the vote outcome formally announced; **Technology** New technology should be utilized to make the process of proxy voting easier.
Codes of best practices:	**Development** All markets should develop an appropriate Code of Best Practices, by which corporate directors and executives can regulate themselves; **Application** Companies should adhere to the principles in Codes of Best Practices; **Review and improvement** Market participants should periodically review Codes of Best Practices.
Long-term vision:	**Content** Corporate directors and management should have a long-term strategic vision which at its core emphasizes sustained shareholder value.

Source: based on CalPERS at www. calpers.ca.gov/invest/corpgov/whycg.htm (Jan. 1999).

5.5 A Theoretical Model of Board Model Convergence

Berger (1996) indicates that the theory of convergence draws on conceptions of international competition, globalization and regional integration. As previously indicated, the diffusion of the role of stock exchanges in self-regulation, the unification of equity markets, emerging new legislation and pressures from institutional investors may contribute to the transformation of corporate governance systems. Pahn (1998:43-61) states: ". . . throughout the world, the practice of corporate governance is increasingly becoming isomorphic as codes of conduct are promulgated and standards of governance are enforced by . . . globally oriented organisations [. . .] It has been easy in the past to identify differences in corporate governance practices, primarily driven by tradition, law and social structure, between Asia, continental Europe and the USA. This is now increasingly difficult. Where before, standards of good practice have merely been suggested, there is an increasing movement within regulatory bodies to render them mandatory and homogenous across jurisdictions." Rubach and Sebora (1998:167) suggest: "As governance structures and systems initially developed, differing legal, financial, and cultural factors caused them to vary. Divergent paths resulted in multiple governance forms. Presently, evidence is growing that these governance systems are changing and are beginning to look more alike. This convergence of governance systems can be viewed as the adoption of the best practices of the existing systems."

Thurman (1990:28) also indicates: "The board of directors, long a bastion of the capitalistic system, is proving to be affected like other institutions, by the economic, political and social environments of the countries around the world."

Seen from a theoretical point of view, this development can be approached from both conflict and consensus perspectives of board organization. According to a conflict perspective of board organization, the composition, the leadership structure and the organization of one-tier boards are negatively associated with the separation of decision management from decision control (see assumptions A.1a, A.1b and A.1d in chapter three). A conflict perspective of board organization suggests that the composition, the leadership structure and the organization of two-tier boards are positively associated with the separation of board roles (see assumptions A.2a, A.2b and A.2d in chapter three). As indicated by figure 5.1, this may suggest that the incorporation of key two-tier board model attributes into one-tier models (arrow a) would facilitate the separation of decision management from decision control. Seen from a consensus perspective of board organization, chapter four suggests that the integration of decision management with decision control can be facilitated by the incorporation of key one-tier board attributes in two-tier boards. This process is indicated by arrow b in figure 5.1.

The combination of assumptions developed in the previous chapters of this study give rise to two propositions on the transformation of board models. These propositions (P1 and P2) are indicated by respectively arrows a and b in figure 5.1. Based on a conflict perspective of board organization, proposition 1 (P.1) states:

To facilitate the separation of executive directors' decision management role from non-executive directors' decision control role, appropriate attributes of two-tier boards are incorporated into one-tier boards.

Proposition 2 (P.2), as suggested by a consensus perspective of board organization states:

To facilitate the integration of executive directors' decision management role with non-executive directors' decision control role, appropriate attributes of one-tier boards are incorporated into two-tier boards.

Developments in major board models, as suggested by propositions P.1 and P.2, may indicate a process of board model transformation due to pressures from legislators, exchanges, institutional investors and others.

Figure 5.1
A Theoretical Framework of Board Model Transformation and Convergence

	Conflict perspective: Separation of decision management from decision control roles.		**Consensus perspective:** Integration of decision management with decision control roles.	
One-tier board attributes:				
Composition.	-	A.1a	+	A.3a
Leadership.	-	A.1b	+	A.3b
Committees.	+	A.1c	-	A.3c
Organization.	-	A.1d	+	A.3d
Two-tier board attributes:	(a) P.1	↑	(b) P.2	↓
Composition.	+	A.2a	-	A.4a
Leadership.	+	A.2b	-	A.4b
Committees.	-	A.2c	+	A.4c
Organization.	+	A.2d	-	A.4d

A.1a = Assumption 1a, etc.

Source: based on Maassen and van den Bosch (1997b).

This may suggest that the transformation of board model attributes works in two directions and that differences between attributes of one-tier and two-tier boards may be reduced over time. One-tier board models may transform towards a two-tier board model and vice versa two-tier boards may incorporate more dual attributes. This observation is formalized by proposition 3 (P.3):

Over time, a tendency towards convergence of major board models can be observed through diminishing differences between the key attributes of one-tier and two-tier boards of directors.

A few studies have considered the transformation and convergence of board models (Demb and Neubauer, 1992b). The International Capital Markets Group (1995) indicates that developments of global markets and the growth of cross-border investment activity have brought about a natural process of board model convergence. The study found international developments in the formation of oversight committees and a global tendency of boards to separate CEO and chairman roles. Cadbury (1995) suggests that American boards are moving towards a de facto two-tier structure by means of an increasing proportion of non-executive directors in the board and the formation of executive board committees comprised entirely of executive directors. Goddard (1996) indicates that there is an increasing similarity of company laws through regional convergence in the European Union and the US that can diminish differences between board models. Yoshimori (1995) and Kester (1996) also suggest that signs of partial convergence are discernible in Japanese and Western board models. To further explore the transformation and convergence of board models, this study elaborates on changes in the formal organization of corporate boards of directors in the US, the UK and the Netherlands.

5.6 Summary

Empirical evidence on the transformation and convergence of boards is still limited. Although a process of board model transformation seems to be inevitable, systematic research on developments in corporate boards of directors is still underdeveloped. To contribute to the corporate governance literature, this chapter presents a formal framework on board model transformation and convergence. Seen from a conflict perspective of board organization, international developments suggest that one-tier boards are under pressure to transform towards a more independent board model. Although not promoted by reformers, proponents of a consensus perspective of board organization seek more duality in two-tier boards. As such, the transformation of board models could be a two-directional process. Part II of this research further elaborates on the transformation and convergence of board models. In chapter six, changes in one-tier boards of the largest listed corporations are explored in more detail in the US. Chapter seven concentrates on developments in one-tier boards in the UK. To reveal developments in the structure and the composition of two-tier boards, chapter eight concentrates on changes in the attributes of supervisory boards of listed corporations in the Netherlands.

Chapter 6: Changing One-Tier Board Attributes, the Case of the US

6.1 Introduction

Undoubtedly, most of the discussion on corporate governance originates from the US (Sheridan and Kendall, 1992). Central to the corporate governance discussion in this country is the independence of corporate boards of listed corporations. Due to the absence of stringent requirements in federal securities laws and state corporation laws, and guided by the assumption that managerial behavior needs to be constrained by internal and external monitoring devices, boardroom reformers are continuously emphasizing the need to impose self-regulatory schemes on boards of directors of listed corporations. The need of these boardroom reform initiatives has often been supported by anecdotal evidence from the business press. Respected corporations like General Motors, Kodak and Westinghouse - for example - have been targeted by the media to exemplify the need to improve the independence of corporate boards of listed corporations. These and other large corporations experienced widely publicized turbulence in their boardrooms that often has resulted in changes in the composition and the structure of boards of directors. In addition to pressures from the media, institutional investors such as CalPERS and TIAA-CREF and second-tier regulatory agencies such as the NYSE and NASDAQ are increasingly flexing their muscles to alter the governance structure of corporate boards through special investment programs and additional listing requirements. The latest developments suggest that legal scholars, representatives from the accounting profession and independent commentators are increasingly encouraging corporations to use board structures that clearly separate the responsibilities of executive directors from those of non-executive directors. In general, these initiatives aim at the separation of the roles of the CEO and the chair of the board, the introduction of non-executive lead directors to boards when these roles are put in the hands of one individual, the appointment of an increasing number of non-executive directors to corporate boards who have not been affiliated with the corporation and the formation of independent oversight board committees composed predominantly of non-executive directors. These reform initiatives suggest that boardroom reformers increasingly advocate design strategies that facilitate the separation of decision management from decision control in one-tier boards in the US. These and other initiatives are further explored in this chapter.

Outline

The governance structure of corporations is regulated by both federal and state securities laws and state corporation laws. Federal and state securities laws mainly regulate the disclosure of detailed information in annual reports, proxy statements and other reporting titles on matters related to the nomination of directors, the formation and composition of board committees, the organization of board leadership structures and the remuneration of directors in publicly held corporations. The Securities Act of 1933 and the Securities Exchange Act of 1934 are discussed in paragraph 6.2 to exemplify the federal standards on board disclosure. In addition, this paragraph also briefly refers to the role of state securities laws in the disclosure of corporate governance structure of publicly held corporations. To describe the formal governance structure of corporations, paragraph 6.3 relies on the Model Business Corporation Act (MBCA) and the General Corporation Law of the State of Delaware. Most states in the US have adopted sections from the MBCA in their corporation laws while a majority of large listed corporations is incorporated under the rules of the State of Delaware. Paragraph 6.4. explores developments in board attributes and the formal independence of one-tier boards in listed corporations. The analysis is based on data collected between 1981 and 1997. In general, information on board size and composition, board leadership structures and the formation of standing oversight board committees is based on studies from executive search firms (Spencer Stuart, Heidrick and Struggles, Korn/Ferry International), The Business Roundtable, the NACD, The Conference Board and others. This chapter concludes with a summary in paragraph 6.5.

6.2 Federal Level: The Disclosure of Corporate Boards Under Federal Securities Laws

Federal securities laws regulate the disclosure of information on publicly held corporations. These laws were originally enacted in response to the "financial traumas" of the Wall Street crash of October 1929 (Millstein and Katsh, 1981). The number of traded shares on the New York Stock Exchange (NYSE) dramatically diminished from 1.125 billion shares in 1929 to 425 million shares in 1932. The NYSE market capitalization dropped from approximately USD 89 billion in 1929 to about USD 15 billion in 1932 (Khademian, 1992; Afterman, 1995). To protect the interest of investors from further financial tragedies, Congress enacted the Securities Act of 1933. Initially, the enforcement of this Act fell under the jurisdiction of the Federal Trade Commission (FTC). To further extend the protection of investors, Congress also passed the Securities Exchange Act of 1934. The 1934 Act created the Securities Exchange Commission (SEC). The SEC is an independent regulatory agency in Washington D.C., mandated to administer several federal securities laws, including the 1933 Act.

The following six laws were enacted between 1933 and 1940:

- the Securities Act of 1933;
- the Securities Exchange Act of 1934;
- the Public Utility Holding Company Act of 1935;
- the Trust Indenture Act of 1939;
- the Investment Company Act of 1940;
- the Investment Advisers Act of 1940.

Source: Afterman (1995).

Of particular interest to this study are the Securities Act of 1933 and the Securities Exchange Act of 1934. The 1933 and 1934 Acts are based on the philosophy that investors can be protected by a regulatory framework that provides full disclosure of information related to the distribution and trading of securities. The 1933 Act mainly concentrates on initial public offerings (IPOs) and secondary offerings of previously unregistered securities. The 1934 Act focuses on the trading of issued securities. This Act provides an elaborated regulatory framework to control the disclosure of information on boards in publicly held corporations that are registered under the rules of the 1933 Act. Besides the regulation of proxy solicitation, the 1934 Act also provides continuous reporting schemes. These currently require corporations to file annual Forms 10-K and quarterly Forms 10-Q. In addition, the 1934 Act concentrates on the:

- regulation and registration of activities of securities brokers, dealers, investment advisers, thirteen national and regional securities exchanges and over-the-counter (OTC) markets;
- prevention of securities fraud and market manipulation;
- recommendation of administrative sanctions, injunctive remedies, and criminal prosecution against those who violate securities laws;
- control of credit for the purchase of securities;
- regulation of insider trading.

Sources: Clarkson et al. (1989); Afterman (1995).

Proxy Rules Under the 1934 Securities Exchange Act

Proxy solicitation is also regulated by the 1934 Act. Proxy solicitation enables shareholders - also those with very small holdings - to submit proposals to shareholders and to vote for resolutions at the corporations' annual meetings. These proposals deal with a vast variety of matters that are increasingly concerned with corporate governance (ICMG, 1995). The election of directors is often a primary aim of the proxy solicitation process.

Proxy Statements

To secure the position of shareholders, the 1934 Act also rules that publicly held corporations are required to file proxy statements with the SEC for a formal review of its contents. Besides the annual report, proxy statements inform shareholders on the following matters:

- the election and appointment of directors;
- the appointment of auditors;
- the adoption of executive retirement and remuneration plans;
- the issuance of new securities;
- the amendment of articles of incorporation and by-laws;
- the adoption of anti-takeover measures.

Source: Afterman (1995).

Proxy statements also furnish information on the names and the age of directors, the background of directors, the possible criminal records of directors, the family-relationships among directors, executives and board nominees, and the names of directors who failed to attend 25 percent or more of board meetings and/or committee meetings. In addition, proxy statements provide detailed information on the remuneration of executive and non-executive directors. The SEC revised and extended its disclosure requirements on executive compensation in 1992. As part of new disclosure regulations, corporations subject to the rules of the 1934 Act have to disclose the existence and the composition of a remuneration committee in reporting titles.

State Securities Laws

Like federal securities laws, state securities laws or "blue-sky"[2] laws focus on the protection of investors during offerings (IPOs) and the distribution and sales of securities (Clarkson et al., 1989; Khademian, 1992). The regulation by means of blue-sky laws is to a large extent similar to federal SEC regulations. Blue-sky laws - for example - provide antifraud provisions and rule the regulation of financial markets and the registration of securities. Similar to federal securities laws, state securities laws seek to protect investors by means of the disclosure of detailed information on the governance structure of corporations. Yet, both federal and state securities laws have not much to say about the structure and the composition of corporate boards. According to the ICMG, "The underlying and pervasive premise of the federal (and state, eds.) regulation of securities matters is that government should not generally determine whether securities may be offered and sold, but should only be concerned with whether there is adequate disclosure

[2] The term blue-sky law is " . . . derived from an early twentieth-century sentiment that slick and clever investment bankers from Wall Street would attempt to sell securities in entities with no much more substance than the blue sky above to unwitting investors on Main Street" (Afterman, 1995:7).

with respect to offerings, secondary market transactions, and the solicitation and voting of proxies in connection with shareholder meetings" (ICMG, 1995:52). As such, securities laws generally focus on the disclosure of relevant information related to the issuance of securities. These laws do not regulate the governance structure of corporations. The SEC, for example, does not require audit and remuneration committees. The SEC only seeks full disclosure of the activities and the composition of these standing oversight board committees when they are established by corporations.

In summary:

- in response to financial traumas in the 1930s, Congress enacted federal securities laws that provide an elaborated system of supervised disclosure in the US. The rules of these laws are expanded through state securities legislation;
- the SEC regulates the disclosure of information on board practices through the Securities Act of 1933 and the Securities Exchange Act of 1934;
- the cornerstone of the securities laws is the full disclosure of issuers registered under the 1933 and 1934 Acts;
- the 1934 Act provides detailed information on board practices in annual Forms 10-K, quarterly Forms 10-Q, proxy statements and other reporting titles;
- securities laws do not regulate the governance structure of corporations which are predominantly regulated by state corporation laws (see the next paragraph).

6.3 State Level: The Attributes of One-Tier Boards Under State Corporation Laws

While federal and state securities laws focus on the disclosure of the structure and the composition of corporate boards in publicly held corporations, state corporation laws (statutes) provide the regulatory framework that regulates the structure, the composition and the responsibilities of corporate boards of directors. State statutes more or less regulate the minimum size of boards of directors, the minimum number of board meetings and the formation of board committees. Other provisions relate to the nomination, the appointment and the removal of directors, the rights of directors to amend the by-laws of the corporation and to approve certain mergers and consolidations. Some 37 states, excluding the State of Delaware, have adopted sections from the Model Business Corporation Act (MBCA or "Model Act") to regulate the governance structure of corporations. The Model Act is no corporation law. It is a legal model that has originally been developed by the American Bar Association in 1933. Its main purpose is to guide legislators and other regulators in the development and amendment of state statutes on corporate governance. Its sections become only part of state corporation laws after they have been enacted by state legislators. The Model Act has been revised in June 1984. This version is called the RMBCA. Although no single state has fully adopted either the entire Model Act or the Revised version of

1984, the Model Act is recognized as a codification of modern corporation law in the US (Clarkson et al., 1989).

Delaware's Corporation Laws

Delaware is the "State of Incorporation" in the US due to its tax structure, its rather liberal regulatory framework and its large body of existing case law (Soderquist and Sommer, 1990). The State of Delaware has its own legal system with highly specialized lawyers in corporation laws. The latest figures from Delaware's Division of Corporations indicate that some 250,000 corporations are incorporated in Delaware. Nearly fifty percent of corporations listed on the NYSE and the American Stock Exchanges, and approximately 58 percent of Fortune 500 corporations, are incorporated in this small state[3]. Like the Model Act, Delaware's statutes on corporate governance substantially influence corporation laws in other states. For the purpose of this study, both the Model Act and Delaware's statutes are helpful guides to describe the formal organization of one-tier boards in publicly held corporations. The following paragraphs elaborate in more detail on the legalistic aspects of the internal governance structure of publicly held corporations in the US.

Articles of Incorporation and By-Laws

The Model Act states that the by-laws of the corporation may contain any provisions related to the regulation and the management of the affairs of the corporation when these are not inconsistent with state corporation laws or inconsistent with the corporation's articles of incorporation. In general, by-laws cover the following subjects:

- offices of the corporation and shareholders' meetings;
- number of directors and their qualifications;
- number of board meetings;
- officers;
- transfer of shares and certificates of shares;
- corporate seal;
- fiscal year;
- procedure for amendment;
- miscellaneous matters pertaining to the particular corporation.

Source: Grange et al. (1967).

Control over the amendment of these internal rules of management in the by-laws rests with the board of directors if this right is not granted to the shareholders by

[3] Information is obtained from the Delaware Division of Corporations at internet page http://www.state.de.us (Jan. 1999).

the articles of incorporation[4]. Accordingly, state statutes can almost give the corporate board a "carte blanche" to determine the organization of the board and the powers of the board (Soderquist and Sommer, 1990). This provides a great variety in governance structures in publicly held corporations in the US. According to Baysinger and Butler (1984:562): "State's indifference to prescribing board composition and size has fostered much experimentation and, hence, diversity in the structure and composition of corporate boards." The corporation's articles of incorporation, the by-laws and boards' powers to amend the by-laws provide this diversity (Soderquist and Sommer, 1990). Although provisions for directors in by-laws vary considerably among corporations, state corporation laws provide certain minimum requirements that shape the organization and composition of one-tier boards in the US. These requirements refer to directors' legal duties and responsibilities, the size and the composition of the board, the positions of chair and the CEO, the formation of board committee structures, and the election and removal of directors. These requirements are further explored in the following paragraphs.

The Responsibilities of Directors

State corporation laws formally provide a description of board responsibilities. According to ICMG (1995:53), state corporation laws ". . . have in the past provided that the board shall manage the company; increasingly the statutory formulation is that the board shall oversee or monitor the management of the company or that the company shall be managed under the direction of the board." As such, state corporation laws recognize that corporate boards of directors do have a responsibility to monitor the management of the corporation. According to the American Bar Association (ABA) and The Business Roundtable[5], it is the responsibility of directors "not to manage, but to oversee" the management of the corporation. An inherent problem with this definition lies in the legal responsibilities of both executive and non-executive directors. Corporation law does not provide a distinction between the responsibilities of executive directors to manage the corporation and the responsibilities of non-executive directors to oversee management. The responsibilities of both classes of directors include:

- the approval of fundamental operating, financial, and other corporate plans, strategies, and objectives;
- the evaluation of the performance of the corporation and its senior management;
- the selection, regularly evaluation and determination of the compensation of senior executives;

[4] The State of Delaware has granted the power to the board of directors to make or to alter by-laws.

[5] Established in 1972, The Business Roundtable is an association of 200 CEOs in Fortune 500 and other leading corporations. It was founded in the belief that "business executives should take an increased role in the continuing debates about public policy" (The Business Roundtable, 1990:241).

- the approval and the implementation of senior executive succession plans;
- the adoption of policies of corporate conduct, including compliance with applicable laws and regulations, and the maintenance of accounting, financial, and other controls;
- the review of the process of providing appropriate financial and operational information to decision makers (including board members);
- the selection of board candidates with diverse backgrounds, talents and perspectives who can work effectively together;
- the evaluation of the overall effectiveness of the board and the review of its own structure, governance principles, composition, agenda, process and schedule;
- provision of advice and counsel to management.

Sources: ABA (1994); The Business Roundtable (1997).

The Revised Model Act requires directors to act according to generally accepted standards of conduct. A director is obliged to discharge his duties in good faith, with care and in a manner reasonably to be in the best interests of the corporation. These fiduciary duties are formalized by director's "Duty of Care"[6] and "Duty of Loyalty." Directors for example need to attend meetings regularly, have a duty to exercise a reasonable amount of supervision and need to be properly informed on corporate matters (Clarkson et al., 1989). The National Association of Corporate Directors (NACD) indicates that these board responsibilities " . . . are founded in legal imperatives, but . . . [they are, eds.] . . . by no means limited to them. Beyond its duties of loyalty and care on behalf of shareholders, each board has the freedom – and [. . .] the obligation - to define its role and duties in detail" (NACD: 1996:1).

Directors are increasingly exercising responsibilities that go beyond the formal description of the fiduciary duties in the Model Act (see also box 6.1). The expanding role of US-corporate boards beyond its duties of care and loyalty is reflected by a 1993 survey among 495 corporate secretaries (The Conference Board, 1996). The study found that boards spend some 25 percent of their meeting time on strategy (setting corporate objectives, determining resource allocation and strategic direction). Another study also indicates an expanding role for directors in the strategic course of corporations (The Conference Board, 1977).

[6] See also Eisenberg (1990) for an extensive review of the duty of care of corporate directors and officers.

Box 6.1
The NACD on Board Professionalism

> "A professional boardroom culture requires that the governance process be collectively determined by individual board members who:
>
> are independent of management;
> are persons of integrity and diligence who make the necessary commitment of time and energy;
> recognize that the board has a function independent of management and explicitly agree on that function, and;
> are capable of performing that function as a group, combining diverse skills, perspectives, and experiences."

Source: NACD Blue Ribbon Commission on Director Professionalism (1996:vii).

A total of 60 percent of participating directors and senior executives indicates that their boards devote more meeting time to strategy discussion compared to the 1993 survey[7]. A majority of 51 percent of the participating corporations also indicated that the board has a greater role in strategy formulation. The 1995 NACD/Deloitte and Touche LLP Corporate Governance Survey indicates a similar development. Compared to a NACD 1992 survey, the 1995 survey showed: "In 1992, over one-third of CEOs described their boards - in extreme terms - as 'passive' or 'captive' on the one hand, or as 'micro-managing' on the other. In 1995, only one in ten used these descriptions; the great majority called their boards 'proactive' or monitoring' " (NACD/Deloitte and Touche LLP, 1995:1)[8].

The Independence of Directors

State corporation laws do not specify the degree of independence a director should have from a corporation[9]. Yet, the certificate of incorporation or by-laws of the corporation may prescribe qualifications of directors related to the type of business relationships directors can have with the corporation[10]. The Corporate Director's Guidebook provides the following definition of board independence:

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[7] Note that the data was originally obtained from a total of 51 US corporations and 32 European corporations. The figures are based on N=78.
[8] The 1995 survey was sent to nearly 6,000 CEOs in the US and to more than 1,000 CEOs in eight other countries. The response rate of the total sample was eight percent.
[9] As indicated above, corporation laws do not provide a formal distinction between the duties and responsibilities of executive and non-executive directors.
[10] See the appendix of the 1994 Report of the NACD Blue Ribbon Commission on Director Professionalism for an overview of definitions of board independence.

“As a general rule a director will be viewed as independent only if he or she is a non-management director free of any material business or professional relationship with the corporation or its management. The circumstances and various relationships that have been often identified as presumptively inconsistent with independence include a close family or similar relationship with a member of key management; any business or professional relationship with the corporation that is material to the corporation or the director; and any ongoing business or professional relationship with the corporation, whether or not material in an economic sense, that involves continued dealings with management, such as the relationship between a corporation and investment bankers or corporate counsel” (ABA, 1994:1258).

The American Law Institute's (ALI) definition of directors’ independence is similar to the American Bar Association’s (ABA) definition. The ALI identifies that an independent relationship exists between directors and the corporation when, e.g., the director has not been employed by the corporation, when directors are not immediate family of executive officers of the corporation and when directors have not received more than USD 200,000 in commercial payments from the corporation during two years prior to an appointment. Affiliations with law firms and investment banking firms are considered to influence the relationship directors have with a corporation (ALI, 1992). See also paragraph 6.4.5 in this chapter for the NYSE rules on director independence and the composition of audit committees.

Board Responsibilities and the Business Judgement Rule

Directors are protected by the Business Judgement Rule from liabilities if they have acted in good faith and have acted in what they consider to be in the best interests of the company. The Business Judgement Rule “immunizes” directors and officers from liabilities “. . . when a decision is made within managerial authority, as long as the decision complies with management’s fiduciary duties . . . and as long as acting on the decision is within the powers of the corporation” (Clarkson et al., 1989:725). Other means to protect directors from costs associated with liabilities are officers and directors’ liability insurance and the possibility to include provisions in the by-laws that indemnify directors against most litigation expenses and liabilities (ICMG, 1995).

6.3.1 Board Size

The Model Act states that all corporate powers shall be exercised by or under the authority of a board of directors unless the articles of incorporation determine otherwise. Although a board of directors is a requisite in most of states, the size of the board is not directly regulated by state statutes. The Model Act and Delaware's corporation laws require only a minimum of one director (Varallo and Dreisbach, 1996b). The certificate of incorporation of the corporation sets the initial size of the board. The articles of incorporation may determine a minimum or maximum quorum of directors. The by-laws of the corporation finally prescribe the exact number of directors.

6.3.2 About Board Composition

The Model Act indicates that directors are not required to be residents of the state of incorporation. Directors also do not need to be a shareholder of the corporation and do not need to be independent of management. As such, state corporation laws do not provide requirements with respect to how the board of directors should be constituted (ICMG, 1995). Only a handful of states require a minimum age of directors (Clarkson et al., 1989). As with the size of the board, the Model Act and state statutes give corporations the freedom to prescribe qualifications for directors in the articles of incorporation and the by-laws of the corporation.

The Election of Directors and Classified Boards of Directors

Directors are elected by a majority vote of shareholders at the annual shareholders' meeting. State statutes may provide the formation of a "staggered" board of directors when the board consists of nine or more members. A staggered board exists of several classes of directors who each serve for a two- or three-year term. Each year, only one class of directors is re-elected or replaced by new candidates at the general meeting of shareholders.

Box 6.2
The Appointment of Directors

"In the typical American company, the board of directors must be elected by the shareholders. Generally, in publicly held companies, nominees for the board are formally proposed for election by the board of directors (in a company with a nomination committee of the board, the committee will recommend the nominees to the full board, which will in turn recommend their election by shareholders). The reality is that the CEO of a publicly held company still frequently proposes new members for the board, after which the nominating committee and/or board will simply endorse his/her choice. However, nominating committees in many companies are playing a more decisive role in searching for and nominating directors, and it is expected that this trend will continue."

Source: ICMG (1995:55).

According to Varallo and Dreisbach (1996b), staggered boards are widely used as anti-takeover devices. Staggered boards are also used to discourage proxy contests. Investors who seek control over the corporation through changes in the composition of the board are confronted with a protective shield when a board is divided into classes. On the other hand, staggered boards may provide stability in the composition of corporate boards because abrupt changes are less likely to occur. Second-tier regulatory agencies under SEC jurisdiction may include provisions related to board classes. The NYSE for example permits corporations to form a board with a maximum of three classes as part of its listing requirements (NYSE Listed Company Manual, section 304.00). These classes should be of approximately equal size and tenure. The NYSE listing rules also dictate that directors' term of office should not exceed three years in classified boards.

The Removal of Directors

As stated in the by-laws or the articles of association, shareholders have the inherent right to remove directors "for cause" (breach of duty or misconduct) by a majority vote at the general meeting of shareholders. The articles of incorporation can also grant rights to shareholders' meetings to remove a director at any time "without cause" by a majority vote. Directors can also be held liable for breach of their fiduciary duties. Cases dealing with such violations typically involve directors in:

- competing with the corporation;
- usurping a corporate entity;
- having an interest that conflicts with the interests of the corporation;
- engaging in insider trading;
- authorizing some corporate transaction that is detrimental to minority shareholders;
- selling control over the corporation.

Source: Clarkson et al. (1989).

6.3.3 About Board Leadership Structures

Delaware's corporation laws provide the so-called "integration of offices." This means that one natural person can combine the positions of director, president, treasurer and secretary. The Model Act also allows officers or directors to hold multiple offices[11]. In this provision lies the legal foundation of the combination of the positions of chairman and CEO of the board (CEO-duality) in the US. According to the Corporate Director's Guidebook (ABA, 1994), the discussion on board leadership in the US has resulted to several suggestions to improve the independence of the board and to strengthen the role of non-executive directors. Proposals include the separation of CEO and the chair and the designation of independent lead directors to boards of directors. Bagley and Koppes (1997) recently proposed an amendment to the NYSE and NASDAQ/NMS listing rules. The authors suggest that corporations should be required to disclose whether there is an independent chair and whether or not the board has designated a senior

[11] An exception to this rule is the integration of the offices of the president and secretary of the corporation.

independent lead director. Accordingly, "the use of the listing requirements as an instrument for change provides a practical and easy way to promote the consideration by publicly traded companies of board leadership structure and methods for improving it, without requiring the SEC to amend its proxy rules or states to amend their corporation laws" (Bagley and Koppes, 1997:153). According to this proposal, the board would be required to explain why it is in the best interest for the corporation to support the integration of chairman and CEO roles and why the board has decided not to appoint a lead director to the board of directors. These aspects of board independence are discussed in more detail in paragraph 6.4.

6.3.4 About Board Committees

In general, state corporation laws do not require corporations to designate directors to board committees. Yet, the Model Act provides the possibility that the full board of directors may designate from its members an executive committee and other special committees. Delaware's General Corporation Law also provides the possibility that boards can designate directors to board committees by majority vote. The Model Act and Delaware's statutes restrict the permissible activity of committees. Some corporate actions may not be delegated to board committees.

Board committees can not:

- initiate amendments to the certificate of incorporation;
- amend the by-laws of the corporation;
- designate candidates for the office of director for the purpose of proxy solicitation or otherwise, or fill vacancies on the board of directors or any committee thereof;
- authorize the distribution of dividends;
- adopt an agreement of merger or consolidation;
- perform transactions outside the "ordinary course of business" like major capital transactions and entry into new lines of business.

Source: Clarkson et al. (1989).

6.3.5 Summary

State corporation laws (statutes) provide the regulatory framework that regulates the governance structure of corporations. A majority of states have based the statutes on the Model Act and Delaware's corporation laws. As such, the Model Act and Delaware's corporation laws substantially influence general state corporation law in the US. Most states require corporations to have a board of directors. Yet, the articles of incorporation and the by-laws can provide much diversity in the structure and composition of corporate boards. Control over the amendment of the internal rules of management in the by-laws can rest with the board. This gives corporate boards much power to determine its responsibilities, size, composition and structure. Although provisions for directors in by-laws vary considerably among corporations, state corporation laws provide minimum requirements that shape the composition and the organization of one-tier boards. These focus on three distinctive attributes of one-tier boards in the US: (1) board size and composition, (2) board leadership structures and (3) board committees.

Board Size and Composition Most state corporation laws are indifferent to the size and the composition of the board. A board can be composed entirely of executive directors or - for example - can be composed of a majority of non-executive directors. The Model Act and Delaware's corporation laws require a minimum of one director. Only a handful of states require a minimum age of directors. State statutes give corporations the freedom to prescribe qualifications for directors in the articles of incorporation and the by-laws of the corporation. Directors are elected by a majority vote of shareholders at the annual shareholders' meeting.

Board Leadership Structure Corporation laws do not make a distinction between the fiduciary duties of executive and non-executive directors. Directors can combine executive and non-executive positions such as those of the CEO, the president and the chairman of the board.

Board Committees Boards of directors are authorized to establish board committees by majority vote of the board. State statutes only restrict the permissible function and activities of board committees. Committees - for example - are not authorized to initiate amendments to the certificate of incorporation and to alter the by-laws of the corporation.

6.4 Facts About Changing One-Tier Board Attributes

Based on the previous description of the formal structure of one-tier boards, this paragraph further explores changes in the attributes of boards of directors in publicly held corporations in the US. Guided by reform issues identified by The Corporate Director's Guidebook of the American Bar Association, developments in the governance structure of Fortune 500 corporations are portrayed for a period between 1987[12] and 1997. Principle data is collected by Spencer Stuart Board Services in the US and obtained from proxy statements and annual Forms 10-K. Additional information is provided by Heidrick and Struggles, Korn/Ferry International, the NACD, The Conference Board and others.

6.4.1 The Main Issue: The Independence of Corporate Boards of Directors

It is widely accepted by reformers and commentators that there should be a balanced mix of executive and non-executive directors in the boards of directors of listed corporations. The Business Roundtable emphasizes that ". . . it is important for the board of a large publicly owned corporation to have a substantial

[12] When available, data from 1981 is included in the data set.

degree of independence from management. Accordingly, a substantial majority of the directors of such a corporation should be outside (non-management) directors" (The Business Roundtable, 1997:10). To have boards that communicate an "appearance of independence", the American Bar Association encourages boards to work with at least a majority of independent directors (ABA, 1994). The American Law Institute (ALI) recommends in the Principles of Corporate Governance that ". . . the board of every large publicly held corporation … should have a majority of directors who are free of any significant relationship . . . with the corporation's senior executives . . . unless a majority of the corporation's voting securities . . . are owned by a single person . . . a family group . . . or a control group . . ." (ALI, 1992:144). The NYSE requires all listed domestic companies to have at least two non-executive directors (NYSE, Listed Company manual, §303.00).

Fact 1 -> Board Size: Total Board Size is Shrinking

Spencer Stuart (1997) indicates that the size of boards of directors in listed corporations has changed from an average of sixteen directors in 1981 to a total average of thirteen directors in 1997. This figure is based on a sample of one hundred leading corporations. According to Pic (1997:4), the reduction in board size " . . appears to be the consequence of an aspiration for more professional and efficient boards." This has resulted in a net reduction of 200 directorships (13,3 percent) in the sample between 1981 and 1997. Boards with sixteen and more directors have also become more uncommon. Only nine percent of the corporations investigated have boards with sixteen or more directors while more than half of the boards (51 percent) had sixteen or more board members in 1982! The data undoubtedly indicates a trend in the size of US-boards. Instead of "downsizing" the corporate board, the trend may be best described with "rightsizing" the board (NACD/Deloitte and Touche LLP, 1995:9). Spencer Stuart (1997:5) suggests that this development may indicate that there is little room for a further shrinkage in board size in the US. As a practical matter, boards need to have a certain number of directors to operate their board committees.

Korn/Ferry International (1997) indicates that board size continues to vary with the size of corporations and the type of its businesses. Boards of retailers and corporations in advanced technologies are on average composed of ten directors. Banks do have the largest boards with an average of fifteen directors. According to Spencer Stuart (1997), the largest boards also can be found in financial institutions.

Fact 2 -> Board Composition: Non-executives Gain Dominance in Boards

Directly related to developments in the size of corporate boards, changes in the composition of boards of directors have become more evident during the last decade in the US. Spencer Stuart (1987-1997) indicates that boards of one hundred of the country's largest corporations are composed of 3.5 non-executives to every executive director in 1996, compared to two non-executive directors to every executive director in 1987. The latest figures indicate that some 87 percent of a total of 1,302 board positions in the one hundred corporations investigated were occupied by non-executive directors in 1996.

Fact 3 -> Board Composition: Total Number of Executives is Shrinking

This development has resulted in a net reduction of 195 executive board positions between 1987 and 1996 in corporations surveyed (Spencer Stuart, 1987-1997). In contrast, the total number of non-executive directors decreased with five directorships between 1987 and 1996 (Spencer Stuart, 1987-1997). The Heidrick and Struggles Indexes indicate a similar development in the composition of corporate boards. In 1986, 57.5 percent of directorships in the Fortune 1000 boards was occupied by independent directors. In 1988, this percentage increased to a total 71.7 percent. This development in board composition may demonstrate an increasing emphasis on the appointment of independent non-executive directors to corporate boards in the US. As such, this development may suggest evidence that listed corporations are increasingly adhering to pressures from reformers and regulators to compose their boards of directors more independently of management. Related to the first proposition of this study, this development may also suggest that the separation of decision management from decision control is facilitated by an increasing number of positions held by non-executive directors in boards of listed corporations in the US.

6.4.2 The Second Issue: Board Leadership and the Separation of Chairman and CEO Roles

While there seems to be a common consent among those involved in the debate on boardroom reform that boards should be composed of a majority of non-executive directors, the separation of the roles of chairman of the board and the CEO is clearly a more controversial matter (Lipton and Lorsch, 1992). As part of the promotional system of directors and as a means of board effectiveness, CEO-duality is widely supported by executives in the US. Bagley and Koppes (1997:158) indicate that " . . . promotion to the CEO and chair is often viewed as a reward for excellent service and a vote of confidence by the board." In an early statement, The Business Roundtable explicated that the integration of chair and CEO roles benefits the corporate board. Accordingly, "the general experience of the Roundtable members has been that the board functions well where the CEO also serves as chairman and where there is no sharp organizational line drawn between the board and operating management" (The Business Roundtable, 1978:2112). The Business Roundtable emphasizes in a more recent report:

“Most members of The Business Roundtable believe their corporations are generally well served by a structure in which the CEO also serves as chairman of the board. They believe that the CEO should set the agenda and the priorities for the board and for management and should serve as the bridge between management and the board, ensuring that management and the board are acting with a common purpose.”

Source: The Business Roundtable (1997:12).

Bagley and Koppes (1997) refer to a 1992 Korn/Ferry International study to address that many executives still strongly oppose the idea of splitting the chair and CEO roles. The Korn/Ferry International study found that 41 percent of CEOs believes that the separation of the roles of CEO and chair roles impedes “management effectiveness.” A recent survey of Korn/Ferry International among 1,125 directors also indicates that only two percent would consider a non-executive chairman who is neither at present employed nor has been a former employee of the corporation. A minority of six percent of the 878 investigated Fortune industrial and service corporations has appointed a non-executive chairman (Korn/Ferry International, 1997).

Fact 4 -> Board Leadership: There is Only a Very Modest Support To Split CEO and Chair Roles

Interestingly, a recent NACD/Deloitte and Touche LLP 1995[13] survey may suggest that more corporations are considering to separate the roles of the CEO and the chair of the board. NACD/Deloitte and Touche LLP (1995) found that a majority of CEOs believes that boards of directors should be required to split the chairman and CEO roles (see box 6.3 for more details on the study findings)[14].

[13] The survey was sent to nearly 6,000 CEOs in the US. The response rate was eight percent.
[14] Data on the separation of CEO and chairman roles is not available in the Spencer Stuart data set.

Box 6.3
The Separation of Chairman and CEO Roles

"One of the most striking findings in the 1992 survey was the relatively high number of CEOs (23 percent) who said they believed boards of directors should be required to separate chairman and CEO roles. In 1995, role separation appears to be winning not only acceptance, but adherence in a growing number of companies.

The 1992 survey did not probe actual practice, but other studies appearing around the same time did. According to separate research by Institutional Shareholder Services in Bethesda, Maryland and by the Institute for Research on Boards of Directors, Inc. in Sarasota, Florida, levels in 1992 were about 20 percent. Comparing these figures with 1995 survey results, it appears that the chairman-CEO role split has nearly doubled in three short years. Well over one-third of respondents (38 percent) say they currently separate the roles, and of those not doing so, nearly half (45 percent) say they would consider doing so. Conversely, fewer than one in five (17 percent, down from 1992's 23 percent) said a top role split should be required by law."

Source: NACD/Deloitte and Touche LLP (1995:18).

Some 38 percent of the respondents also indicate that their board has separated the roles. Although the general opinion suggest that there is only a very modest support to split CEO and chair roles, the 1995 NACD/Deloitte and Touche LLP survey may indicate a development towards more independent board leadership in US. This development may suggest that the first signs can be observed that an increasing number of corporations are recognizing the need to separate decision management from decision control through changes in the formal leadership structure of their boards. Although the legal community has addressed the separation of chair and CEO roles, so far it has not resulted in any legislative reform or amendments of models and codes of conduct. In very general terms, the ABA identifies the separation of chair and CEO roles as a means to strengthen the role of independent directors (ABA, 1994).

6.4.3. The Third Issue: Board Leadership and the Designation of Lead Directors

Closely related to the issue of CEO-duality is the relatively new development of directors to appointment "lead directors" to their boards. The Corporate Director's Guidebook refers to the designation of a non-executive director selected by independent directors as a lead director if the CEO also serves as chair of the board (ABA, 1994). The role of the lead director is to provide the CEO with advice on the selection of board committee members and to provide advice on the organization of board meetings. The lead director also monitors the adequacy of management information, sets the board agenda and organizes procedures to evaluate the performance of the CEO (Lipton and Lorsch, 1992). According to The Business Roundtable (1997:12-13), a lead director ". . . is sometimes designed with specific duties, such as consultation with the CEO on board agendas and chairing the executive sessions of the board. In other cases, the lead director has no special duties in ordinary situations, but assumes a leadership role in the event of the death or incapacity of the CEO or in other situations where it is not possible or appropriate for the CEO to take the lead."

Fact 5 -> Board Leadership: More Lead Directors Assigned to Corporate Boards

Spencer Stuart (1995-1996) indicates an increasing number of lead directors appointments in the US. Out of a total of one hundred large corporations, ten corporations had lead directors assigned to their boards in 1995. The number of lead directors has increased to a total of 36 corporations in 1996. A survey of Korn/Ferry International among 1,125 directors also indicates an increasing number of lead director appointments to boards of Fortune corporations. A total of 24 percent of 878 Fortune industrial and service corporations has a lead director in 1997 compared to 22 percent in 1994 (Korn/Ferry International, 1997). The NACD/Deloitte and Touche LLP 1995 survey on corporate governance indicates that 43 percent of participating CEOs consider the appointment of lead directorship to their boards. According to the survey, a majority of 53 percent of participating CEOs also prefer lead directors to separating the chairman and CEO roles.

This relatively new development may suggest that an increasing number of listed corporations seek to counter balance the power of the CEO when he or she also holds the position of chairman of the board. As such, it may indicate that while directors favor a leadership structure that is based on CEO-duality, they also do recognize the need to separate decision management from decision control through the appointment of non-executive lead directors to boards of directors in listed corporations in the US.

6.4.4 The Fourth Issue: The Independence of Oversight Board Committees

Much of the public scrutiny of corporate governance issues concentrates on the composition and function of board committees (Varallo and Dreisbach, 1996a). The Corporate Director's Guidebook recognizes that the formation of committees with independent directors lies at the core of many boardroom proposals (ABA, 1994). Although operating committees are recognized in the contemporary corporate governance discussion, reformers mainly concentrate on the formation of oversight board committees (audit, compensation and nominating committees) in boards of listed corporations. Comprised entirely of independent non-executives, these oversight committees are predominantly accepted by reformers as valuable devices to improve the independence of corporate boards. The Business Roundtable recommends that listed corporations should have an audit committee, a compensation/personnel committee and a nominating committee with membership limited to non-executive directors (The Business Roundtable, 1997).

Fact 6 -> Board Committees: The Formation of Audit Committees Has Become More Common

The discussion on the formation of audit committees goes back to the 1930s. The formation of audit committees was actively supported and recommended by the SEC in response to a Supreme Court decision in the McKesson-Robbins case on fraudulent financial reporting in 1938: “The company was found to have been deceiving investors by issuing fraudulent financial statements - statements given an apparent clean bill of health by the outside auditing firm, even though they showed large amounts of assets that did not exist and grossly overstated profits . . . One of the recommended practices that emerged from the SEC’s investigation of the McKesson-Robbins scandal was the establishment of an audit committee, a concept that was unusual at that time . . .” (The Conference Board, 1979:6). Through several “Accounting Series Releases” (ASR) and “Exchange Act Releases”, the SEC continuously recommended corporations to establish audit committees. In 1972, the SEC urged “registrants” to form audit committees comprised of non-executive directors (ASR, No. 123). In 1974, all publicly held corporations were required to state the number of audit committee meetings and were required to indicate the function of the audit committee (ASR, No. 165). The SEC has also allowed constituencies like the accounting profession and the respective security markets and stock exchanges (secondary regulatory agencies) to decide whether audit committees are required (Cobb, 1993). The SEC[15] strengthened the role of audit committees by encouraging stock exchanges to include audit committees as a condition for listing in 1978. This has resulted in the alteration of the listing requirements of three major stock exchanges in the US (Todd DeZoort, 1997; Maassen, 1998b).

In 1939, the New York Stock Exchange recommended the formation of audit committees. More recently, the NYSE requires domestic corporations with common stock listed on the exchange to establish audit committees since June 30, 1978 (NYSE, Listed Company Manual, §303.00). Both NASDAQ and AMEX followed the NYSE requirements regarding the composition of audit committees (Cobb, 1993). In 1987, the National Association of Securities Dealers (NASDAQ) required listed corporations on the National Market System to establish audit committees. The American Stock Exchange (AMEX) followed in 1992[16]. The SEC reporting requirements and the exchanges’ listing requirements have strongly

[15] In November 1978, the SEC approved disclosure rules on the function of audit committees, the names of committee members, the relationships that corporate directors have with the company, the resignation of directors and the attendance of directors at board meetings. Although the SEC strongly advocates audit committees, it does not require corporations to establish such board committees.

[16] The AMEX recommended the formation of audit committees composed solely of independent directors in 1980.

contributed to the popularity of audit committees in the US. In addition to these forces, Jeremy Bacon of The Conference Board (1979) indicates that scandals and public distrust of business, changing legalistic environments in which directors operate and pressures from the accounting profession have contributed to the rise of audit committees in the US.

The high profile reports of the ‘National Commission on Fraudulent Reporting’ (Treadway Commission) have also encouraged corporate boards of directors to form audit committees (McMullen and Raghunandan, 1996). Funded by the Institute of Internal Auditors (IIA), the American Institute of Certified Public Accountants (AICPA), the Financial Executives Institute, the American Accounting Association and the National Association of Accountants, the “Treadway Report” of October 1987 was issued to help prevent and detect fraudulent corporate financial reporting (Bull and Sharp, 1989). The Treadway Commission published eleven recommendations for audit committees (see box 6.4). Treadway did, to some degree, set new standards for audit committees in the US. In response to the Treadway report, the AICPA issued several ‘Statements on Auditing Standards’ (SAS) to emphasize the role of auditors and audit committees in corporate governance in April 1988. The AICPA established with “SAS 61 – Communicate with Audit Committees”, and other Statements on Auditing Standards a new standard for auditors that recommends external auditors to communicate formally with audit committees (Braiotta, 1994; Todd DeZoort, 1997). The 1987 Treadway report was followed by the a report of “The Committee of Sponsoring Organizations” (COSO) of the Treadway Commission.

The report, “Internal Control-Integrated Framework”, also greatly contributed to the popularity of audit committees in the US after its publication in September 1992. The report sought to reflect a broad consensus of opinion on the definition of internal control methods that provide standards to measure the effectiveness of the internal control systems of corporations (Kelley, 1993). Despite increasing pressures on corporate boards to establish audit committees, audit committees are not required by state corporation laws. State law of Connecticut forms an exception for domestic corporations with at least one hundred record holders (Harrison, 1987; Varallo and Dreisbach, 1996b). Another law, The Foreign Corrupt Practices Act (FCPA) of 1977, addresses accounting and internal control standards for publicly held corporations. Its purpose is to prohibit US corporations and their affiliates (directors, officers, etc.) from bribing foreign governmental officials. The law also provides “ . . . the establishment and maintenance of a system of internal accounting control and record-keeping requirements with respect to all publicly held corporations” (Braiotta, 1994:29). As such, the FCPA applies increased pressure on corporate boards and audit committees members to comply with “enforceable guidelines” (Todd DeZoort, 1997:211).

Box 6.4

The Treadway Report - 11 Recommendations For Audit Committees

A company's audit committee should annually review the management program to monitor compliance with the code of corporate conduct. Management and the audit committee should ensure that the internal auditors' involvement in the audit of the entire financial reporting process is appropriate and properly co-ordinated with the independent public accountant. The boards of directors of all public companies should be required by Securities and Exchange Commis-sion rules to establish audit committees composed solely of independent directors. Audit committees should be informed, vigilant and effective overseers of the financial reporting process and the company's internal controls.	All public companies should develop a written charter of the audit committee's duties and responsi-bilities. The board should approve the charter, review it periodically and modify it as necessary. Audit committees should have adequate resources and authority to discharge their responsibilities. The audit committee should review management's evaluation of factors related to the independence of the company's public accountant. Both the audit committee and management should assist public accountants in preserving their independence.	Before the beginning of each year, the committee should review management's plans for engaging the company's independent public accountant to perform management advisory services during the coming year, considering both the types of services that may be rendered and the projected fees. All public companies should be required by SEC rules to include in their annual report to stockholders a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year. Management should advice the audit committee when it seeks a second opinion on a significant accounting issue. Audit committees should oversee the quarterly reporting process.

Source: Treadway Report (1987), summarized by Bull and Sharp (1989).

A relatively new development is the introduction of the Federal Deposit Insurance Corporation Improvement Act' (FDICIA) that regulates audit committee requirements for banks and savings institutions with over USD 500 million in assets in the US (see box 6.5).

Box 6.5
The FDICIA Rules on Audit Committees

" (1) Independent Audit Committee.-

Establishment. – Each insured depository institution (to which this section applies) shall have an independent audit committee entirely made up of outside directors who are independent of management of the institution, and who satisfy any specific requirements the Corporation may establish.

Duties. – An independent audit committee's duties shall include reviewing with management and the independent public accountant the basis for the reports issued under subsections (b)(2), (c), and (d).

Criteria applicable to committees of large insured depository institutions. – In the case of each insured depository institution which the Corporation determines to be a large institution, the audit committee required by subparagraph (A) shall

(i) Include members with banking or related financial management expertise;
(ii) Have access to the committee's own outside council; and
(iii) Not include any large customers of the institution."

Source: Braiotta (1994).

6.4.5 The Fifth Issue: The Composition and Independence of Audit Committees

The Model Business Corporation Act does not specify any qualifications for directors who work in board committees. Formally, board committees can be comprised of executive directors or, if desirable, committees can be comprised of non-executive directors. In the case of audit committees, the Corporate Director's Guidebook strongly advocates for an independent committee consisting of three to five independent directors. Under the rules of the NYSE, audit committees need to be solely comprised of directors who are independent of management: "Each domestic company . . . shall establish . . . an Audit Committee comprised solely of directors independent of management and free from any relationship that, in the opinion of its Boards of Directors, would interfere with the exercise of independent judgement as a committee member. Directors who are affiliates of the company or offices, or employees of the company or its subsidiaries would not be qualified for Audit Committee Membership" (NYSE, Listed Company Manual, §303.00).

Fact 7 -> Board Committees: Audit Committees Have Become More Independently Composed

The Heidrick and Struggles 1986-1988 indexes indicate an increasing number of non-executive directors in audit committees in Fortune 1000 corporations. The Korn/Ferry International 1997 study of proxy statements of 878 corporations even indicates that all corporations have established audit committees in 1996. These committees were on average composed of four non-executive directors (Korn/Ferry International, 1997). This development indicates that audit committees have become common in the US. It also indicates that directors increasingly understand the need to operate with audit committees that are comprised of directors who operate independently of management. As such, related to the first proposition of this research, the increasing popularity of independent audit committees may suggest that directors are using this committee as a vehicle to formally separate boards' decision management role from its decision control role.

Vicknair et al. (1993) and Braiotta (1994) suggest that it is important to standardize the rules on the independence of audit committees. Vicknair et al. (1993) examined the proxy statements of one hundred NYSE-corporations on the background of audit committee members between 1980 and 1987 (see table 6.1). The research indicates that a total of 26 percent of the corporations had a majority of audit committee members who can be classified as grey area directors[17].

Table 6.1
The Percentage of Directors in Each Grey Area Category in 100 NYSE-Corporations (1989-1987 Proxy Statement Data)

Interlocking directorships	12.0%
Other related party transactions	11.5%
Affiliated with corporations' bank	3.1%
Lawyers receiving fee income	2.9%
Retirees of the corporation	2.4%
Consultants to the corporation	0.5%
Relatives of management	0.5%
Full sample is 428[18] directors in audit committees	

Source: Vicknair et al. (1993:56).

[17] The study also indicates that 74 percent of corporations had at least one grey area director in their audit committees.

[18] Note: Interlocking directorships include directors who are engaged in a business venture with a member of the corporation's management team, who are executives or directors of major suppliers or customers of the corporation or who are affiliated with the corporation's investment banker. In table 6.1, the total of percentages is more than 32% of the 428 directors in the sample because some directors fit in more than one category (Vicknair et al., 1993:56).

According to Vicknair et al. (1993), grey area directors are not employed by corporations on whose boards they serve. Yet, these directors are affiliated with the corporation or its management or their background suggests that they enjoy a direct or indirect financial interest in the corporation. A total of some 32 percent of 418 audit committee members in the sample are classified as grey area directors. Table 6.1 indicates the grey area categories in the Vicknair et al. (1993) study.

Vicknair et al. (1993:57) conclude: "Given the evidence . . . we feel that it is premature for accountants and others interested in improving corporate governance to relax their concern over audit committee independence [. . .] the pervasiveness of 'Grey' area directors . . . suggests the existence of a more serious potential independence problem." Also noted by Vicknair et al. (1993), this problem seems to be less persistent in a study of The Conference Board in 1988. The Conference Board study indicates a decreasing number of former employees in audit committees (from 19 percent in 1978 to 13 percent in 1987). Bankers' representatives dropped from 23 percent in 1978 to 10 percent in 1987. Jeremy Bacon of The Conference Board concludes: "In fact, figures for most of the potentially non-independent directors listed in the table have decreased since the last report. Since many survey companies are not listed on the NYSE, the high compliance with the Exchange's guidelines . . . is evidence that many non-Exchange companies believe in independent committees and voluntarily abide by strict membership standards" (The Conference Board, 1988:7-8). Table 6.2 presents the grey area categories in The Conference Board study.

Table 6.2
Grey Area Categories in The Conference Board Study

Relationship of director to corporation	Number of corporations with at least one such director on the audit committee	1987 study results in percentages	1978 study results in percentages
Former employee	93	13	19
Attorney	80	12	10
Banker	68	10	23
Investment banker	48	7	9
Employee	44	6	3
Major customer	33	5	9
Major supplier	5	1	2
	692 corporations		
Note: the relationships in this table are based on the NYSE policy statement on audit committees. Attorneys are affiliated with corporation's outside counsel. Bankers are representing banks customarily serving the corporation and investment bankers provide service to the corporation.			

Source: The Conference Board (1988:7).

6.4.6 The Sixth Issue: The Function of Audit Committees

Samet and Sherman (1984) indicate that while the SEC, exchanges, legislators, auditors and others strongly have encouraged the use of audit committees, the objectives and duties of audit committees are still diverse. The authors indicate that the ambiguities with respect to the function of audit committees may be due to three factors:

- the relatively recent development of the audit committee as part of the corporate structure;
- the lack of a single central authority in the US that has established the functions and duties of the audit committee, and;
- the fact that the functions of audit committees vary according to the context in which audit committees exist.

Source: Samet and Sherman (1984:47-48).

Cobb (1993) and Maassen (1998b) refer to at least four key functions of audit committees identified in the Anglo-Saxon corporate governance literature (see table 6.3). (1) The first function concentrates on the internal control and financial reporting procedures of the firm. According to McMullen (1996:88): “Effective audit committees enhance the credibility of annual audited financial statements and thus assist the board of directors which is charged with safeguarding and advancing the interests of shareholders . . .” (2) Another function of the audit committee aims at reducing illegal activity and preventing fraudulent financial reporting. Beasley (1994) indicates that the audit committee can play an important role in preventing and detecting management fraud because audit committee members may be often the first non-management personnel to identify a potential irregularity. (3) To strengthen the position and the independence of the external auditor, the audit committee is also a means to create a link and a channel of communication between the auditor and the board of directors. The audit committee can reduce the liability of external auditors, can assist external auditors in reviewing the activities of the internal auditors of the corporation and can assist the board of directors in reviewing the nomination and performance of external auditors. (4) Finally, an audit committee can assist the board of directors to conform to standards and institutional norms.

According to Harrison (1987:11): “For a board of directors, its committee structure symbolizes its methods of operation, which itself is not readily observable. With the increasing attention focused on board committees by the SEC disclosure requirements, the New York Stock Exchange regulations, the AMEX and ABA recommendations, and the courts, the board’s committee structure is becoming increasingly visible and important for legitimacy maintenance.”

Despite legislators' and commentators' disagreement on the precise function of audit committees (Cobb, 1993; Wallage, 1995; Varallo and Dreisbach, 1996b; Todd DeZoort, 1997; Maassen, 1998b), it is generally agreed upon that audit committees of publicly held corporations should perform functions that are indicated by the ALI, The Business Roundtable and the ABA.

Table 6.3
Four Functions of Audit Committees in the Anglo-Saxon Literature

Enhance the integrity and the credibility of financial statements and corporate accountability:	oversee the total audit of the financial reporting process, including the internal control system and the use of generally accepted accounting principles (McMullen, 1996); review financial statements and other financial information distributed externally (KPMG, 1996).
Reduce illegal activity and prevent fraudulent financial reporting:	provide detailed information to the board of directors to signal potential irregularities (Cobb, 1993; Beasley 1994, 1996).
Strengthen the position and the independence of the external auditor:	provide a link and a channel of communication between the auditor and the board of directors (The Conference Board, 1988; Cobb, 1993; Vicknair et al., 1993); reduce the liability of the external auditor (Samet and Sherman, 1984); review of the recommendations and activities of the internal auditors of the corporation (Samet and Sherman, 1984); review the nomination and performance of the external auditor (KPMG, 1996; The Business Roundtable, 1997).
Pursue legitimacy to conform to standards and institutional norms:	promote corporate legitimacy as "a signal to the outside world" by adapting to methods of operation that adhere to socially acceptable standards (Harisson, 1987; Cobb, 1993); review the corporation's code of ethics or code of conduct (The Business Roundtable, 1997); reduce the liability of boards and directors (Braiotta, 1984).

Sources: Cobb (1993); Maassen (1998b).

Based on the ALI's Principles of Corporate Governance and The Business Roundtable's 1990 statement, the Corporate Director's Guidebook suggests the following functions of audit committees:

- make recommendations to shareholders concerning the engagement or termination of the corporation's external auditor;
- review the compensation, proposed terms of engagement and the independence of the external auditor;
- review the appointment and replacement of internal auditing executives;
- serve as a channel of communication between the board and the internal and external auditors;
- review the external audit, the management letter and management's response to recommendations from the external auditor and internal auditors;
- review and discuss internal financial controls.

Source: ABA (1994:1265-1266).

Fact 8 -> Board Committees: Compensation Committees Become More Common and More Independently Composed

As an independent source of advice, the compensation committee can support boards' policies regarding the remuneration of top executives and the recommendation of board candidates. The Corporate Director's Guidebook and the ALI indicate - amongst other things - the following duties of compensation committees that are comprised entirely of non-executives:

- review and recommend to the board, or determine, the annual salary, bonus, stock options, and other benefits, direct and indirect of the senior executives;
- review new executive compensation programs; review on a periodic basis the operation of the corporation's executive compensation programs to determine whether they are properly coordinated; establish and periodically review policies for the administration of executive compensation programs; and take steps to modify any executive compensation programs that yield payments and benefits that are not reasonably related to executive performance;
- establish and periodically review policies in the area of management perquisites;
- plan for executive development and succession; in that capacity some compensation committees take on a broader role, to actually plan for management development and evaluation of key personnel.

Source: ABA (1994:1269,1271).

The Business Roundtable recognizes the compensation/personnel committee as an independent source for "ensuring that a proper system of long- and short-term compensation is in place to provide performance-oriented incentives to management" (The Business Roundtable, 1997:16). Another important function of the compensation committee is also to fulfill the 1992-SEC requirement to file a "Compensation Committee Report" on executive remuneration programs. In general, corporations registered under the 1934 Act are required to describe " . . . the performance factors on which the Committee relied in determining the compensation of the CEO, as well as a discussion of the Committee's general policies with respect to executive compensation" (ABA, 1994:1270).

According to Varallo and Dreisbach (1996a:21), the compensation committee is "likely second only to the Audit Committee in its prevalence . . ." The Heidrick and Struggles indexes indeed confirm the popularity of the compensation committee. A vast majority of boards in Fortune 1000 corporations (95,1 percent) had established such a committee in 1986. A majority of the compensation committees is also composed of non-executive directors. In 1986, some 69 percent was entirely composed of these directors. In 1988, more than three-fourth of the committees were solely composed of non-executive directors. Based on proxy statements, Korn/Ferry International (1997) indicates that 99 percent of 878 Fortune industrial and service corporations have established a compensation committee in 1996. The average compensation committee was composed of four non-executive directors. Executive directors were on average no member of the compensation committee.

Fact 9 -> Board Committees: Nominating Committees Become More Common and Independently Composed

According to the Corporate Directors' Guidebook, the nominating committee has two principle functions:

- to recommend to the board the slate of nominees of directors to be elected by the shareholders (and any director to be elected by the board to fill vacancies); and
- to recommend the directors to be selected for membership on the various board committees including the designation of chairs of board committees.

Source: ABA (1994:1272).

These responsibilities are similar to The Business Roundtable's definition of the duties of nominating committees. In addition to the recommendations of the ALI and the ABA, The Business Roundtable identifies the following responsibilities of the nominating committee:

- to develop a policy on the size and composition of the board;
- to review possible candidates for board membership;
- to evaluate the participation and contribution of current board members.

Source: The Business Roundtable (1997).

The ABA, ALI and The Business Roundtable all acknowledge a certain degree of CEO involvement in the nomination of directors. According to The Business Roundtable: “While the CEO must be involved, boards should create a process that makes it apparent to the corporation’s stakeholders that selecting director nominees is the board’s responsibility” (The Business Roundtable, 1990:250). Although the ALI states that: “ . . . officers and employees should not be members of the nominating committee, officers and other agents and employees are in no way disqualified from playing an active role in the nominating process. On the contrary, such persons, and in particular the chief executive officer, can be expected to be highly active in recommending to and discussing candidates with the committee and in recruiting candidates for the board. Indeed, the chief executive officer’s active participation in recruitment is often an important and perhaps essential element in convincing high-quality individuals to become directors, and recommendations as to nominees made by the chief executive officer for directorships to be filled by other senior executives should normally carry very substantial weight. However, this kind of participation can be achieved without making the chief executive officer a member of the committee” (ALI, 1992:161). According to proxy statements, Korn/Ferry International (1997) indicates that 74 percent of 878 Fortune industrial and service corporations have a nominating committee in 1996. The average committee was composed of four non-executive directors. Executive directors were on average no member of the nominating committee.

Fact 10 -> Board Committees: More Independent Leadership at Board Committees

It is generally accepted by reformers that oversight board committees should be entirely composed of non-executive directors. To strengthen the role of independent directors, it is suggested that members of oversight board committees choose their own committee chairs rather than having CEOs who designate the chairs of board committees (ABA, The Corporate Director’s Guidebook, 1994). According to Heidrick and Struggles (1986), a majority of board committees are chaired by non-executive directors in 1986, with the exception of the executive committee, which is generally headed by a managing director who is usually also the CEO of the corporation. Korn/Ferry International (1997) indicates that all audit, compensation and nominating committees in 878 Fortune industrial and service corporations are chaired by non-executive directors in 1996. As such, these oversight committees are formally composed and chaired independently of management.

6.5 Summary

The discussion on boardroom reform in the US concentrates on both legalistic and economic perspectives of corporate governance. One stream of reformers stresses the need to adopt new legislative standards to improve the formal independence of corporate boards. The American Law Institute's (ALI) Corporate Governance Project - for example - has been a high profile attempt from the legislative community to set forth new legal standards and recommendations for corporate boards. On the other hand, instead of imposing more legislation on corporate boards, reformers try to set new standards of corporate governance by means of a variety of market forces that give managers and directors the right incentives to act in the interests of shareholders. Institutional investors like CalPERS and TIAA-CREF - for example - have taken the lead in the shareholder activism movement to impose more pressures on corporate boards to alter their governance structures.

According to ICMG (1995:64): "While there have been a number of developments stemming from increased institutional investor pressures on boards and management, this has all occurred within the existing legal and regulatory framework." As such, the corporate governance debate so far has not resulted to new legislative standards in the US. Federal securities and state corporation laws still do not dictate the structure and composition of corporate boards and the qualification of directors. Instead, the corporate governance system in the US heavily relies on federal and state law regulations that concentrate on the disclosure of board practices. The Securities and Exchange Commission rigidly enforces the rules of the Securities Act of 1933 and the Securities Exchange Act of 1934. Yet, its powers to regulate the governance structure of corporate boards is rather limited. The corporate governance structure of corporations is mostly a matter of state corporation laws which are generally based on the Model Business Corporation Act and the General Corporation Law of the State of Delaware. Yet, state's indifference to prescribing board composition and size has fostered much diversity in the governance structure of corporate boards (Baysinger and Butler, 1984). The Task Force on Corporate Governance of the International Capital Markets Group (ICMG) states: "There is no significant pressure to change state company laws or federal securities laws and regulations. It is generally believed that the reforms in corporate governance considered necessary can be accomplished within the present legal and regulatory structure and there is no significant desire to revamp it" (ICMG, 1995:67).

Despite the absence of regulatory changes on state corporation level, chapter six has indicated many changes in attributes of one-tier corporate boards of directors in the US. Data from Spencer Stuart, Heidrick and Struggles, Korn/Ferry

International, The Conference Board, the NACD and others, suggest that boards are adapting to new corporate governance practices and standards. These changes in the structure and the composition of corporate boards suggest a tendency of one-tier boards in the US to transform towards a more independent board structure. More corporations are assigning non-executive directors to the chairman seat of the board. In the case of CEO-duality, an increasing number of corporations appoints a lead director to their boards. More non-executive directors take over positions from executive directors while the average size of corporate boards has decreased. Non-executive directors are also increasingly confronted with more stringent requirements with respect to their business relationships with corporations. Finally, audit, remuneration and nomination committees composed of non-executive directors have become increasingly popular in the US. As such, these developments indicate that corporate boards formally have become more independently composed and structured in the US. This development suggests support for the theoretical framework on the separation of decision management from decision control in one-tier boards and the transformation of board models presented in part I of this research. In summary, box 6.6 portrays the developments in the governance structure of boards of directors in publicly held corporations in the US.

Box 6.6
Current Trends in Corporate Governance in the US

Existing corporate governance framework:

- federal and state securities laws strongly focus on the disclosure of board practices;
- the State of Delaware and the (R)MBCA provide minimum requirements on board structure and composition in some 37 states;
- state corporation laws do not rigidly determine board structure and composition - they are to a large degree indifferent to prescribing board structure and composition;
- articles of incorporation and by-laws provide a diversity in the composition and structure of corporate boards;
- independent audit committees have become mandatory for listed corporations at the major stock exchanges in the US;
- compensation committees – when formed - are required by the SEC to file a compensation committee report.

Boards in listed corporations are undergoing changes:

- independent board leadership is receiving more attention - CEO and chairman roles are increasingly being separated;
- lead directors are becoming more popular - more corporations are designating lead directors to their boards;
- total board size is downsizing;
- boards are more predominantly composed of non-executive directors – more non-executive directors take over positions from executive directors;
- the number of executive directors is decreasing;
- more work is being done in standing oversight board committees;
- more non-executive directors take over (leadership) positions in standing oversight committees.

Current issues:

- ongoing debate on self-regulation and implications of corporation laws;
- whether roles of the CEO and the chairman should be separated;
- more disclosure of standing oversight board committee composition;
- ongoing debate on fiduciary duties of non-executive directors.

Sources: ICMG (1995); Spencer Stuart (1997); Korn/Ferry International (1997); Chapter 6.

Chapter 7: Changing One-Tier Board Attributes, the Case of the UK

7.1 Introduction

Chapter six indicates that one of the main issues in the corporate governance debate concerns the influence of management on the role of corporate boards (Rechner and Dalton, 1991). Based on the assumption that the structure and the composition of corporate boards should support the control roles of directors, numerous recommendations have been proposed to improve the formal independence of boards of directors in publicly held corporations. In a similar way to the corporate governance discussion in the US, the structure and the composition of corporate boards of directors are fiercely debated in the UK. High profile corporate failures of Maxwell[19] and others have heightened the emphasis on the strengths and weaknesses of the one-tier board model in the UK (Charkham, 1994). The Cadbury Code of Best Practice, the Greenbury Report on Directors' Remuneration and Cadbury's successor - the Hampel Committee on Corporate Governance - have strongly contributed to the discussion on the openness, the integrity and the accountability of boards of directors in publicly held corporations. It has been suggested that these initiatives have resulted to considerable changes in the composition and the structure of corporate boards of directors in listed corporations during the last five years. The 1992 Cadbury Code - for example - requests boards to have at least three non-executive directors. Compliance reports indicate that this practice has been widely adopted by listed corporations in the UK. Although not required by the Cadbury Code, corporations have also changed their board leadership structures by separating the CEO and chairman roles. In addition, the Cadbury Code stipulates that audit committees should have at least three independent non-executive directors. This recommendation has been realized by a strong majority of listed corporations in the UK as well (Spencer Stuart, 1996a).

Outline

The organization of this chapter is to a large extent similar to the organization of chapter six. First, to review the discussion on the composition, the leadership

[19] According to Boyd (1996:168): "The Maxwell case was the most dramatic of the cases involving abuse of power by the founder of a large public firm who acted as Chief Executive while simultaneously chairing the board." See also Boyd (1996) for an overview of high profile failures in the UK.

structure and the committees of one-tier (unitary) boards, relevant recommendations of Cadbury and its successors are briefly discussed in paragraph 7.2. Guided by the recommendations of the Cadbury, the Greenbury and the Hampel committees, paragraph 7.3 portrays the discussion on the composition of boards in publicly held corporations in the UK. Paragraph 7.4 concentrates on the board leadership structure of these corporations. Finally, paragraph 7.5 portrays the discussion on board committees. Developments and facts about changing board attributes are presented in paragraph 7.6. In this paragraph, empirical findings on changes in board size and composition, board leadership structures and standing oversight board committees are based on data collected by Spencer Stuart Board Services in the UK. The data is culled from 1993 - 1997 annual reports[20]. In addition, the London Spencer Stuart office has sent a questionnaire to chairmen of the top one hundred corporations - by stock market value – listed on the London Stock Exchange in June 1996. Questions of the survey related to the composition of the board, the leadership structure of boards and other related corporate governance issues. Additional information from ICMG, PRO NED, The Institute for Chartered Accountants, the 1995 report of the Monitoring Sub-Committee of the Cadbury Committee, The Hampel Committee on Corporate Governance and information from independent commentators is used to exemplify changes in the attributes of one-tier boards of publicly held corporations in the UK. This chapter ends with a summary in paragraph 7.7.

7.2 Corporate Governance in the UK

Similar to the US-system, the governance structure of listed corporations in the UK is based on a classic governance structure. Directors, the chairman of the board and auditors are elected by shareholders at the Annual General Meeting (AGM). The directors appoint the chief executive of the corporation. By means of externally validated annual reports, shareholders are informed on the financial performance of the corporation (see box 7.1). According to Boyd (1996:168-169), the business scandals of the 1980s made clear that “self-interested directors could manipulate the operations of the classic governance structure for their own gain at the expense of shareholders and other fiscal stakeholders [. . .] It can be seen that corporate directors are able, if they are so motivated, to manipulate the classic governance structure in a variety of ways so as to promote their own ends. When we add in other elements of human fallibility we have the full recipe for the recent history of corporate abuses in the United Kingdom.”

Triggered by corporate failures and excessive remuneration plans, a series of committees have been formed to investigate the strengths and potential weaknesses of the one-tier board model in the UK. To improve the classic corporate governance model, one of the first initiatives came from the City with the Cadbury Committee in 1992. This committee was shortly followed by the

[20] In comparison to the Board Indexes in the US, Spencer Stuart only recently has initiated a research program on corporate governance developments in the UK. As such, information in this series is mainly based on annual reports issued in 1995 and 1996.

Greenbury and Hampel committees in 1995 and 1998 respectively. The next paragraphs discuss in more detail the contribution of these committees to the corporate governance debate in the UK.

Box 7.1
The Classic Governance Structure

Directors and the chairman are elected by shareholders in the general meeting of shareholders. The Company Act requires all corporations to have at least two directors. Yet, the Company Act does not provide separate classes of directors or a distinction between executive and non-executive directors. Consequently, laws do not require corporations to have non-executive directors or independent leadership in their boards of directors. According to Sheridan and Kendall (1992), it is legally perfectly in order for companies to have only executive directors in their boards. Corporation law provides the possibility that one individual can be appointed as both chair and chief executive.

Sources: Sheridan and Kendall (1992); Boyd (1996).

The Cadbury Report on the Financial Aspects of Corporate Governance

The UK-system of corporate governance is to a large extent based on the same mechanisms that form the foundation of the governance system in the US. Both systems heavily rely on self-regulation and market-based sanctions to govern corporations (Short, 1996). Within the tradition of self-regulation, the Cadbury Report on "The Financial Aspects of Corporate Governance" is recognized to be the most far-reaching publication to strengthen the independence of corporate boards of directors in listed corporations (Conyon and Mallin, 1997). Set up in May 1991 by the Financial Reporting Council (FRC)[21] and the London Stock Exchange (LSE), the Committee released a draft report for public comment on May 27, 1992. The Committee issued a final version of the report in December 1992. According to the Cadbury Committee Report (1992), the Committee's main objective was to help to raise the standards of corporate governance and the level of confidence in financial reporting and auditing. Its recommendations are based on the core belief that self-regulation – and not statutory enforcement – is an adequate way to put pressures on corporations to improve their governance structures (Finch, 1992). The Committee strongly emphasized that financial markets are more likely to provide the necessary external controls, rather than regulators, to enforce the implementation of its recommendations. Clements (1995) indicates that the Cadbury Committee focused on three objectives to set forth new standards of corporate governance in the UK: (1) to improve the governance structure of corporations; (2) to avoid legislation that would bring the

[21] The Financial Reporting Council is the standard-setting body for accountants in the UK.

two-tier board model to the UK, and; (3) to improve the involvement of institutional investors in the governance of corporations to avoid legislative changes in the UK. To achieve these objectives, the Cadbury Report was based on four different kinds of prescriptions: codified recommendations, mere recommendations, calls for legislative change and exhortations[22] (Finch, 1992). The codified recommendations in "The Code of best Practice" attracted the greatest attention from the business press.

The Cadbury Committee and the Governance Structure of Corporations

The first objective of the Cadbury Committee was to improve the governance structure of corporations. To avoid the repetition of corporate affairs like Maxwell, the Committee placed much stress on the need for strong and independent non-executive directors in corporate boards. Cadbury also stressed the need to split the positions of the CEO and chairman to achieve a clear division of power in the top of corporations. The formation of standing oversight board committee - e.g., the audit committee - was also encouraged to support boards' control roles. In addition to these recommendations, Cadbury recommended corporations to reconsider the remuneration schemes and bonus plans for executive directors and to reconsider the position of the independent auditor. Cadbury's main recommendations are discussed in more detail in the next paragraphs.

The Cadbury Committee and the Discussion on Two-Tier Boards

Another objective of Cadbury was to strengthen the position of one-tier boards in the UK and to avoid any legislation that would require corporations to form a two-tier board structure – in particular the German two-tier board structure[23]. According to ICMG (1996:85): "Some commentators have argued that the requirement for non-executive directors on the board as prescribed by Cadbury represents a step towards a two-tier board system. However, this was clearly not the intention of the Committee. In focusing its recommendations on the control and reporting functions of the board, Cadbury stated that its proposals aimed ' . . . to strengthen the unitary board system and increase its effectiveness, not to

[22] According to Finch (1992), the Cadbury Report contains a series of mere recommendations that deal with the application of the Code. One of these states that the LSE should require corporations to publish a statement of compliance with the Cadbury Code. The Cadbury Code also contains some recommendations for legislative reform in the UK (e.g., an amendment of the Companies Act with the requirement that executive directors' service contracts should not exceed three years without the approval of shareholders - see also section 3.1 of the Code). The Committee has also welcomed exhortations - actions by "others" like the FRC to set forth new reporting standards.

[23] Many commentators have referred to the system of co-determination in German two-tier boards and are afraid that such a system will erode the current labor relations in the UK. Chapter eight on the Dutch corporate governance system indicates that codetermination is not necessarily an attribute of the two-tier board model.

replace it'."[24]

In 1995, the Institute of Chartered Accountants (ICA) published a report on the future of Britain's boards of directors. The study concentrated on the feasibility to introduce a two-tier board model in the UK as an alternative for the one-tier board. The report states: "The role of the board, and that of non-executive directors on it, has been one of the most debated of the many issues that Cadbury raised. Many felt that it was odd that Cadbury never examined in detail the possibility of two-tier boards as an alternative to our current system" (ICA, 1995:3). Based on a comparison with the German two-tier board model, the ICA concluded that the two-tier board is not an appropriate model for corporations in the UK.

While the ICA recognized that the German two-tier board provides a "clear separation between supervision and management", the institute also recalled disadvantages of the system: "While in principle the separation of supervision from day-to-day management is attractive, it has the practical consequence of limiting the access of the supervisors to the information which they need to perform the monitoring role [. . .] For the same reason a general requirement that all boards should have a majority of outside directors would be inappropriate. Improving the unitary board, with a strong but not necessarily dominant element made up of non-executive directors, makes more sense for Britain than the introduction of the two-tier system" (ICA, 1995:5,17). In line with Cadbury's recommendations, the ICA therefore stated that " . . . the priority should be to strengthen the unitary board, which requires, among other things, improved procedures for appointing non-executive directors and for ensuring that they can play an effective monitoring role . . ." (ICA, 1995:4).

In a report called "Boards without Tiers", the Confederation of British Industry (CBI[25]) argues that the introduction of a two-tier board model would undermine the direct link between executive directors and shareholders and that it would slow the decision making processes in the corporation. The Institute of Directors (IOD) also strongly supported the unitary board model. In response to the Cadbury Report, the IOD remarked: " . . . the IOD is also totally committed to the principle of a unitary board, under which all directors have equal responsibility to all shareholders. By highlighting the monitoring responsibilities of non-executive directors, the Committee's recommendations come close to advocating the principle of a two-tier board, and seem to us to be unnecessarily divisive" (Jenkins, 1993:13).

Sir Adrian Cadbury also reinforced the need to improve the one-tier board model. Although Sir Adrian Cadbury recognized the need of corporations to experiment with alternative board models, he stated: " . . . in the context of closer European unity, should British companies be at least considering a move towards a two-tier

[24] See also Cadbury (1993).

[25] The Confederation of British Industry is an organization of employers in the UK.

board structure, so separating the supervisory role of the board from its management role? [. . .] What the Committee is proposing is a division of responsibilities between the members of a united board, not a division of the board [. . .] As to whether the way in which the role of the outside director is developing will nudge Britain towards two-tier boards, that is likely to remain an open question for some time to come [. . .] What would be helpful, however, would be a willingness by British companies to experiment with varieties of board structures, so that the evolution of board systems could be guided by practical experience" (Cadbury, 1993:9)[26].

Charkham (1994:333) indicates that there should not be a need to take sides: "If it is desired to put an end to fudge, the logic is to differentiate between the duties of supervisors and the managers, whether they are on a single- or two-tier board. Such a suggestion arouses deep opposition from those who are happy for the non-executive director to have a dual role as contributor and monitor. A formal differentiation is seen as a step to a two-tier system, which many distrust [. . .] There is no logical reason why all companies should be best suited at all times by a single structure; much depends on personalities and circumstances. Why not give shareholders a choice as the French do?" This is also Labor's view. The Labour Party published a paper in 1994 that strongly advocates a statutory basis for corporations which would prefer to establish a two-tier board. The Labour Party stated: "The logic of the Cadbury report might lead some companies 'to prefer a two-tier board in which a supervisory board of non-executives sets objectives and monitors the performance of an executive board with managerial freedom' " (quoted in ICA, 1995:7).

The Greenbury Report on Directors' Remuneration

Cadbury was followed by the Greenbury Committee in 1995. Initiated by the CBI, the committee published a report[27] with a new Code of Best Practice related to the remuneration of directors on July 17, 1995. The key themes in the report were accountability, responsibility, full disclosure, alignment of director and shareholder interests and improved company performance (Greenbury, 1995). Due to public and shareholder concerns about excessive remuneration packages, the report emphasized the need of corporations to publicly disclose more information on the remuneration of directors. The Code contains detailed provisions that supplement the requirements of the Companies Act on the disclosure of board remuneration elements in annual financial reports. One of the controversies Greenbury had to resolve was to improve the methods of disclosing pension plans in annual reports[28]. Another requirement for listed corporations,

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[26] Not to be confused with the committee named after Sir Adrian Cadbury.
[27] Directors' Remuneration. Report of a Study Group Chaired by Sir Richard Greenbury.
[28] Kelly (1996) reports that shareholders could not tell the actual costs of pensions. Greenbury requested the Institute of Faculty and Actuaries to work out a new method to disclose the figures on the true cost of pension entitlements to the corporation. The actuaries responded with the so-called "transfer value method" which received a chilly

introduced by Greenbury, was to set up a remuneration committee consisting exclusively of non-executive directors ". . . with no personal financial interest other than as shareholders in the matters to be decided, no potential conflicts of interest arising from cross-directorships and no day-to-day involvement in running the business" (Greenbury, 1995:14).

Like Cadbury, Greenbury did not seek any legislative changes in the UK to enforce compliance with the code: "The way forward as we see it lies not in statutory controls, which would be at best unnecessary and at worst harmful, but in action to strengthen accountability and encourage enhanced performance. Such action should build on progress already made" (Greenbury, 1995:11). Greenbury recommended that all listed companies in the UK should make an annual compliance statement to their shareholders. As such, the LSE should ". . . introduce continuing obligations for listed companies to the Code's provisions . . . [and, eds.] the investor institutions should use their power and influence to ensure the implementation of best practice as set out in the Code" (Greenbury, 1995:19).

The Hampel Report on Corporate Governance

The Cadbury and Greenbury Committees were followed by the Hampel Committee in 1995[29]. The committee emphasized the need to review the overall governance structure of listed corporations in the UK. The committee published its preliminary report in August 1997 and its final report on January 28, 1998. The initial objective of the committee was to conduct a fundamental review of the corporate governance system in the UK. Its main objectives were to renew the code of Cadbury, to solve unresolved Greenbury issues and to compose a universal code to make an end to the confusion on codes of best practice and other guidelines in the UK. According to Sir Ronald Hampel: "Cadbury and Greenbury were produced in response to particular concerns – corporate collapse and fraud in the first case, and remuneration excesses in the second. My committee was asked to review corporate governance in its totality . . ."[30].

The Financial Times (Jan 29, 1998) indicates that the contribution of the Hampel Report to "changes for the better in UK corporate governance practice" falls into three broad areas:

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reception in the UK. This led to an intense and as yet unfinished discussion on the disclosure of pension plans in the UK.

[29] The Hampel Committee is also called "Cadbury II" or "The Mark II Committee." Compared to Cadbury I, the committee "has a much stronger business flavour than its predecessor" (Hall, 1995). The committee is chaired by Sir Ronald Hampel – the chairman of Imperial Chemical Industries (ICI) – and more than one third of the committee's members were either chairman and/or CEO of listed corporations. Other members were a lawyer, a financier, an actuary, an accountant and an institutional shareholder.

[30] Personal comment of Sir Ronald Hampel in the Financial Times (Jan 29, 1998).

- first, Hampel recognizes the need for board structures that provide both accountability and profitability. Similar to Cadbury, the Hampel Report - for example - supports the recommendation to separate the CEO and chair roles and to increase the number of non-executives in corporate boards;
- second, the Hampel Committee recommends corporations to improve the transparency of their governance structures. Corporations should indicate their preferences for a certain combination of board roles and their preferences for the formation of specific board structures. The board – for example – should explain its decision to combine the roles of CEO and chair in annual reports. The board should also clearly indicate which board members are seen as independent directors. In addition, to enhance the transparency of the governance structure of the board, the biographical details of directors nominated for re-election should be disclosed to the public;
- the third distinctive contribution of Hampel is the consolidation of its recommendations with the codes of Cadbury and Greenbury into a "super code." According to the Hampel Report (1998b:6): "We see this Combined Code as a consolidation of the work of the three committees, not as a departure [. . .] We should in particular like to make clear, in relation to the detailed provisions in the Listing Rules on directors' remuneration, that we envisage no change except where we take a different view from the Greenbury Committee . . . (yet, eds.) these changes are minor."

Source: Financial Times (Jan 29, 1998).

The Combined Code, published in June 1998, supplements the LSE's listing rules book (the Yellow Book). The Code itself will not be included in the exchange's listing rules. A statement will be added to the listing rules which will require corporations to provide a statement of compliance in two parts with the principles and guidelines of the Combined Code. According to the Combined Code, the first part requires corporations to report how the principles of the Code are applied. In the second part, corporations are required to provide an explanation when they do not comply with certain provisions of the Code.

The Hampel Report received a "rather grudging reception" when it was published (Financial Times, Jan 29 1998). The TUC reported that Hampel had "a misplaced faith in the effectiveness of self-regulation." The Institute of Internal Auditors stated that the internal reporting procedures between audit committees and auditors (both internal and external) were not clearly defined. Others strongly supported the report of the committee. Not surprisingly, the IOD welcomed "the report's emphasis on flexible principles rather than a 'cookbook' of rules." The CBI saw Hampel as a "viable framework which allows companies the flexibility they need to operate."

The Future of Corporate Governance in the UK

The Hampel Committee follows the tradition of self-regulation and flexibility in corporate governance in the UK. To avoid legislation, Hampel called for time to give corporations a possibility to comply with its recommendations. In the Financial Times of January 29, 1998 Sir Ronald Hampel stated: "Public companies today recognize as never before both their formal accountabilities and their wider public responsibilities. In the context of today's corporate governance requirements and of public scrutiny, they will have to demonstrate these over the next few years or the demands for government action will become more strident and probably irresistible. Good governance requires judgement, not prescription, and for that reason I believe it is in business's own interest to conform, and that it will." Sir Ronald Hampel stated the hope that the government will allow corporations time to comply with the Code. In a response to the Hampel Report, Margaret Beckett, Trade and Industry Secretary gave a "guarded welcome" to the report – although she had criticized the draft report of the Hampel Committee because it "failed to address concerns about corporate short-termism" (Financial Times, Jan 29 1998). The Department of Trade and Industry (DTI) announced that it would issue a Green Paper on proposals to review corporation laws in 1998. Consequently, the debate on corporate governance has not been ended yet in the UK and probably it will never end!

7.3 About Board Composition

The Company Act does not make a distinction between executive and non-executive directors in the UK. Directors are nominated and elected at the AGM. The control over the slate of nominations of directors for election at the AGM can lie in the hands of executive directors. According to Boyd (1996:169), "there is obvious potential for corruption in this process, as a CEO can effect the nomination of directors who may further the board's interest rather than the shareholders." Boyd indicates three ways in which the nomination of directors who favor the interests of the CEO can be effected:

- first, the CEO can nominate executive directors who are allied to the CEO;
- second, the board can also nominate non-executive directors who are not only in favor of the CEO, but who are also financially dependent on the corporation;
- finally, the CEO may nominate executive and non-executive directors for re-appointment due to the absence of a system that guarantees the rotation of directors. As such, it is possible for directors to become entrenched.

To avoid these problems, the first recommendation to appoint more non-executive directors to UK-boards was already made by the Watkinson Report of the Confederation of British Industry (CBI) on the responsibility of public companies in 1973. The report concluded that "the inclusion on the board of public companies of non-executive directors is highly desirable . . . by virtue of the fact that unlike executive directors they are not closely involved in the day to day affairs of the company, and they are in a better position to see the company as a whole and to take a critical view of it" (quoted in: Tricker, 1984:187)[31].

The appointment of non-executives to boards of listed corporations has also been encouraged by the Institute of Directors (IOD)[32], the Governor of the Bank of England and other City institutions (Tricker, 1984). In 1980, the Bank of England, the London Stock Exchange, CBI and the British Institute of Management founded PRO NED to promote a wider use of non-executive directors (Charkham, 1994). More recently, the Cadbury and Hampel Reports strongly reinforced the position of non-executive directors. The voluntary Cadbury Code recommends that there should be a minimum of three non-executive directors in the board – of whom two non-executives should be independent of management and the company (Cadbury Code, § 4.11). On the independence of non-executive directors, Cadbury recommends that "An essential quality which non-executive directors should bring to the board's deliberations is that of independence of judgement. **We recommend** that the majority of non-executives on a board should be independent of the company. This means that apart from their directors' fees and shareholdings, they should be independent of management and fees from any business or other relationship which could materially interfere with the exercise of their independent judgement" (Cadbury Code, § 4.12).

The ICA proposed that references in the Cadbury Code to non-executive directors should be changed into independent directors. In addition, the ICA recommended more guidance on the criteria to be satisfied by non-executive directors when they are independent of management. The Hampel Committee followed Cadbury's definition of independence: "There was some concern expressed that we had ducked the issue of what was independence . . . We believe that Cadbury had defined independence in the best possible way and we could not improve on it" (Sir Ronald Hampel, quoted in: Financial Times, Jan 29 1998).

In the final Combined Code, the independence of non-executives is further explained. Provisions A.3.1 and A.3.2 of the Combined Code state: "The board should include non-executive directors of sufficient calibre and number for their views to carry significant weight in the board's decisions. Non-executive directors should comprise not less than one third of the entire board [. . .] The majority of these directors should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement. Non-executive directors considered by the board to be

[31] According to ICMG (1995), only fifty percent of listed corporations had non-executive directors in their boards at that time. Of these directors, approximately twenty percent were categorized as independent directors. Related to this figure, ICMG does not provide a definition of the independence of these directors.

[32] The IOD published a Code of Practice for the Non-Executive Director in 1982. The Code states that every board of directors should have a minimum of two independent directors (see Tricker, 1984).

independent in this sense should be identified in the annual report" (Hampel, 1998b:14-15). Seen from this perspective, the definition of board independence in the UK shows similarities with those of The Business Roundtable, ALI and ABA presented in chapter six on the corporate governance system in the US.

Table 7.1
Recommendations on the Independence of Corporate Boards

Governance Issues	Cadbury Committee Publication December 1992	Hampel Committee (Cadbury II) Publication January 1998
Separate CEO and chairperson:	recommended but not compulsory.	separation of roles is preferred and corporations should justify the combination of these roles in the annual report.
Lead director:	there should be a strong and independent element on the board with a recognized senior member.	there is a need for vigorously independent non-executive directors. A senior non-executive should be identified in the annual report.
Nomination of directors:	directors should be appointed through formal board process via nomination committees dominated by non-executive directors.	the use of nomination committees should be accepted as best practice, with the proviso that smaller boards may prefer to fulfil the function themselves.
Non-executive directors:	minimum of 3 non-executive directors.	minimum of one-third of non-executive directors.
Indepen-dence of directors:	majority of non-executives should be independent.	majority of non-executives should be independent – based on the same definition of Cadbury of independence! Boards should disclose in annual report who is considered to be independent.
Rotation of directors:	directors should be appointed for specific terms with non-automatic reappointment.	all directors should submit themselves for re-election at least every three years.
Pay and bonuses:	annual reports should reveal desegregated director's pay; Remuneration committee of board should be dominated by non-executive directors.	the company's annual report should contain a statement of remuneration policy and details of the remuneration of each director. Membership of remuneration committee should be exclusively limited to independent non-executive directors.
Indepen-dence of the auditor:	audit committee of the board should be formed, comprised exclusively of non-executive directors.	audit committee of the board should be formed, comprised exclusively of non-executive directors.

Table 7.1 continued
Recommendations on the Independence of Corporate Boards

Governance Issues	Cadbury Committee Publication December 1992	Hampel Committee (Cadbury II) Publication January 1998
Flow of information to the board:	boards should have a formal schedule of decisions; directors should have paid access to outside advice.	management has an obligation to provide the board with appropriate and timely information and the chairman has a particular responsibility to ensure that all directors are properly briefed.
Greater scope of auditing:	auditors should review compliance to the Code, including directors' statements on going-concern and statements on internal audit effectiveness.	listing rules now require auditors to review statements on "going concern", certain aspects of the directors' statements of compliance with the Cadbury Code, and certain elements of the report of the remuneration committee. Additional prescribed requirements nor the removal of any existing requirements for auditor verification of governance is recommended.

Sources: Cadbury (1992); Boyd (1996); Hampel (1998a).

7.4 About Board Leadership Structures

The integration of board leadership and the leadership over the day-to-day management of the corporation has been identified as a "fault" in the classic governance structure in the UK (Boyd, 1996). According to Parker (1994:42): "The main purpose of the proposals (of the Cadbury Committee, eds.) is to restore a healthier balance between quite different roles of an effective board of directors under the leadership of an independent chairman, and of the company's management under the leadership of a capable CEO. Such a balance is difficult, if not impossible, to sustain if the chairmanship is combined in one person." This opinion is also shared by the Institute for Chartered Accountants in England and Wales (ICA). In a report on the future of Britain's boards of directors, the ICA indicates that too many boards are dominated by the chief executive of the company and that a split between the role of the chair and CEO could resolve problems associated with a concentration of power in the boardroom (see box 7.2).

The Cadbury Committee recognized the need to reconsider the leadership structure of corporate boards. The Cadbury Report recommended: "Given the importance and particular nature of the chairman's role, it should in principle be separated from that of the chief executive. If the two roles are combined in one person, it represents a considerable concentration of power**. We recommend**, therefore, that there should be a clearly accepted division of responsibilities at the head of a company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. Where the chairman is also the chief executive, it is essential that there should be a strong and independent element on the board" (Cadbury Code, § 4.9).

Box 7.2
A Weakness in the British System

"Too many British boards are dominated by the chief executive of the company. Even when non-executive directors account for a significant fraction of the board, they often lack the authority, motivation and access to information which they need if they are to do an effective monitoring job. Thus the accountability of the chief executive to the board is weak. The problem is reduced but not necessarily eliminated if the post of chairman and chief executive are separated; a great deal then depends on the chairman's ability to lead the board, especially but not exclusively in its monitoring function, and on the relationship between him and the chief executive."

Source: Institute of Chartered Accountants (1995:8).

The Cadbury Committee felt that a separation of CEO and chair positions would be desirable in principle. Yet, according to Charkham (1994:267-268), the Committee ". . . stopped short of making a firm recommendation because it felt that it would be excessively prescriptive to rule out having a concentration of power under any circumstances." As such, the committee did not insist on a total separation of the chair and CEO roles. The Hampel committee also did not require the separation of the roles of chairman and CEO, although the committee prefers the separation of roles to the combination of these board roles.

According to Hampel (1998b): "There are two key tasks at the top of every public company – the running of the board and the executives responsibility for the running of the company's business. There should be a clear division of responsibilities at the head of the company which will ensure a balance of power and authority, such that no one individual has unfettered power of decision" (Hampel, 1998b:14). This principle has resulted to the recommendation of Hampel that require corporations to publicly disclose the leadership structure of their boards. The Combined Code also requires corporations listed at the LSE to identify the chairman, the CEO and senior independent director(s) [33] in annual reports.

7.5 About Board Committees

Another deficiency associated with the one-tier board model in the UK is the control of the CEO over function and composition of board committees. The control over the formation and composition of board committees formally lies in the hands of the board. The audit committee – which may nominate the external auditor for election – may be chaired by the CEO and be composed entirely of executive directors. In addition, the board and the CEO may control the nomination of an auditor at the AGM. According to Boyd (1996:169): "This raises an obvious conflict of interest in that a powerful CEO can effectively choose the auditor who is then supposed to express an independent opinion on the performance of the firm under CEO's management." To strengthen the independence of one-tier boards, the Combined Code states that oversight board committees should be composed entirely of independent non-executive directors. With respect to remuneration committees, Sections B.2.1- B.2.3 of the Combined Code state: "To avoid potential conflicts of interest, boards of directors should set up remuneration committees of independent non-executive directors to make recommendations to the board, within agreed terms of reference, on the company's framework of executive remuneration and its costs; and to determine on their behalf specific remuneration packages for each of the executive directors, including pension rights and any compensation payments [. . .] Remuneration committees should consist exclusively of non-executive directors who are independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement [. . .] The members of the remuneration committee should be listed each year in the board's remuneration report to shareholders" (Hampel, 1998b:14).

With respect to audit committees, Sections D.3.1 and D.3.2 of the Combined Code state that corporate boards should establish audit committees with at least three non-executive directors and a majority of independent non-executive directors. Members of the audit committee should also be named in the annual reports of listed corporations. With respect to the nomination committee, the Combined Code provides the provision that such a committee should be formed to make recommendations to the board on all new board appointments (Section A.5.1 of the Combined Code). As with the audit committee, the Combined Code requires that a majority of the committee is composed of non-executive directors. These should be chaired by the chairman of the board or a non-executive director. The composition of the nomination committee should also be disclosed in annual reports.

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[33] Sir Ronald Hampel described such a non-executive director as an "essential safety valve" for times when shareholders find it difficult to approach senior executive directors of a company.

7.6 Facts About Changing One-Tier Board Attributes

The reform initiatives in the UK suggest that corporations are undergoing major changes in their corporate governance structures. Several studies have been conducted to determine the impact of the recommendations of Cadbury on the composition and organization of listed companies. In two early reports, Stiles and Taylor (1993a, 1993b) found that the recommendations of Cadbury were strongly supported by a majority of the top one hundred companies in the UK in 1993. A total of 98 percent had audit and remuneration committees while 86 percent had split the roles of chairmen and CEO. Conyon (1994) examined changes in the governance structure of approximately 400 large UK corporations between 1988 and 1993. The author concluded that the overall picture was one of rapid change in the governance structure of the corporations surveyed. A total of 77 percent of the sample of listed corporations separated the role of CEO from chairman in 1993 compared to a total of 57 percent in 1987. Conyon also found that 94 percent of the corporations had a remuneration committee in 1993 (compared to 54 percent in 1988). In addition, the study indicated that the incidence of audit committees had doubled and the incidence of nomination committees had trebled between 1988 and 1993. In 1995, the Cadbury Committee published a compliance report based on the top 500 companies and a random sample of smaller companies in the UK (Cadbury Committee Report, 1995). The committee found that 90 percent of the top one hundred companies had issued a statement of full compliance with the code between September 1993 and December 1994. Conyon and Mallin (1997:35) found a very high degree of adherence to the principles contained in the Code: audit and remuneration committees are now universally adopted by UK-boards. Moreover, Conyon and Mallin indicate that the proportion of non-executives is increasing in the UK. In addition, although the separation of the roles of chairman and CEO was not enforced by Cadbury, only 14.2 per cent of all quoted companies in the UK combined the roles of the CEO and the chairman of the board in 1995 (Conyon and Mallin, 1997). In 1992, this figure was 24.5 percent. More recently, Peasnell et al. (1998) found many changes in the governance structure of 700 non-financial companies in the top one thousand LSE corporations over the period between 1990 and 1996.

Facts 1+2 -> Board Composition: Non-executive Directors Gain Dominance in Boards and the Total Number of Executive Directors Decreases

These figures suggest a development in the attributes of corporate boards in the UK. One of the developments relates to the composition of boards. In 1995, the report of the Monitoring Sub-Committee of the Cadbury Committee indicated that the top one hundred UK listed corporations had complied with the recommendation to appoint non-executive directors to the board. According to ICMG (1995), the report indicated that 97 corporations has appointed three or more non-executive directors to their boards. Two corporations (2 percent) had appointed two non-executive directors. Only one corporation had appointed a minimum of one non-executive director to the board. These figures have even improved since the publication of the Monitoring Sub-Committee's survey.

According to Spencer Stuart (1996g), all top one hundred listed corporations have complied with the Cadbury recommendation to have a minimum of three non-executive directors. On average, board size ranged between four and seven non-executive directors. The total number of non-executive directors has also increased in the top one hundred of listed corporations in the UK. The average number of non-executives rose from 6.1 in 1991 to 6.5 in 1996. The average number of executive directors decreased from 6.6 in 1991 to 6.1 in 1996 (Spencer Stuart, 1996g). Peasnell et al. (1998) found a similar development. The authors indicate that 45 percent of board memberships in 700 LSE-corporations were held by non-executive directors in 1996 compared to 34 percent in 1990. Yet, it should be noted that these also include grey directorships. These are non-executive directorships held by directors who have been formerly affiliated with the corporation and/or who are having business and/or family contacts with the firm (see also paragraph 6.4.5 in chapter six of this study). The Peasnell et al. (1998) study indicates that the number of non-grey directors has reached an average of 2.4 directors in 700 LSE-corporations in 1996 and an average of 3.6 directors in the largest corporations in the sample. The authors do not indicate the number of non-grey directorships in 1990.

Fact 3 -> Board Size Has Not Changed Significantly

Despite the developments in the composition of boards, Spencer Stuart (1996g) indicates that corporate boards have not become significantly smaller during the last five years in the UK. The size of the boards of directors has changed a little from an average of 12.7 directors in 1991 to an average of 12.5 directors in 1996. The total number of non-executive directors in the top one hundred corporations was 647 directors (51.6 percent compared to 48.4 percent executive directors) on a total of 1254 executive and non-executive director positions in 1996. These figures indicate that non-executive directors start to form a majority in corporate boards while the total number of executive directors has declined (Spencer Stuart, 1996g). These findings are supported by Peasnell et al. (1998) who found only little changes in the overall board size of 700 LSE-corporations between 1990 and 1996. Like financial institutions in the US, banking groups have on average the largest boards in the UK. Compared to the US, boards are on average nearly equal of size in the UK.

Fact 4 -> Board Leadership: There Is A Strong Support To Split CEO and Chair Roles

An increasing number of corporations also have separated the role of the chairman from the CEO role. According to Spencer Stuart (1996g), the Cadbury Code has influenced the way corporations divide the power structures at the top of corporations. The study indicates that 25 top one hundred corporations combined these roles in 1991. Only a minority of seven corporations (7 percent) continued to have a combined board leadership structure in 1996. This development suggests that directors are increasingly recognizing the need to formally separate decision management from decision control in their boards. According to Spencer Stuart

(1996g:4-5): “However, these statistics do not tell the whole story. The move towards power sharing at the top has left unresolved the issue of who is boss – an issue that job title alone does not always answer. The splitting of function and hence power between chairman and chief executive officer varies between companies. It also varies according to the strength of personalities involved, with some chairmen exercising far more influence than others over strategy, operations and the board.”

Fact 5 -> Board Committees: Total Number of Board Committee Increases

Board committees have become increasingly popular in the UK. A study by the ICA indicates that 66 percent of 202 companies had audit committees in 1992 compared to 17 percent in 1985 (ICA, 1992). Spencer Stuart (1996g:9) also indicates that board committees are growing in importance in the UK: “Boards are devolving increasing amounts of work to them, more committees are being formed and committee chairmen are increasingly being paid for extra time [. . .] Companies responded to Cadbury by forming at least two committees – audit and remuneration – composed predominantly or exclusively of non-executive directors.”

Facts 6+7+8 -> Board Committees: Audit, Remuneration and Nominating Committees Have Become Common

Spencer Stuart (1996g) indicates that the audit and remuneration committees are the most popular committees in the top one hundred corporations in the UK. Without any exception, both committees are formed by all corporations. The nomination committee is second in popularity with a total of 55 percent of the corporations having such a committee in 1996. Changes have also occurred in the composition of oversight board committees. The Cadbury Monitoring Sub Committee indicated that 90 percent of audit committees are composed of three or more non-executive directors in 1995 compared to 59 percent in 1991 (Cadbury Committee Report, 1995). In addition to developments in the composition and the leadership structures of boards, the formation of independent oversight board committees may suggest that directors are recognizing the need to formally separate decision management from decision control in their boards.

7.7 Summary

The figures in this chapter indicate that the recommendations of the Cadbury Committee have had a significant impact on the governance structure of large listed corporations in the UK. The level of compliance with the recommendations of Cadbury and Hampel indicates that corporate boards have adjusted their structure and composition to new corporate governance standards. Although governance structures differ between corporations, the figures suggest a development towards more homogeneity in the composition and structure of corporate boards in large corporations in the UK. Non-executive directors take over positions from executive directors while the average size of corporate boards remains stable. More corporations are assigning non-executive directors to the chairman seat of the board. Also audit, remuneration and nomination committees with a majority of non-executive directors have become increasingly popular in the UK. As such, changes in the structure and the composition of corporate boards suggest a tendency of one-tier boards to transform towards a more independent board structure that formally separates decision management from decision control in the UK. Developments in the governance structure of boards of directors are summarized in box 7.3.

Box 7.3
Current Trends in Corporate Governance in the UK

Existing corporate governance framework:

- the Company Act provides minimum requirements related to the structure and composition of corporate boards;
- corporation laws do not rigidly determine board structure and composition;
- boards are composed of executive and non-executive directors;
- there is no demand for or encouragement of employee representation at board level (co-determination);
- legislative changes may occur in the near future.

Boards in listed corporations are undergoing changes:

- independent board leadership is receiving more attention - CEO and chairman roles are increasingly being separated;
- total board size is not downsizing significantly;
- number of executive directors is decreasing;
- number of non-executives is increasing;
- more work is being done in standing oversight board committees;
- more non-executive directors take positions in standing oversight committees.

Current issues:

- ongoing debate on self-regulation and implications of corporation laws;
- whether the board should be entirely composed of non-executive directors;
- length of directors' service contracts;
- listing requirements and the development of an universal code of best practices;
- ongoing debate on roles and fiduciary duties of non-executive directors.

Sources: Spencer Stuart (1996g); ICMG (1995); Chapter 7.

Chapter 8: Changing Two-Tier Board Attributes, the Case of the Netherlands

8.1 Introduction

This chapter concentrates on the formal organization of boards of directors of listed corporations in the Netherlands. In general, the Dutch corporate governance system is based on a two-tier board principle. Whether or not listed, large corporations normally have an independent supervisory board and an executive management board. In contrast to the one-tier board model, the international discussion on boardroom reform has not paid much attention to the role and position of non-executive directors in two-tier boards. This is certainly not the case for practitioners and regulators in the Netherlands. Of importance to this study is the renewed interest in the role and position of Dutch supervisory directors and the governance structure of large corporations in this country. Although Dutch corporations have been pressured much less than English and American corporations to alter governance structures, supervisory directors are increasingly confronted with new developments in the (inter-)national corporate governance arena. Especially the last two years have been important to the corporate governance discussion in the Netherlands. The introduction of the forty recommendations of the Peters Committee on 25 June 1997 has been a major force in establishing a national corporate governance debate. Representatives from the Association of Securities Issuing Companies (VEUO) and the Amsterdam Stock Exchange Association formed this committee in April 1996.

Under the chairmanship of Mr. Peters, former CEO of AEGON, the attention of the Peters Committee was directed towards the relationship between managing directors, supervisory directors and investors. The committee did not propose major changes in legislation. Its main purpose was to initiate a national debate on the functioning of boards of directors, their accountability and their reporting procedures in relation to internationally accepted corporate governance standards. On 27 May 1998, the Amsterdam Exchanges and the VEUO formed a monitoring committee to investigate the compliance of 159 listed corporations with the voluntary recommendations of the Peters Committee. On December 3, 1998, the "Monitoring Committee Corporate Governance" presented its results. The findings indicated that a large majority of corporations provided compliance reports to shareholders for discussion at annual meetings in 1998.

The detailed information in these compliance reports suggests that corporations are increasingly recognizing the need to publicly disclose information on the composition, the organization and the activities of their supervisory boards. This chapter strongly benefited from changes in the way Dutch corporations disclose information related to the composition of supervisory boards, the appointment of supervisory directors, the formation of board committees and the number of formal meetings (with or without the presence of managing directors). The tests with a possible proxy solicitation system also contributes to the renewed interest of practitioners in the Dutch corporate governance system. In April 1998, eleven large listed corporations - all included in the sample of this research - have formed the “Stichting Communicatiekanaal Aandeelhouders.” Although popular in the US and other Anglo-Saxon countries, proxy solicitation is a relatively new phenomenon for most (minority) Dutch shareholders. Testing will start in 1999 and the system will probably be fully operative in 2000 after some changes in Dutch legislation have taken place.

Outline

To explore the corporate governance system in the Netherlands, this chapter concentrates on developments in the composition and the structure of supervisory boards in corporations listed at the Amsterdam Exchanges. Paragraph 8.2 first describes the historical background and the rules of four legal regimes that regulate the formal structure of Dutch supervisory boards: the common regime, the structure regime, the mitigated structure regime and the exempted structure regime. These legal regimes provide alternative governance models and grant different powers to supervisory directors and shareholders. Similar to the description of one-tier boards in the previous chapters, the study does not directly refer to articles of corporation laws. Its main purpose is to give the reader an overview of the formal and practical characteristics of the Dutch supervisory board model. Guided by the recommendations of the Peters Committee, paragraphs 8.3 – 8.5 concentrate on the formal description of the Dutch board model. Practical developments in board attributes of one hundred listed corporations are portrayed in paragraph 8.6. Information in this paragraph is based on 1987 – 1997 annual reports, two questionnaires sent to chairmen of supervisory boards in 1996 and 1997 and a survey sent to one hundred corporations listed at the Amsterdam Exchanges in 1998. The data portrays developments in Dutch two-tier boards and indicates the degree of corporations’ adherence to relevant recommendations of the Peters Committee. This chapter ends with a summary on changing two-tier board attributes in the Netherlands.

> 8.1 Introduction to chapter eight.
>
> 8.2 Corporate governance in the Netherlands.
>
> 8.3 About board composition.
>
> 8.4 About board leadership structures.
>
> 8.5 About board committees.
>
> 8.6 Facts about changing two-tier board attributes.

8.2 Corporate Governance in the Netherlands

The formal structure of Dutch corporations is regulated by Book 2 of the Civil Code (“Burgerlijk Wetboek”). The Civil Code provides a distinction between private and public corporations. Private corporations with limited liability (“Besloten Vennootschap met beperkte aansprakelijkheid” or “BV”) issue only registered shares. Law restricts the transfer of registered shares. Owners of private corporations control the transfer of ownership, i.e., they may keep voting rights within the family. After sole proprietorships, private corporations with limited liability are by far the most popular corporate form. By October 1994, 358,950 corporations with limited liability were officially registered in the Netherlands (Glasz et al., 1997). Dutch public corporations ("Naamloze Vennootschap" or "NV") - whether or not listed on the Amsterdam Exchanges - can issue and freely transfer registered and bearer shares. Not all public corporations are listed, however. About 7,5 percent of 1,824 public corporations incorporated in the Netherlands is listed on the Amsterdam Exchanges (Glasz et al., 1997)[34].

Table 8.1
The Number of Public Corporations and Corporations With Limited Liability in the Netherlands

	Total	Number of corporations with a supervisory board	Number of board memberships	Average number of supervisory directors
Limited Liability (BV)	358,950	21,082	38,616	1.8
Public Company (NV)	7,076	1,824	7,453	4.1

Source: Glasz et al. (1997).

Regardless of the corporate form of the corporation (public or limited by shares), the Civil Code provides four legal regimes that rule the governance structure of corporations. These are called the common regime ("Gewoon Model"), the structure regime ("Structuurmodel"), the mitigated structure regime ("Verzwakt Structuurmodel") and the exempted regime ("Vrijgesteld Model"). In general, the rules of the common regime are applicable to small and medium-sized corporations. The structure regime is applicable to corporations that meet criteria related to the number of employees and the amount of subscribed capital. The mitigated regime and exempted regime are mostly of importance to multinationals and corporations that are part of a foreign holding structure. The four regimes provide alternative governance models in the Netherlands. The common regime gives small and medium-sized corporations a choice between a governance structure with only a management board entirely composed of managing directors and a two-tier board model with an executive management board and an additional supervisory board comprised entirely of (non-executive) supervisory directors. Regulations on the corporate governance system of large corporations have been expanded through the structure regime. Corporations incorporated

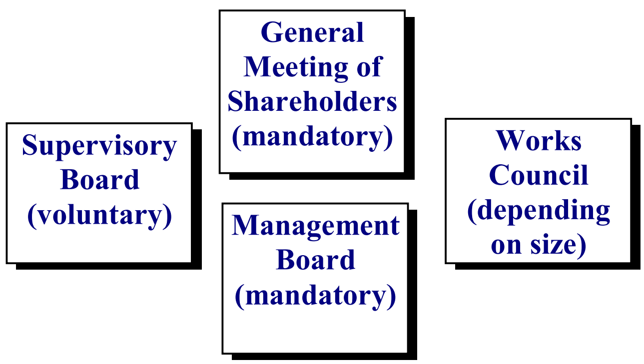
[34] These figures deviate from figures in the Peters Committee Report. According to the Report, 2,042 public corporations and 156,170 corporations with limited liability were incorporated in the Netherlands by January 1995!

under the rules of the structure regime (the so-called structure corporations) have to adopt a two-tier board structure. While the shareholders' meeting has been granted extensive powers to govern corporations that operate under the rules of the common regime, a substantial part of its control shifts to the mandatory supervisory board in structure corporations (Slagter, 1994; de Savornin Lohman, 1996). This transfer of rights is less extensive in corporations that operate under the rules of the mitigated structure regime and the exempted regime. The next paragraphs further explore the differences between the rules of the four regimes and their implications for the position of directors in the governance system in the Netherlands.

The Supervisory Board Under the Rules of the Common Regime

Corporations incorporated under the rules of the common regime meet the minimum requirement by having a management board ("Raad van Bestuur")[35] and a general meeting of shareholders ("Algemene Vergadering van Aandeelhouders").

Figure 8.1
The Governance Bodies Under the Rules of the Common Regime



- the management board and shareholders' meeting are mandatory for public corporations and corporations limited by shares that operate under the rules of the common regime;
- a supervisory board is not mandatory, although it is a common practice for corporations to have one under the rules of the common regime;
- regardless the legal structure of a corporation, a works council needs to be established in corporations with at least 35 employees.

Source: Maassen and van den Bosch (1999a).

Although a supervisory board ("Raad van Commissarissen") is not required for

[35] The management board is also called "Het Bestuur" in small or medium-sized corporations.

corporations that operate under the rules of the common regime, it is a normal practice to have one in medium-sized corporations (see figure 8.1). As a general rule, the shareholders' meeting in corporations that operate under the rules of the common regime has all the powers not held by the management board and - when formed - the supervisory board. Managing directors are nominated and appointed by the shareholders' meeting in corporations that are incorporated under the rules of the common regime. The shareholders' meeting has the right to amend the articles of association, to allocate the profits of the corporation, to adopt the annual accounts and to alter the composition of the management board. If a supervisory board is formed, the shareholder's meeting has the right to appoint, to suspend and to dismiss the supervisory directors. The articles of association can further expand the rights of the shareholders' meeting to direct managing and supervisory directors. Under the rules of the common regime, it is not possible for directors to serve simultaneously on both the management board and the supervisory board.

It is the role of the supervisory board to supervise management and to monitor the general course of affairs of the corporation that operates under the rules of the common regime. Moreover, the supervisory board has a role in advising the management board. According to Blanco Fernández (1993) and de Savornin Lohman (1996), the control role and service role - as a form of preventive supervision of Dutch supervisory boards - are strongly related to each other. Unless the corporation's articles of association provide otherwise, other specific duties and powers of the supervisory board include chairing the general meeting of shareholders, the suspension of managing directors and the appointment of the accountant. The rights of the shareholders' meeting to appoint and to dismiss managing directors can be limited by so-called "oligarchic clauses" in the articles of association of corporations that operate under the rules of the common regime. A popular clause relates to the option of corporations to issue priority shares through a trust. The supervisory council of such a trust is often composed of directors who also have a seat in the supervisory board of the corporation. The trust, i.e. members of the supervisory council of the trust, can exercise the rights attached to priority shares, such as the right to approve the appointment of managing directors. A discussion on the mechanisms that limit the rights of ordinary investors can be found in the Peters Report (see also box 8.1).

The Structure Regime

The structure regime provides additional requirements on the governance structure of public corporations (NVs) and corporations with limited liability (BVs). The corporate governance structure of these so-called "structure corporations" ("Structuurvennootschappen") is regulated by the Structure Act of 1971.

According to Book 2 of the Civil Code, a structure corporation meets the following three cumulative legal criteria[36]:

- the corporation, including its subsidiaries, regularly employs one hundred or more employees in the Netherlands;
- the corporation has established a works council;
- the corporation has a subscribed capital plus reserves of at least NLG 25 million in the latest balance sheet.

Box 8.1
The General Meeting of Shareholders

> "In principle Dutch company law grants considerable powers to shareholders. At the same time, however, it offers possibilities, which are frequently applied, for these powers to be substantially curtailed in the company's articles of association, for example by stipulating that the co-operation of the priority shareholder(s) is required for the adoption of resolutions in the General Meeting of Shareholders. Other circumstances can also result in the investors not enjoying these powers to an extent proportionate to their investment, for example as a result of the presence at the meeting of a dominant block of votes, which has not provided risk capital or not to an extent proportionate to its voting rights [. . .] Special powers are often vested in priority shares with respect to the appointment and dismissal of members of the Board of Directors and Supervisory Board members [. . .] It also happens that decisions made by other bodies, including the General Meeting of Shareholders, on subjects other than the composition of the Board of Directors and the Supervisory Board, such as resolutions to alter the company's articles of association or resolutions on changes in the share capital, are subject to the approval of the holders of priority shares."

Source: Peters Committee (1997:19).

According to Slagter (1996), the enactment of the Structure Act in 1971 was directly related to a national debate in the 1960s on employee participation ("medezeggenschap") in the appointment of supervisory directors in large corporations. At that time, it was felt that there was a need to revise corporation laws that were originally established in 1928. According to Honée (1998), these corporation laws were originally based on a traditional stakeholder approach to the governance of corporations. The 1928 corporation laws viewed the corporation as a vehicle of shareholders to increase their financial wealth. Shareholders were seen as the most important constituents of the corporation. In

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[36] Subsidiaries of a holding company that fulfil the three criteria are exempted from the structural model if the holding company itself is governed under the structure regime (see also the paragraph on the exempted regime).

the Netherlands, this view gradually changed after the second world war. Not only shareholders, but employees as well was increasingly seen as an important interest group of the corporation. As a result, initiatives were undertaken to formally strengthen the role of employees in the appointment of supervisory directors. Of importance to this development was the formation of the Verdam Committee by the Dutch government in 1960. This committee was formed to bring together the views of the government, unions and representatives of corporations on employee participation in large corporations. Initiatives from labor unions were aiming at formal rights of employees to directly appoint supervisory directors in large corporations. Through these appointments, employees could indirectly also influence the appointment of managing directors. Although employers did recognize a need to change the position of labor, they were not in favor of a system that would grant formal rights to employees to directly appoint supervisory directors. The Verdam Committee published a report in 1964. This report suggested a revision of corporation laws in the Netherlands (Honée, 1973). In response to the report of the Verdam Committee, a report of the Social Economic Council ("SER") in 1969 (SER Advies inzake de herziening van het ondernemingsrecht) proposed by common consent the development of new corporation law on large NVs and BVs in the Netherlands. The recommendations of the SER finally resulted in the implementation of the Structure Act in 1971.

The post war discussion on employee participation also resulted in the enactment of the Works Council Act ("Wet op de Ondernemingsraden") in 1950. This act – which was originally amended in 1971 - dictates the formation of a works council for corporations with at least 35 employees regardless of the corporate form of the corporation. The underlying idea of the Works Council Act was - and still is[37] - to give employees a legal base to become more deeply involved in the decision making processes of the corporation. In general, the works council has the right to receive information on corporate decisions and to disapprove the adoption, amendment or withdrawal of certain employment conditions. In addition, the works council has the right to give advice with respect to the appointment and dismissal of managing directors in corporations that operate under the rules of the common regime. The works council also has the right to give advice with respect to the appointment and dismissal of supervisory directors in corporations that operate under the rules of the structure regime (see also paragraph 8.3). Of importance is also the obligation of members of the supervisory board to attend at least two meetings the management board has with the works council in structure corporations.

[37] Although it is beyond the scope of this chapter to discuss the Works Council Act in more detail, it should be recognized that after the amendment of the Works Council Act in 1971, this Act has been amended several times to expand the rights of employees so they can become more deeply involved in corporate decision making.

The Supervisory Board Under the Rules of the Structure Regime

The structure regime provides a mandatory two-tier board structure with a management board and a supervisory board. The management board is entirely composed of managing directors. The supervisory board is entirely composed of supervisory directors with a legal minimum of three directors. Unlike the co-determined German supervisory board, the Dutch supervisory board has no labor seats and employees of a structure corporation or its dependent corporations cannot be members of the supervisory board. Approximately, a total of 447 corporations were incorporated under the rules of the structure regime by September 1994 (Glasz et al. 1997). Of these corporations, 87 were listed at the Amsterdam Exchanges in 1996 (Peters Committee Report, 1997). Corporations that do not fulfill the three criteria can voluntarily apply the rules of the structure regime or the mitigated structure regime when the corporation has established a works council. These corporations are called "vrijwillige structuur-vennootschappen."

The supervisory board has been granted additional powers under the rules of the structure regime. As such, a substantial part of the formal rights of the shareholders' meeting shifts to the mandatory supervisory board in structure corporations[38]. The transfer of rights from the general meeting of shareholders to the supervisory board in the structure regime is fiercely debated in the Netherlands (Honée, 1996). This debate concentrates on the influence shareholders should have on the composition of supervisory and management boards in structure corporations and ultimately the strategic decision making processes of the corporation. Slagter (1994) indicates two main obstacles of shareholders in structure corporations to influence the strategic course of the corporation. (1) In the first place, shareholders have formally much less influence on the composition of both the managing and supervisory boards. Not the shareholders' meeting but the supervisory board nominates, appoints, suspends and dismisses managing directors and supervisory directors.

[38] Under the rules of the common regime, the general meeting of shareholders appoints new members of the management board. In structure corporations, the supervisory board appoints managing directors. Yet, it should be noted that the position of the Shareholders' Meeting can be also weakened by oligarchic clauses in corporations that operate under the rules of the common regime through the execution of "bindende voordrachtsrechten" and other mechanisms that may substantially curtail the power of shareholders in the company's articles of association (see also box 8.1).

Box 8.2
Matters Subject to the Approval of the Supervisory Board in Structure Corporations

- the issuance and acquisition of shares in the corporation and the issue by the corporation of debt instruments;
- co-operation in the issuance of registered depositary receipts for shares;
- an application for a listing or for withdrawal of the listing of the above-mentioned debt instruments or depositary receipts on the official list of any exchange;
- the entry into or the termination of any ongoing co-operation by the corporation or a subsidiary of the corporation with another legal entity or partnership, if such co-operation or the termination thereof is of far-reaching significance for the corporation;
- participation by the corporation or a subsidiary of the corporation in the capital of another corporation, where the value of such participation is at least one quarter of the amount of the issued capital plus reserves or any substantial increase or decrease in such participation;
- investment of an amount of at least one quarter of the issued capital and the reserves of the corporation as shown in the latest balance sheet with explanatory notes;
- a proposal to amend the articles of association and a proposal to dissolve the corporation;
- filling for bankruptcy or application for a suspension of payments;
- termination of the employment of a substantial number of employees of the corporation or of a subsidiary either simultaneously or within a short time frame;
- a drastic change in the employment conditions of a substantial number of employees of the corporation or of a subsidiary and finally a proposal to reduce the issued capital.

Source: Civil Code translated by de Savornin Lohman (1996:23).

As indicated above, Dutch corporation law also provides oligarchic clauses that restrict the formal rights of shareholders to appoint and to dismiss supervisory directors in corporations that operate under the rules of the common regime. (2) Second, the supervisory board in structure corporations has extensive powers to ratify certain management board resolutions. These extra powers are granted by statute and optionally and usually extended by the articles of association of the corporation. Another difference between the powers of the supervisory board under the rules of the common and the structure regime is related to the determination of the annual accounts of the corporation. In the common regime, the general meeting of shareholders has the right to determine and to adopt the annual accounts. Under the rules of the structure regime, the supervisory board has been granted the exclusive right to determine and to adopt the annual accounts of the corporation. The role of the general meeting of shareholders is limited to the approval or disapproval of the annual accounts of structure corporations. Box 8.2 summarizes the matters subject to the approval of the supervisory board in corporations that operate under the rules of the structure regime. Table 8.2 presents an overview of the formal transfer of rights from shareholders' meeting to the supervisory board in structure corporations.

The Supervisory Board Under the Rules of the Mitigated Structure Regime

The Dutch Civil Code also provides a mitigated structure regime ("gedeeltelijke vrijstellingen"). Although rather complicated, the mitigated regime is of great importance to foreign corporations and/or multinationals that seek full control over subsidiaries incorporated in the Netherlands. The mitigated form of the structure regime is applicable to corporations when at least fifty percent of a corporation's shares are held by a holding or a joint venture (a group of parent companies) and when the holding, parent company or joint venture employs a majority of its employees outside the Netherlands.

Table 8.2
Alternative Governance Models and the Transfer of Rights

Rights and other legal imperatives	The supervisory board under the rules of the structure regime.	The supervisory board under the rules of the common regime.
Supervisory board:	Mandatory.	Voluntary.
Supervisory directors:	Cannot be employees of the corporation.	Can be employees of the corporation, but cannot act simultaneously as managing director and supervisory director.
Right to propose supervisory directors:	General Meeting Works Council and management	General Meeting or holders of priority shares.
Right to appoint supervisory directors:	Supervisory Board (co-opted).	General Meeting or holders of priority shares.
Right to suspend supervisory directors:	Supervisory Board or governmental body in the case of a supervisory director representing the Dutch government.	General Meeting or holders of priority shares.
Right to dismiss supervisory directors:	Enterprise Chamber upon request from: supervisory board, General Meeting and Works Council. Governmental body in the case of a supervisory director representing the Dutch government.	General Meeting or holders of priority shares.
Approval of certain decisions:	Supervisory Board	General Meeting
Adoption of annual accounts:	Supervisory Board Submitted to General Meeting for approval or disapproval. Submitted to Works Council for discussion.	General Meeting

Table 8.2 continued
Alternative Governance Models and the Transfer of Rights

Rights and other legal imperatives	The management board under the rules of the structure regime.	The management board under the rules of the common regime.
Right to appoint managing directors:	Supervisory Board General Meeting must be notified and Works Council can give advice.	General Meeting or holders of priority shares.
Right to suspend managing directors:	Supervisory Board	General Meeting or holders of priority shares.
Right to dismiss managing directors:	Supervisory Board General Meeting must be consulted and Works Council can give advice.	General Meeting or holders of priority shares.

Sources: the following authors refer to relevant articles of the Civil Code: Honée (1979); Blanco Fernández (1993); Gelauff and den Broeder (1996); de Savornin Lohman (1996); Glasz et al. (1997); Maeijer (1997).

Compared to supervisory boards that operate under the rules of the structure regime, the supervisory board has less extensive powers under the rules of the mitigated structure regime. Under the rules of the mitigated structure regime, the supervisory board does not have the formal rights to:

- appoint and to dismiss members of the management board;
- adopt the annual accounts of the corporation.

These rights are put in the hands of the shareholders' meeting in mitigated structure corporations. However, an independent supervisory board is still mandatory under the rules of the mitigated form of the structure regime and the co-optation system is still in place. In addition, the supervisory board remains in the formal position to approve management decisions as identified in text box 8.2 in this chapter. The Civil Code provides these rules to secure an independent supervisory board that no only protects the rights of shareholders, but those of employees and other stakeholders as well.

There are two main reasons why the Dutch Civil Code provides the mitigated structure regime (Honée, 1979). (1) The Civil Code recognizes the need to support the position of parent companies in a group of corporations. Through the shareholders' general meeting, the parent company can formally exert its powers to influence the top decision making processes of subsidiaries. It not only gives the parent company the possibility to appoint managing directors to management boards of its subsidiaries. By means of the formal rights of the general meeting of shareholders, the parent company has also the right to dismiss managing directors whose visions do not coincide with those of the parent company. The appointment and/or dismissal of managing directors would be more complicated if the parent company were to have subsidiaries that operate under the rules of the full structure regime. In such a case, the position of a parent company in a group of corporations could be weakened by an independent co-opted supervisory board that holds the exclusive rights to appoint and to dismiss managing directors and that holds the right to adopt the annual accounts of the subsidiary. As such, through the rules of the mitigated structure regime, the Dutch Civil Code provides legislation that supports the position of a parent company as majority shareholder in a group of corporations. (2) The internationalization of the Dutch economy has also stimulated the growing importance of the mitigated structure regime. The rules of the Civil Code are designed to stimulate foreign investments in the Netherlands and to provide large groups some flexibility in the design of their governance structures.

The Supervisory Board Under the Rules of the Exempted Regime

The Dutch Civil Code also provides rules that exempt corporations from the structure and the mitigated structure regimes (the exempted regime or "volledige vrijstellingen"). Of importance to groups is the rule that corporations are exempted from the structure and mitigated structure regimes when corporations are dependent of a holding, parent company or group that is already subject to the structure regime or the mitigated structure regime. Although these dependent corporations may meet the three cumulative criteria of structure corporations, the formation of a supervisory board in these dependent corporations is not mandatory. If a supervisory board is formed, the general meeting of shareholders appoints and dismisses supervisory directors. The general meeting of shareholders has also the formal right to appoint and dismiss managing directors and to approve certain decisions (see text box 8.1 in this chapter). Corporations can be also exempted from the rules of the mitigated and structure regimes when:

- the corporation is a mere holding company belonging to an international group of corporations, provided that the majority of the employees of the entire group are employed outside the Netherlands, and/or;
- the corporation acts exclusively as a service corporation for affiliated corporations.

Source: Civil Code, translated by de Savornin Lohman (1996:24). See also Honée (1979).

Due to its flexibility, the Dutch Civil Code provides corporations that operate under the rules of the mitigated and exempted regimes the possibility to practically adhere to board practices that are common to large corporations in the US and the UK. The Dutch supervisory board has less extensive powers under the rules of these regimes while the formal rights to appoint and to nominate managing directors are granted to the general meeting of shareholders.

Table 8.3
The Four Regimes Summarized

The Common Regime	The Structure Regime
Applicable to all NVs and BVs that do not operate under the rules of the other three regimes.	The corporation, including its subsidiaries, regularly employs one hundred or more employees in the Netherlands, the corporation has established a works council and the corporation has a subscribed capital plus reserves of at least NLG 25 million in the latest balance sheet.
General Meeting of Shareholders (mandatory)	General Meeting of Shareholders (mandatory)
Holds all formal rights such as the appointment and the dismissal of managing directors and supervisory directors if not transferred to a trust or the supervisory board.	Certain rights of the general meeting are transferred to the supervisory board.
Supervisory Board (not mandatory)	Supervisory Board (mandatory)
Holders of priority shares can be granted rights to appoint managing directors.	The co-optation system is in place, the supervisory board adopts the annual accounts, appoints and dismisses managing directors and approves certain management decisions.

Table 8.3
The Four Regimes Summarized (continued)

The Mitigated Structure Regime	The Exempted Regime
At least fifty percent of a corporation's shares are held by a holding or a joint venture (a group of parent companies) and the holding, parent company or joint venture employs a majority of its employees outside the Netherlands.	The corporation is a mere holding company belonging to an international group of corporations, provided that the majority of the employees of the entire group are employed outside the Netherlands, and/or the corporation acts exclusively as a service corporation for affiliated corporations, and/or is a dependent of a corporation that is already subject to the structure regime or the mitigated regime in the Netherlands.
General Meeting of Shareholders (mandatory)	General Meeting of Shareholders (mandatory)
Appoints and dismisses members of the management board and adopts the annual accounts of the corporation.	See Common Regime.
Supervisory Board (mandatory)	Supervisory Board (not mandatory)
the co-optation system is in place and the supervisory board approves certain management decisions.	See Common Regime.

Source: Civil Code, translated by de Savornin Lohman (1996:24). See also Honée (1979).

In general, this is a normal practice of corporations in Anglo-Saxon countries. Especially the exempted regime may not hinder large Dutch multinational corporations to adapt to internationally accepted corporate governance standards due to the absence of the co-optation system (see also paragraph 8.3).

8.3 About Board Composition

The general meeting of shareholders of a corporation that operates under the rules of the structure regime and the mitigated structure regime has no formal powers to appoint supervisory board members. In the case of a vacancy, the supervisory board appoints directors through a system of formal "co-optation."[39] This means that supervisory directors are nominated and elected by the supervisory board. Candidates are neither appointed by managing directors nor elected by shareholders.

Yet, the supervisory board must inform the shareholders' meeting and the works council about pending supervisory board vacancies and nominations. Before the supervisory board appoints a new supervisory board member, the works council, the management board and the shareholders' meeting have the right to propose other board candidates for nomination ("aanbevelingsrecht"). The shareholders' meeting and works council also have equal rights to object to the appointment of candidates. This right is not granted to the management board. The right of the works council and the shareholders' meeting to raise objections to the appointment of a supervisory director is based on three grounds:

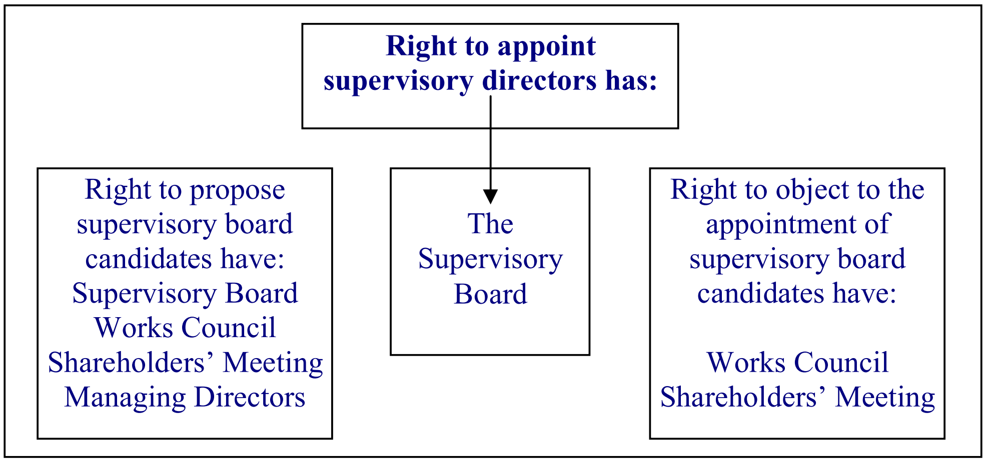
- the nomination and appointment procedures are not diligently adhered to by parties involved;
- proposed board candidates are found to be unqualified by parties involved to fulfil a position in the supervisory board and/or;
- parties involved object to the appointment of candidates because appointment of the new candidate would not result in a sound composition of the supervisory board.

Source: Civil Code, translated by Slagter (1994:332).

When an objection is made, the supervisory board needs to obtain a ruling from the Enterprise Chamber of the Court of Appeal in Amsterdam in order to have a candidate appointed. The shareholders' meeting and works council have no further rights to nominate and dismiss managing directors in structure corporations (see also figure 8.2). As indicated above, the shareholders' meeting has the right to appoint and to dismiss members of the management board and has the right to adopt the annual accounts in corporations that operate under the rules of the mitigated structure corporations.

[39] Supervisory directors in large corporations under government control or of which the Dutch government owns a large amount of equity are sometimes appointed and dismissed by the government.

Figure 8.2
The Appointment of Supervisory Directors in Structure Corporations



Source: Maassen and van den Bosch (1999a).

Board Composition and the Co-optation of Supervisory Directors

The appointment of non-executive supervisory directors by co-optation can shield the Dutch supervisory board from influences outside the corporation. Gelauff and den Broeder (1996:59) indicate: "The fact that members of the supervisory board are appointed by co-optation and are not selected by the general meeting of shareholders limits the powers of shareholders through the general meeting." As such, it is suggested that the co-optation of supervisory directors in corporations that operate under the rules of the structure regime facilitates the independent position of the supervisory board. Investors that seek control over corporations through direct changes in the composition of boards of directors in structure corporations have virtually no formal powers to alter the composition of the supervisory board and the management board.

Seen from this point of view, in addition to other anti-takeover devices, co-optation can be seen as a means to protect the corporation from hostile takeovers and undesired shareholder activism[40]. Although it was a highly unusual proxy fight in the Netherlands, the hostile take-over bid from Thorn Hagen in 1992 for Nedlloyd (see box 8.3) clearly demonstrated the power of the co-optation system to protect structure corporations from unwanted take-overs (Slagter, 1994).

[40] The co-optation system does not hinder the transfer of shares nor does it hinder a public bidding on shares (van der Hoeven, 1995).

Box 8.3
The Proxy Fight at Nedlloyd

"Much commotion has been caused last fall (1993, eds.) by an attempt of Mr. Hagen, through his investment company Marine Investments, for 17.2 . . . percent shareholder and with the help of 22 percent of supporting shareholders of NV Nedlloyd, the largest Dutch shipping company, to gain a seat on the supervisory board. At first, the management and supervisory board were not in favour of this appointment, arguing that the interests of such a large shareholder could conflict with those of the company. After refusal of the shareholders' meeting to approve the annual accounts over 1990 to express its dissatisfaction with the failure of the management and supervisory board to propose Mr. Hagen for an existing vacancy on the supervisory board, and after establishment of a committee proposing Mr. Hagen to the supervisory board, the management and supervisory board relinquished their opposition, but only after they made Mr. Hagen make a statement of "good conduct" . . . After this obstacle had been removed following numerous meetings, Mr. Hagen found a second obstacle on his way to the supervisory board: the central works council exercised its right of objection at this structure company, compelling the supervisory board . . . of NV Nedlloyd to bring this case before the Chamber of Enterprises of the Court of Appeal. This affair has caused observers in other countries to suppose that it is hardly possible to gain participation in decision making by investing in a Dutch structure company, and that the Dutch structure regime is, from a perspective of European law, objectionable. From a Dutch perspective, this is regrettable, since the structure regime, instituted at the time as an ingenious compromise between employers and employees and therefore received with scepsis by both sides, after 20 years of experience is generally appreciated as a workable institution to reconcile wishes with regard to efficient management and co-determination."

Source: Slagter (1994:343).

The position of shareholders is not only weakened by the statutory power of the supervisory board to appoint its members under the rules of the structure regime. The general meeting of shareholders also has to consider the equal rights of the works council to raise objections to a candidate proposed by the shareholders (Slagter, 1994). In this way, the Dutch system seeks to balance the interests of not only shareholders but those of employees and other stakeholders as well. This is regulated by the general rule that supervisory directors must act in accordance with the best interests of the corporation (de Savornin Lohman, 1996).

The Discussion on the Co-optation System

The discussion on the position of shareholders and employees in the nomination and the appointment of managing directors and supervisory directors goes back to the early proposals of the Stichting van de Arbeid in 1948, the Committee Verdam in 1960 and the Social Economic Council in 1984. More recently, Ophof (1994) introduced an alternative procedure to increase the rights of shareholders to appoint and dismiss supervisory directors in structure corporations. In this proposal, the shareholders' meeting should have the right to appoint and to dismiss supervisory directors. The supervisory board and the works council would have equal rights to propose new supervisory board members. Boot (1994, 1995) also advocated an alternative procedure for the nomination of supervisory directors in structure corporations. Through a nomination committee composed of representatives of employees, shareholders and independent experts, candidates should be appointed to the supervisory board. The Peters Committee also proposed the formation of selection and nomination board committees to prepare the selection criteria and nomination procedures for supervisory board members (Peters, 1997). At this moment, Groen Links - a left-wing political party in the Netherlands - and labor unions are flexing their muscles to increase workers' participation in the appointment of supervisory directors.

The VEB ("Vereniging van Effectenbezitters") - an active shareholder association in the Netherlands - strongly opposes the shareholders' limited rights related to the appointment of managing directors in structure corporations. In a recent response to the Report of the Committee Peters, the VEB seeks support for more shareholder power to dismiss managing directors (VEB, 1997). In the case of dismissal, the VEB advocates that at least two-thirds of the shareholders with a total minimum of fifty percent of the shares must support the dismissal of the managing director before such a proposal could become effective. Notwithstanding the attention given to these proposals in the business press, initiatives to increase shareholders' rights have not resulted to changes in the way supervisory directors are formally nominated, appointed and dismissed in structure corporations. Changes in legislation related to the co-optation system are also not expected in the near future. This is particularly articulated by the recent recommendations of the Peters Committee. Although the Peters Committee sought to increase the power of shareholders, it did not seek the alteration of the statutory powers of the supervisory board to appoint itself under the rules of the structure regime (see also box 8.4).

Box 8.4
The Peters Committee's Statement on Co-optation

> "The basic principle is that the board of directors and the supervisory board have the confidence of the shareholders' meeting. The Committee therefore recommends that this (should, eds.) be borne in mind when appointing board members. Boards of directors and supervisory boards cannot perform satisfactorily in the long run without that confidence. If corporations comply with and implement these and other related recommendations by the Committee, then the co-optation system laid down in the 'structure company' regime should be able to continue functioning satisfactorily."

Source: Peters Committee (1997:20).

Co-optation of Supervisory Directors and Foreign Investments in the Netherlands

According to Horringa (1994), the co-optation system may have a negative impact on the expansion of large Dutch structure corporations that seek co-operation through international strategic alliances. Due to its specific procedures, the appointment of supervisory directors by co-optation is not widely accepted and not well understood internationally. As a result, foreign partners may be reluctant to engage in strategic alliances when they discern that the appointment of directors lies in the hands of the supervisory board in the Netherlands. Although Horringa (1994) recognizes that this should not always be a problem, the prospect of complicated and time consuming nomination procedures may hinder foreign investors and corporations to form strategic alliances. Moreover, Horringa (1994) suggests that the globalization of corporations may be hindered by group thinking and old boys networking associated with the appointment of supervisory directors through the co-optation system.

Supervisory directors may have a preference to appoint candidates with similar backgrounds and the board may suffer the hazards of all small groups, including the tendency of certain individuals to dominate discussions, to avoid conflicts or to seek orderly resolution of issues (Demb and Neubauer, 1992b). So when globalization is a strategic issue for the management board, a conservative, risk-averse supervisory board may hinder the engagement in international strategic alliances (Maassen and van Montfort, 1994). Although the co-optation system may hinder the internalization of Dutch corporations, recent research shows an increasing emphasis on foreign director representation and international work experience in Dutch supervisory boards. Studies indicate that chairmen of supervisory boards increasingly emphasize the international management experience of common supervisory directors (Maassen, 1997; 1998a). The latest figures also indicate that more foreign non-executive directors are appointed to Dutch supervisory boards (Maassen, 1999a).

Board Composition and Interlocking Directorates (Board Memberships)

Although managing directors are not allowed to serve in the supervisory board of the corporation, corporation laws do not restrict the number of managing directors' interlocking directorates. Also interlocking directorates of supervisory directors are not limited by corporation law in the Netherlands. It is often suggested that it is a common practice of top executives and supervisory directors to serve in other supervisory boards of listed corporations. In November 1993, the NCD – the Dutch Center for Boards of Directors – published voluntary guidelines that recommend directors to restrict the number directorships to a maximum of ten directorships in structure corporations. Directorships in corporations that operate under the rules of the common regime are not part of the NCD-guidelines. Supervisory directors are also recommended by the Peters Committee to limit the number of their supervisory board memberships. The Peters Committee does not advocate a maximum number of directorships. It states: "The number of supervisory board memberships which a person can hold with a (listed) company should be limited in such a way as to guarantee the satisfactory performance of duties. Companies should allow employees in active service to hold memberships on supervisory boards of other companies" (Peters Committee, 1997:35).

Maassen (1998a) asked thirty chairmen of supervisory boards about the maximum number of boards memberships directors are allowed to have in supervisory boards of listed corporations. The chairmen indicated that the maximum should be on average between five and six supervisory board memberships. The chairmen indicated the following circumstances which would determine the maximum number of board memberships:

- the position of directors: directors who chair supervisory boards have a much higher workload than common board members;
- the workload of supervisory directors;
- the size of the corporation and the complexity of its operations;
- the possibility of conflicts of interest;
- the support from staff personnel;
- the location of head offices and the number of supervisory board meetings;
- the overall quality of the supervisory board;
- the age of supervisory directors;
- the time available.

Source: Maassen (1998a).

On average, the latest figures on interlocking directorates indicate that supervisory chairmen often serve on two supervisory boards in a sample of one hundred corporations listed at the Amsterdam Exchanges in 1998 (Maassen 1999a). The study indicates that a majority of the supervisory positions (54,7%) is held by directors who hold only one non-executive directorship. A total of nineteen supervisory directors have four or more directorships in supervisory boards of corporations in the corporations surveyed in 1998 (some 16,4% [97] of the total number of non-executive directorships [592]). Not included in the study are supervisory board positions in smaller (non-) listed corporations and not-for-profit institutions.

Board Composition and the Appointment of Formerly Affiliated Managing Directors

Dutch corporation laws do not prohibit the appointment of formerly affiliated managing directors to supervisory boards. Maassen (1998a) asked thirty supervisory board chairmen about the appointment of formerly affiliated managing directors. In general, chairmen indicate that through these appointments, the supervisory board can obtain more detailed information about the company and may benefit from the experience of former management. Chairmen also value the appointment of former management as a means to support the company culture and the continuity of long term strategic decisions. In summary, supervisory boards appoint formerly affiliated managing directors to their boards, in order to:

- maintain company culture and family traditions;
- bring in knowledge about the corporation;
- secure the continuation of strategies and policies;
- and if the nominee fits in the group considering his/her personality and background.

Source: Maassen (1998a).

The chairmen also indicate that the appointment of formerly affiliated managing directors may impede the independent position of the supervisory board. The "danger" of becoming actively involved in operational matters of the corporation may conflict with the distance supervisory directors should have from day-to-day operations. The chairmen suggest that appointments should only be made after careful consideration of the personality and experience of the nominee. The chairmen sometimes justify the appointment of formerly affiliated managing directors especially when highly specialized skills are unavailable outside the corporation.

8.4 About Board Leadership Structures

The Civil Code does not provide the possibility to combine executive and non-executive positions at supervisory board level. Active management and employees of a structure corporation, or its dependent corporations, cannot act as supervisory directors. It is therefore not possible to find the combination of CEO and chairman roles in Dutch two-tier boards. Yet, the appointment of formerly affiliated managing directors to the chairman seat of the supervisory board remains an important issue in the contemporary corporate governance debate in the Netherlands. The Peters Committee recommends that formerly affiliated managing directors should not be appointed to the chair of the supervisory board.

The Committee states: "A point of consideration here should be the influence that a person's former membership of the Board of Directors (the management boards, eds.) may have on that individual's functioning on the supervisory board as well as on the functioning of the supervisory board and of the Board of Directors. This especially applies in cases where a former chairman of the board of directors is the intended chairman of the supervisory board" (Peters, 1997:11).

Maassen (1998a) asked thirty supervisory board chairmen about their opinion on the appointment of formerly affiliated managing directors to the chairman position of supervisory boards (see also table 8.4). With a vast majority of 88 percent, chairmen strongly disapprove of the appointment of formerly affiliated managing directors to the chairman seat of the supervisory board.

The study revealed that chairmen prefer independent supervisory board leadership:

- to avoid the "danger" of active participation of formerly affiliated managing directors in operational matters of the company;
- to secure the independence of the supervisory board;
- because there is no need to appoint a formerly affiliated managing director to the position of supervisory chairman: expertise and knowledge of formerly affiliated managing directors become obsolete quickly;
- to enable changes in the corporation's structures, product lines, strategies and policies.

Source: Maassen (1998a).

Table 8.4
The Appointment of Formerly Affiliated Managing Directors to the Supervisory Board

	Chair	Common Member
Favor appointment of formerly affiliated managing directors as:	0%	27%
Neutral position:	12%	40%
Disapprove appointment of formerly affiliated managing directors as:	88%	33%

Source: Maassen (1998a).

8.5 About Board Committees

Although not required by Dutch company laws or the listing rules of the Amsterdam Exchanges, board committees are receiving more attention in the Netherlands. The Peters Committee recommends the formation of board committees such as the nomination committee, the remuneration committee and the audit committee. The Peters Committee (1997:15) states: “The supervisory board considers whether to appoint from its midst a selection and nomination committee, an audit committee and a remuneration committee. These committees submit reports on their findings and make recommendations to the full supervisory board. The supervisory board should report on the existence of such committees in the annual report.”

According to the Peters Committee, the selection and nomination committee could be used to:

- prepare the selection criteria and nomination procedures for supervisory board members, managing directors and higher management posts;
- periodically assess the size and the composition of the supervisory board and the management board;
- periodically assess individual supervisory board members and managing directors;
- prepare proposals for (re)appointments.

The Peters Committee identifies the following functions of the remuneration committee to:

- periodically assess the remuneration system;
- periodically assess the granting of options, pension rights, redundancy compensation schemes and other benefits;
- periodically assess the company’s liability insurance.

The Peters Committee also paid attention to the audit committee. In a special paragraph, the Committee specified the specific duties of the audit committee to:

- supervise the quality of all external financial reports;
- supervise compliance with internal procedures and laws and regulations and the control of company risks;
- facilitate the communication with the auditors;
- assess the activities and functioning of auditors.

Source: Peters Committee (1997:15).

According to the chairmen in the Maassen (1998a) study, the most important function of the audit committee is to monitor the financial reporting activities of the corporation. A second important purpose is the exchange of information between the management board and the supervisory board (see also table 8.5).

Table 8.5
The Function of Audit Committees

<table>
<tr><td>Purpose</td><td>Not important Very Important</td></tr>
<tr><td>Governance function</td><td>----------|----------|----------|----------|---x------</td></tr>
<tr><td>Exchange information</td><td>----------|----------|----------|----------|--x-------</td></tr>
<tr><td>Consult accountant</td><td>----------|----------|----------|----------|-x--------</td></tr>
<tr><td>Consult executive chairman</td><td>----------|----------|----------|--------x-|----------</td></tr>
<tr><td>Discussions within the board</td><td>----------|----------|----------|-----x----|----------</td></tr>
<tr><td>Consult managing directors</td><td>----------|----------|----------|----x-----|----------</td></tr>
</table>

Sources: Maassen (1998a, 1998b).

The study also indicated that supervisory directors met on average twice a year with the certified public accountant (see also Maassen, 1998b). The Peters Committee recommends the audit committee - when formed - to have a meeting with the external auditor at least once a year.

8.6 Facts About Changing Two-Tier Board Attributes

Compared to information available on corporate boards in the US and the UK, the number of publications and databases available on Dutch two-tier boards is rather limited (Glasz et al., 1997). Despite the extra attention recently given to board disclosure, annual reports still present a limited view of board practices in the Netherlands. Typically disclosed information on Dutch supervisory boards is often limited to:

- the composition of supervisory and management boards;
- the age of supervisory directors;
- the professional background of directors when they are nominated to be appointed to the supervisory board;
- the total number of formal supervisory board meetings;
- the total of supervisory board compensation including additional fees.

Changing Disclosure Culture in the Netherlands

The recommendations of the Peters Committee are changing the reporting culture in the Netherlands. More detailed information on the governance structures of corporations is becoming available to the public. With respect to the supervisory board, the Peters Committee's aims to bring more openness on the following topics:

- the duties, profile, appointment and remuneration of supervisory directors;
- the composition of the supervisory boards and demographic data on supervisory directors;
- the procedures of supervisory boards;
- the committees of the supervisory board and the number of board meetings;
- the compliance of corporations with the recommendations of the Peters Committee.

Although corporations are not required by the Amsterdam Exchanges to comply with the forty recommendations of the Peters Committee, many have already indicated their level of compliance in annual reports published in 1998. Maassen (1998a, 1999a) indicates that many supervisory boards have already set corporate governance principles identical to the recommendations of the Peters Committee.

These include the recommendations to:

- appoint not more than one formerly affiliated managing director to the corporation's supervisory board;
- draw up a profile of the supervisory board;
- form board committees such as the audit, the remuneration and the nomination committee;
- meet without the presence of managing directors.

This paragraph further explores developments in the governance structure of one hundred corporations listed at the Amsterdam Exchanges. The figures in this chapter are culled from annual reports and additional compliance reports of 25 AEX-corporations, 25-AMX corporations and fifty randomly selected smaller corporations. The sample represents 74 percent of corporations listed in the Netherlands in 1998.

Fact 1 -> Board Composition: Supervisory Board Size is Stable

Maassen (1999a) indicates that the size of Dutch supervisory and management boards has been fairly stable between 1987 and 1998. The average supervisory board consisted of six supervisory directors. The average size of management boards has also hardly changed during the last twelve years. The management board is on average composed of 3.3 managing directors in 1998 (3.4 in 1987).

Fact 2 -> Board Composition: The Appointment of Formerly Affiliated Managing Directors to the Supervisory Board

As indicated above, corporation laws do not prohibit the appointment of formerly affiliated managing directors to supervisory boards. The Peters Committee recommends that no more than one formerly affiliated member of the corporation's management board should be appointed to the corporation's supervisory board. Maassen (1999a) calculated the number of formerly affiliated managing directors who have a seat in supervisory boards 1998 based on a sample of one hundred AEX-corporations[41]. Based on an analysis of annual reports published between 1987 and 1998, the Maassen (1999a) study indicates that a majority of seventy percent of one hundred listed corporations had no formerly affiliated managing directors in their boards in 1998. Only 37 positions out of a total of 592 supervisory board positions were held by formerly affiliated managing directors in 1998 (about six percent). When formerly affiliated directors are appointed, corporations also generally adhere to the recommendations of the Peters Committee to appoint a maximum of one formerly affiliated managing director to their supervisory boards.

Fact 3 -> Board Leadership: The Appointment of Formerly Affiliated Managing Directors to the Chair Position of the Supervisory board

Based on the same method to measure the composition of supervisory boards, Maassen (1999a) calculated the number of supervisory boards that were chaired by a formerly affiliated managing director in 1998. The latest figures indicate that only four supervisory boards out of a total of one hundred listed corporations were chaired by a formerly affiliated managing director in 1998 (Maassen, 1999a). These appointments took place between 1987 and 1998. These findings indicate that a strong majority of the one hundred corporations investigated (96 percent) adhere to the recommendations of the Peters Committee to avoid the appointment of a formerly affiliated managing director to the chairman seat of supervisory boards. The findings also indicate that these appointment rarely take place in the top one hundred of Dutch listed corporations.

Fact 4 -> Board Composition: Executive and Supervisory Directors Meet Together

The Peters Committee recommends that a supervisory board meets at least once a year without managing directors to discuss its own performance, its relationship

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[41] The initial sample includes one hundred corporations listed at the AEX. Due to mergers, takeovers and other major strategic changes, the study could not always calculate changes in corporations' supervisory board composition between 1987 and 1997. In addition, some corporations were only recently listed on the AEX. In these cases, changes were calculated after the major event or listing took place. For example, ABN and AMRO merged into ABN AMRO in 1990. In this case, changes in board composition have been calculated in the period between 1990 and 1998.

with the management board, the performance of the management board and to discuss matters related to the succession and remuneration of managing directors. Maassen (1998a) indicates that it is common for supervisory directors to meet regularly with managing directors. The study indicates that approximately fifty percent of the chairmen interviewed indicate that their supervisory board always met with the managing directors and about 26 percent of supervisory boards scheduled only one meeting a year without executive board members in 1996. The study indicates that supervisory boards formally met six times on an annual base. This means that a large majority of formal supervisory board meetings have been held together with the managing directors in 1996. The latest figures indicate a similar development for supervisory boards in 1997. On average, directors met six times formally in 1997. The corporations' compliance reports with respect to the recommendations of the Peters Committee indicate that 49 supervisory boards out of a total of one hundred corporations met at least once without the presence of managing directors in 1997. As such, a large majority of formal meetings were held together with managing directors in 1997 (Maassen, 1999a).

Fact 5 -> Board Committees: Supervisory Directors Work in More Board Committees

Board committees are usually not disclosed in annual reports or other reporting titles in the Netherlands. This makes it rather difficult to reveal historical developments in the use of committees in the Netherlands. The recommendation of the Peters Committee to disclose the existence of board committees in annual reports has recently resulted in more openness on committee structures in supervisory boards. Developments in the number of board committees could be determined for 1996 and 1997[42]. Although they are not required by Dutch company laws or stock exchanges, board committees are increasingly receiving more attention in the Netherlands. The Peters Committee recommends the formation of board committees such as the nomination, the remuneration and the audit committee. At least 45 supervisory boards out of a total of one hundred corporations had one or more board committees in 1997 compared to 38 in 1996. Like last year, the remuneration committee was the most popular supervisory board committee. A total of at least 42 supervisory boards had established such a committee, compared to thirteen supervisory boards in 1996. The number of audit committees increased as well from 26 in 1996 to at least 32 in 1997. A similar development can be observed in the formation of nomination committees (from fourteen in 1996 to 23 in 1997). These figures are supported by Vergoosen en Muys-de Graaf (1997) who found an increasing number of board committees in supervisory boards of listed AEX-corporations.

[42] Due to mergers, changes in listings etc, the number of corporations included in the 1997 data set totals to 99 corporations compared to one hundred in 1996. See also Maassen (1999a).

The study indicates that 12,4 percent (or seventeen corporations) used audit committees in 1995 compared to 16,8 percent (23 corporations) in 1996[43]. Other committees include the strategic committee and several specific ad hoc committees.

Fact 6 -> Board Committees: Supervisory Boards Often Too Small For Committees

In a recent study, Maassen (1998a) asked chairmen to indicate why some of their supervisory boards do not use board committees. The main reason given is the size of the supervisory board. A total of 47 percent of the chairmen indicate that their supervisory boards are too small for board committees. Other reasons why chairmen have decided not to use board committees are:

- there is no immediate reason to establish committees; 25%
- board committees may sometimes result to more bureaucracy; 3%
- decision making takes place collectively within the board. 25%

Source: Maassen (1998a).

Corporations also frequently indicate in their compliance reports with respect to the recommendations of the Peters Committee that the size of the supervisory board does not justify the formation of board committees. Table 8.5 finds support for the general rule that the larger the size of the board, the more common it is for directors to operate in board committees in the Netherlands. In 1997, the average board with an audit committee and/or remuneration committee was comprised of more than seven supervisory directors. Boards without these committees are on average comprised of five supervisory directors. In the same year, the average supervisory board with a nomination committee was comprised of eight supervisory directors. Directors that do not work with nomination board committees also often operate in boards with an average size of a little more than five supervisory directors.

[43] Vergoosen en Muys-de Graaf (1997) indicate that 23 supervisory boards (out of a total of 137 corporations listed at the AEX) had formed an audit-committee in 1996. Maassen (1998b) indicates that at least 26 supervisory boards in a total of one hundred AEX-corporations had an audit committee in 1996. This suggests that prior to the recommendations of the Peters Committee, corporations have not always reported the existence of audit committees in annual reports. This should be borne in mind when the impact of the Peters Committee on corporate governance structures in the Netherlands is being assessed.

Table 8.6
Board Committees in Dutch Supervisory Boards

Supervisory Board Size and Audit Committees

	Average Supervisory Board Size	Average Supervisory Board Size Without an Audit Committee	Average Supervisory Board Size With an Audit Committee
1996 n = 100	5,8	5,2	7,5
1997 n = 99	5,9	5,1	7,4

Supervisory Board Size and Remuneration Committees

	Average Supervisory Board Size	Average Supervisory Board Size Without a Remuneration Committee	Average Supervisory Board Size With a Remuneration Committee
1996 n = 100	5,8	5,1	7,5
1997 n = 99	5,9	4,8	7,3

Supervisory Board Size and Nomination Committees

	Average Supervisory Board Size	Average Supervisory Board Size Without a Nomination Committee	Average Supervisory Board Size With a Nomination Committee
1996 n = 100	5,8	5,3	8,5
1997 n = 99	5,9	5,2	8

Source: Maassen (1999a).

Fact 7 -> Board Committees: Dutch Supervisory Board Committees Also Seat Managing Directors

As indicated by chapter six, audit committees are mandatory for corporations listed at the major stock exchanges in the US (NYSE, NASDAQ and AMEX). Also developments in the UK increasingly put pressure on corporations to establish independent audit committees. To support the independence of the board, audit committees are predominately composed of non-executive directors in these countries. The voluntary introduction of committees to Dutch supervisory boards resembles the common practice of directors in one-tier boards to operate in committees. Yet, the function of Dutch board committees seems to differ from those in one-tier boards.

According to Maassen and van den Bosch (1999a): " . . . the function of Dutch board committees seems to differ from the oversight function of committees in one-tier boards. The survey results indicate that nearly all committees are composed of both managing directors and supervisory directors. So, while one-tier board committee structures serve purposes which are, to some degree, similar to the legal separation of the management and supervisory boards in two-tier boards . . . Dutch board committees may serve as integrative devices by means of a mixed composition." Maassen (1998a) asked supervisory chairmen more about the composition of their audit committees. According to thirty chairmen surveyed, it is a common practice of supervisory directors to meet together with managing directors in audit committees. On average, one managing director is also a member of the audit and the nomination committee. By general rule, the remuneration committee has no managing directors in the committee (see also table 8.7).

Table 8.7
The Composition of Board Committees

Committees	Number of committee meetings	Number of supervisory members	Number of executive members	Number of executives attending meetings
	(averages)	(averages)	(averages)	(averages)
Remuneration	2	2	0	2
Audit	3	3	1	3
Nomination	3	3	1	2

Source: Maassen (1998a).

The study also indicates that nearly all of the observed board committees have managing directors attending board committee meetings. In addition, the study indicates that these committees met on average between two and three times in 1996.

8.7 Summary

The Dutch corporate board model is generally based on a two-tier board principle. Directors operate in a hierarchical board organization with a supervisory board ("Raad van Commissarissen") and a separate management board ("Raad van Bestuur"). The Dutch supervisory board is entirely comprised of supervisory directors. The management board is composed of managing directors. Supervisory directors within so-called "structure corporations" are nominated and appointed by the supervisory board through a system of controlled co-optation. Shareholders at the annual meeting and employees in the works council have the right to propose supervisory directors in structure corporations. The Civil Code provides also for regimes that grant flexibility to foreign investors with respect to the governance structure of corporations incorporated in the Netherlands that belong to an international group of corporations. In these corporations, the annual meeting nominates and appoints managing directors. Yet, the co-optation system is still in place in these so-called mitigated structure corporations. With the publication of the final forty recommendations of the Peters Committee, corporate governance has also been put on the agenda of institutional investors, legislators and directors in the Netherlands. Although it is too early to determine the impact of the recommendations on board practices of corporations listed at the Amsterdam Exchanges, research in this chapter suggests that developments take place in the structure and the composition of supervisory boards in the Netherlands. Although managing directors and supervisory directors normally meet together, more emphasis is placed on separate supervisory board meetings. When justified for the size of the supervisory board, board committees have become more common. More emphasis is also put on independent supervisory board leadership and supervisory board composition. These developments suggest that supervisory directors are increasingly responding to pressures from commentators to adapt to new corporate governance standards in the Netherlands.

Box 8.5
Current Trends in Corporate Governance in the Netherlands

Existing corporate governance framework:

- the Civil Code provides four legal regimes. The formation of a supervisory board is not mandatory for smaller and medium sized corporations that operate under the rules of the common regime. A two-tier board structure is mandatory for large corporations that operate under the rules of the structure and mitigated structure regimes. The regimes grant different powers to shareholders and supervisory directors;
- supervisory boards are composed of non-executive supervisory directors. Management boards are entirely comprised of executive managing directors;
- supervisory boards are not co-determinated;
- legislative changes are not likely to occur in the near future.

Boards in listed corporations are undergoing changes:

- independent board leadership and board composition is receiving more attention. More attention is being paid to formerly affiliated managing directors in supervisory boards;
- total supervisory board size has been stable en when taking into account the size of the supervisory board, more work is being done in supervisory board committees;
- managing directors occupy positions in supervisory board committees and regularly formally meet together with supervisory directors.

Current issues:

- ongoing debate on self-regulation with the recommendations of the Peters Committee;
- more openness on the governance structure of listed corporations;
- whether the structure regime should be altered to give shareholders and employees a bigger voice in the nomination and appointment of managing and supervisory directors;
- the development of a universal code of best practice;
- the introduction of a proxy solicitation system.

Sources: Maassen and van den Bosch (1997, 1999a); Maassen (1998b, 1999a).

Chapter 9: Comparing Changing Board Attributes

9.1 Introduction

Part II of this research indicates that corporations are responding to external pressures with changes in the attributes of their boards of directors. The analyses in chapters six and seven of this study suggest support for the proposition (P.1) that one-tier boards are becoming more independently composed and organized in the US and the UK. In the Netherlands, changes are also observable in the organization and the composition of two-tier boards. Chapter eight found that Dutch supervisory directors increasingly work with board committees. Similar to the organization of board meetings in one-tier boards, executive managing directors and non-executive supervisory directors also often meet together in two-tier boards. In addition, formerly affiliated managing directors are sometimes appointed to supervisory boards which resembles a common practice of boards in the US and the UK to have formerly affiliated managers appointed to non-executive positions. These findings suggest support for the proposition (P.2) that supervisory directors incorporate one-tier board attributes in the organization of their boards. The third proposition in this study builds on the propositions P.1 and P.2. This proposition (P.3) suggests that differences between the attributes of board models will be reduced over time due to pressures from legislators, boardroom reformers, stock exchanges and institutional investors. This chapter further concentrates on developments in the composition and the formal structure of boards of listed corporations in the US, the UK and the Netherlands. The organization of this chapter is as follows. Paragraph 9.2 reviews the research findings of chapter six and chapter seven on changes in one-tier boards in the US and the UK to find support for proposition P.1. Paragraph 9.3 reviews developments in the governance structure of Dutch two-tier boards. This paragraph uses the research findings of chapter eight to find support for proposition P.2. Paragraph 9.4 presents a comparison of research findings to find support for proposition P.3. Paragraph 9.5 presents the practical implications of the research findings of this study for directors, stock exchanges, institutional investors and the theoretical implications of the research findings for academics involved in theory building. Suggestions for future research on corporate boards of directors are presented in paragraph 9.6. This chapter ends with a summary in paragraph 9.7.

9.2 The Transformation of Corporate Boards in the US and the UK

The previous chapters indicate that the separation of decision management from decision control can be accomplished in several ways in the top decision making structure of corporations. One way to accomplish an independent structure is to compose corporate boards of directors with a majority of non-executive directors. Other design strategies focus on the separation of CEO and chair roles, the appointment of independent senior lead directors to boards and the formation of oversight board committees comprised entirely of non-executive directors. The analyses in chapters six and seven of this study indicate that initiatives from stock exchanges, regulators and institutional investors have put more pressure on corporations to apply these design strategies. According to reformers, one-tier boards composed of a majority of executive directors are associated with the concentration of executive power that may lead to conflicts of interest between management and shareholders, such as greenmail payments, excessive executive compensation schemes and the adoption of poison pills. The way corporations have organized the leadership structure in their one-tier boards is another important aspect of board organization that receives much attention from boardroom reformers. These suggest that the decision control task of the board to monitor and to discipline management is weakened when CEO and chairman roles are combined. The analyses of board attributes in the US (chapter six) and the UK (chapter seven) indicate that directors apply design strategies that separate decision management from decision control in their boards in response to external pressures. These changes are summarized in the next sections of this paragraph to find support for the proposition that one-boards have become more independently composed and organized in the US and the UK.

Changes in the Size and The Composition of One-Tier Corporate Boards in the US and the UK

According to Spencer Stuart (1996), the average size of boards has decreased from sixteen directors in 1981 to thirteen directors in 1996 in the top one hundred corporations in the US. The decreasing representation of executive directors mainly counted for a net reduction of 195 executive directorships between 1987 and 1996. The study also found that boards are more often composed of a majority of non-executive directors. The latest figures indicate that boards are composed of nearly 3.5 non-executive directors to every executive director in 1996 compared to two non-executive directors to every executive director in 1987 (Spencer Stuart, 1996). On average, corporate boards are composed of three executive directors and ten non-executive directors in 1996. Although a similar development can be observed in the UK, changes in the size and the composition of boards appear to be less significant in a sample of one hundred corporations listed on the London Stock Exchange in 1996 (Spencer Stuart, 1996g). The average number of non-executive directors increased from 6.1 in 1991 to an average of 6.5 non-executives in 1996. The average number of executive directors decreased from 6.6 in 1991 to 6.1 executive directors in 1996. As such, the average size of boards of directors did not change significantly between 1991 and

1996. This indicates that on average corporations did respond to external pressures with modest changes in the size and the composition of boards in the UK.

Changes in the Leadership Structure of One-Tier Corporate Boards in the US and the UK

Another development in the governance structure of listed corporations relates to changes in the leadership structure of one-tier boards. The figures in chapter six suggest that more senior non-executive lead directors are appointed to boards of listed corporations in the US. These lead directors are appointed to provide the CEO advice on the selection of board committee members and the organization of board meetings. Lead directors also monitor the adequacy of management information, set the agenda of the board and set up procedures to formally evaluate the performance of the CEO and other executive directors (Lipton and Lorsch, 1992, The Business Roundtable, 1997). The appointment of lead directors is a relatively new development in the US. This development is illustrated with the following figures: Spencer Stuart (1996) indicates that a minority of ten corporations out of a total of one hundred listed corporations had assigned lead directors to their boards in 1995. This number totaled to 36 corporations that had assigned lead directors to their boards in the same sample in 1996! Also studies from NACD/Deloitte and Touche LLP (1995) and Korn Ferry International (1997) indicate that corporate boards increasingly favor the appointment of independent lead directors. In comparison to the appointment of lead directors, the separation of CEO and chair roles receives only modest support from corporations in the US. Korn Ferry International (1997) found that two percent of 1,125 directors consider the separation of the CEO and chair roles. The study also indicates that six percent of 878 investigated Fortune industrial and service corporations have separated the CEO position from the chair position of the board. Baliga et al. (1996) found several possible explanations for the persistence of CEO-duality in the US:

- duality reflects the traditional influence of firm management in board composition and the reluctance of the board to exercise its governance prerogative;
- the board may be indifferent to the duality issue and is content to let duality prevail as long as it is convinced that the CEO has the ability to occupy both positions effectively;
- duality may be a superior organizational structure;
- though a non-duality structure may be superior to a duality structure, ceteris paribus, there are other managerial control mechanisms in place to mitigate the abuse of managerial discretion that may arise from a duality structure.

Source: Baliga et al. (1996).

In contrast to the findings in the US, chapter seven of this study found strong support from the business community to split the two roles in the UK. According to Spencer Stuart (1996g), the Cadbury Code has influenced the way corporations divide the power structures at the top of corporations. The study indicates that 25 corporations out of a total of one hundred corporations listed on the London Stock Exchange combined the roles of CEO and chair in 1991. Only seven corporations in the sample continued to have a combined board leadership structure in 1996. The appointment of lead directors to corporate boards is less common compared to the number of lead director appointments in US due to the strong support of the business community to separate the chair role from the CEO role in the UK.

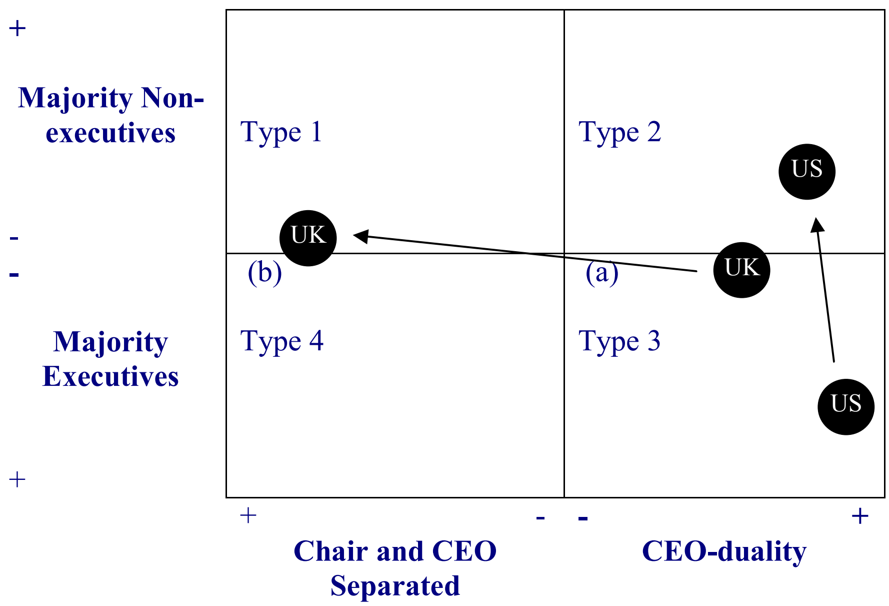
Changes in Board Committees of One-Tier Corporate Boards in the US and the UK

Another development relates to the formation and the composition of oversight committees in one-tier boards. This study found that oversight board committees have become common elements of the corporate governance structure of listed corporations in the US. Developments in legislation and listing rules have resulted in the formation of audit committees in corporations listed at the NYSE, NASDAQ and AMEX. Audit committees have become more independently composed in the US between 1978 and 1987. Also compensation and nominating committees have become more common and more independently composed in the US. Developments in the UK suggest a similar emphasis on the formation of independence board committees. A study by the ICA indicates that directors in 66 percent of 202 corporations worked with audit committees in 1992 compared to 17 percent in 1985 (ICA, 1992). The Cadbury compliance report also indicates that 90 percent of audit committees are composed of three or more non-executive directors in 1995 compared to 59 percent in 1991. Also remuneration and nomination committees have become standard elements of the governance structure of listed corporations in the UK.

Signs of Board Model Transformation in the US and the UK

The findings on changes in the composition, the leadership structures and the oversight committees of one-tier boards may reveal a process of board model transformation in the US and the UK. This process is visualized in figure 9.1. This figure presents a classification of board models based on the composition and the leadership structure of one-tier boards in the US and the UK. The figure is based on the assumption that the board becomes more independently composed and structured when the governance structure of a board transforms from a “type 3” one-tier board into one of the three other types of board organization. In its dual form, the classic one-tier board model (type 3) is entirely composed of executive directors who are chaired by the CEO. The analyses in part II of this research indicate that this model used to be the dominant board model in the US. Yet, the findings indicate that directors have applied design strategies that have altered the governance structures of their boards in this country. Arrow a in figure 9.1 indicates that directors have transformed their boards from a board type with a majority of executives (board type 3) into a structure with a majority of non-executive directors (board type 2) between 1981 and 1996 in the US. Meanwhile, directors have paid more attention to the appointment of lead directors to compensate the persistence of CEO-duality in the US. Interestingly, arrow b in figure 9.1 indicates that directors have followed a different path in response to external pressures from boardroom reformers, investors and regulators in the UK between 1992 and 1997.

Figure 9.1
Changing Board Leadership Structures and the Appointment of Non-Executive Directors To One-Tier Boards in Listed Corporations in the US and the UK



Sources: chapters 7 and 8.

A majority of boards of top one hundred listed corporations have changed from a board with a small majority of executive directors and combined CEO and chair roles (between board type 2 and board type 3) to a model with a small majority of non-executive directors and an independent board leadership structure (somewhere between board type 1 and board type 4). As such, the relatively large number of executive directors in boards of listed corporations in the UK - compared to non-executive directors - seems to be compensated with a strong emphasis on the separation of CEO and chair roles in these boards. In addition to these observations, independent oversight board committees have become common elements of the governance structure of listed corporations in the US and the UK.

Implications for the Independence of One-Tier Boards in the US and the UK

What do these developments mean for the independence of one-tier boards in the US and the UK? Changes in the organization of one-tier boards may indicate that corporations, directors, legislators, institutional investors and other reformers have observed that board design strategies which do not facilitate the separation of decision management from decision control can potentially threaten the independence of boards of directors in listed corporations. As such, changes in the composition of boards in the US and the UK suggest support for assumptions A.1a and A.3a that state that one-tier boards composed of a majority of executive directors are negatively associated with the separation of decision management from decision control and positively associated with the integration of these roles. Changes in the board leadership structure and the nomination of lead directors to one-tier boards also suggest support for the assumption that one-tier boards with a combined board leadership structure are negatively associated with the separation of decision management from decision control (assumption A.1b) and positively associated with the integration of these roles (assumption A.3b).

These changes indicate that dual board leadership structures are increasingly replaced with independent leadership structures or that these are counter balanced by the appointment of independent non-executive lead directors to one-tier boards. The empirical analyses in part II of this research also indicate that independent oversight committees have become more popular in the US and the UK. To support the independence of corporate boards in these countries, board committees have become more independently composed and chaired. These observations suggest support for two additional assumptions on the association between the formation of independent oversight board committees and the separation of decision management from decision control (assumption A.1c) and the integration of these roles (assumption A.3c) in one-tier boards. Changes have not taken place in the unitary structure of one-tier boards in the US and the UK (assumptions A.1d and A.3d).

These developments in the formal organization and the composition of one-tier boards may also generate support for the first proposition of this study on the transformation of one-tier board models. This proposition (P.1) states that directors apply design strategies that facilitate the separation of decision management from decision control in their boards. Seen from an empirical point of view, directors are adopting board attributes that show some similarities with those of two-tier boards, e.g., the independent leadership structure of two-tier boards. These developments may suggest a movement of one-tier board types into the direction of the two-tier model. As such, differences between the formal organization of one-tier and two-tier boards may diminish in the US, the UK and the Netherlands. A summary of research findings on the independence of one-tier boards and relevant assumptions are presented in table 9.1.

Table 9.1
Assumptions on One-Tier Board Attributes and Research Findings

Assumptions:	Relates to:	Findings are based on an analysis in the US between 1981 and 1997 and in the UK between 1992 and 1997.
A.1a, A.3a.	Board composition:	board composition receives more attention from reformers and directors who recognize a potential threat of insider-dominated boards to the formal independence of one-tier boards.
A.1b, A.3b.	Board leadership structure:	board leadership receives more attention from reformers and directors who recognize a potential threat of combined leadership structures to the formal independence of one-tier boards.
A.1c, A.3c. A.1d, A.3d.	Oversight board committees and board organization:	oversight board committees receive more attention from reformers and directors who recognize a potential threat of insider-dominated boards and combined leadership structures to the formal independence of one-tier boards. Changes in the formal unitary structure have not taken place.

Proposition P.1

↓

Proposition P.1: to facilitate the separation of the executive directors' decision management role from the non-executive directors' decision control role, appropriate attributes of two-tier boards are incorporated into one-tier boards.	more non-executive directors are appointed to one-tier boards and the number of executive directors decreases while overall board size is stable in the UK or while board size decreases in the US. directors have put in place more independent leadership structures, such as lead directors and separate chair and CEO positions. more oversight committees are formed composed of a majority of independent non-executives directors, chaired by a senior non-executive director.

9.3 The Transformation of Corporate Boards in the Netherlands

Signs of board model transformation can also be observed in the organization of Dutch two-tier boards. The next sections of this paragraph summarize developments in the attributes and the formal independence of Dutch two-tier boards.

Supervisory Board Committees in the Netherlands

Although one-tier boards appear to use committee structures far more often than two-tier boards (Demb and Neubauer, 1992b), this study found an increasing number of board committees in Dutch two-tier boards. The Peters Committee recommends the formation of board committees such as the nomination committee, the remuneration committee and the audit committee. At least 45 supervisory boards out of a total of one hundred listed corporations have one or more board committees in 1997 compared to 38 in 1996. A total of at least 42 supervisory boards work with a remuneration committee in 1997 compared to thirty supervisory boards in 1996. The number of audit committees has increased from 26 in 1996 to at least 32 in 1997. The voluntary introduction of committees to Dutch boards - even before the publication of the Peters Committee's recommendations - resembles the common practice of non-executive directors to operate in committees in the US and the UK. Yet, the function of supervisoy board committees seems to differ from the oversight function of committees in one-tier boards. Survey results indicate that supervisory board committees are composed of both managing directors and supervisory directors with the exception of remuneration committees (Maassen, 1998a). So, while one-tier board committee structures serve purposes which are, to some degree, similar to the legal separation of management and supervisory boards in two-tier boards (Demb and Neubauer, 1992b), supervisory board committees may serve as integrative devices by means of a mixed composition (Maassen and van den Bosch, 1999a).

The Combined Meetings of Management and Supervisory Boards in the Netherlands

It appears to be a common practice of Dutch supervisory directors to meet with managing directors. The latest figures indicate that supervisory boards formally met on average six times in 1997. Of these meetings, a large majority of formal supervisory board meetings were held together with the management board (Maassen, 1998a, 1999a). These observations directly challenge the assumption that two-tier boards divide board responsibilities of management and supervisory boards (assumptions A.2d and A.4d). Although a division of board roles is carried out between the two boards, in reality the organization of two-tier boards suggests that supervisory directors operate in a board structure similar to one-tier boards in which both executive and non-executive directors have a seat in a unitary board and where they meet together on a regular basis.

The Roles of the Supervisory Board in Strategic Decision Making

Sheridan and Kendall (1992) suggest that two-tier boards transparently define board responsibilities of executive managing directors and non-executive supervisory directors by separate management and supervisory boards. Dutch company law prescribes several supervisory board responsibilities related to the management board's decision-management role. Under certain circumstances, the supervisory board may " . . . be entrusted with the management tasks or a part thereof. This relates to the replacement of the management in the event of absence or hindrance . . . and the representation of the company in the event of a conflicting interest of managing directors" (Blanco Fernández, 1993:213-214). Dutch law also specifies an advisory task of the supervisory board. Consequently, in practice a clear division between decision management and decision control may be diminished. This is reflected by the role of supervisory boards as perceived by Dutch supervisory chairmen. Two thirds of the chairmen interviewed in the Maassen (1998a) study indicate an increasing emphasis on the role of supervisory directors in the formulation and ratification of strategy. The chairmen observe that supervisory directors are more involved in the development and analysis of strategic corporate opportunities, as well as in the supervision of the implementation and the evaluation of strategies.

The Appointment of Formerly Affiliated Managing Directors to Dutch Supervisory Boards

Chapter eight indicates that the common and structure regimes do not prohibit the appointment of formerly affiliated managing directors to supervisory boards in the Netherlands. Directly related to assumptions A.2a and A.4a in this study, this observation may challenge the conventional wisdom that the composition of supervisory boards is positively associated with the separation of decision management from decision control in two-tier boards. In addition, the appointment of formerly affiliated managing directors and CEOs to the chair position of supervisory boards could theoretically challenge assumptions A.2b and A.4b. These assumptions indicate that the leadership structure of two-tier boards is positively associated with separation of decision management from decision control and negatively associated with the integration of these roles. Based on an analysis of annual reports published between 1987 and 1998, Maassen (1999a) indicates that a majority of seventy percent of one hundred listed corporations have no formerly affiliated managing directors in their boards in 1998. Only 37 positions out of a total of 592 supervisory board positions are held by formerly affiliated managing directors in 1998 (about six percent). When formerly affiliated directors are appointed, corporations also generally adhere to the recommendations of the Peters Committee to appoint a maximum of one formerly affiliated managing director to their supervisory boards.

The latest figures indicate that only four supervisory boards out of a total of one hundred listed corporations are chaired by a formerly affiliated managing director in 1998 (Maassen, 1999a). These appointments took place between 1987 and

1998. These findings indicate that a strong majority of the one hundred corporations investigated (96 percent) adhere to the recommendations of the Peters Committee to avoid the appointment of a formerly affiliated managing director to the chairman seat of supervisory boards. The findings also indicate that these appointment rarely take place in the top one hundred of Dutch listed corporations.

Implications for the Independence of Two-Tier Boards in the Netherlands

Pressures from the Peters Committee have certainly resulted in more openness from supervisory directors on their working methods and their board structures. The research findings of this research also indicate that some developments take place in the organization and the composition of two-tier boards in the Netherlands. What do these observations mean for the formal independence of two-tier boards in the Netherlands? According to Maassen and van den Bosch (1999a), the combination of the appointment of formerly affiliated managing directors to the supervisory board, the mixed composition of board committees, the combined board meetings and the diffusion of supervisory board responsibilities may challenge the widespread agency theoretical belief that supervisory directors operate per definition independently of managing directors in two-tier boards. It is, for example, a common practice for the supervisory board to organize joint meetings with the entire management board. This study also found that supervisory boards increasingly work with audit and nomination committees composed of both managing directors and supervisory directors, when the size of the corporation and the supervisory board justifies the formation of these committees. Through these arrangements, it is likely to be the case that directors apply design strategies that aim to facilitate the integration of decision management with decision control in their two-tier boards. This might especially be the case when formerly affiliated managing directors are appointed to supervisory boards and when these directors would act in the same way as executive directors in one-tier boards. Yet, the convergence hypothesis would not be supported if formerly affiliated directors act truly independent of management. More research is needed to understand the roles of these directors due to the fact that figures on formerly affiliated managing directors in this research do no explicate the role these directors perform in the decision control activities of the supervisory board. The relevant assumptions and research findings are summarized in table 9.2.

Table 9.2
Assumptions on Two-Tier Board Attributes and Research Findings

Assumptions:	Relates to:	Findings are based on an analysis in the Netherlands between 1987 and 1998.
A.2a, A.4a.	Board composition.	the legal requirement to separate managing directors from supervisory directors has not been changed. Formerly affiliated managing directors are sometimes appointed to supervisory boards (about six percent of supervisory board positions in 1998 in one hundred listed corporations).
A.2b, A.4b.	Board leadership structure.	no changes have occurred in the formal organization of the leadership structure of Dutch supervisory boards. In a few cases, formerly affiliated managing directors are chairing supervisory boards after their retirement (four percent of one hundred listed corporations in 1998).
A.2c, A.4c. A.2d, A.4d.	Oversight board committees and board organization.	managing and supervisory directors meet together during most formal board meetings of supervisory boards and meet together in board committees when these are formed.

Proposition P.2

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Proposition P.2: to facilitate the integration of the executive directors' decision management role with the non-executive directors' decision control role, appropriate attributes of one-tier boards are incorporated into two-tier boards.	Supervisory directors apply design strategies that integrate decision management with decision control: more board committees are formed with both managing and supervisory directors; combined meetings are held with managing directors; a minority of supervisory boards has appointed formerly affiliated managing directors.

9.4 The Convergence of Board Models

The third proposition (P.3) in this study suggests that a process of board model transformation can be observed through diminishing differences between the key attributes of one-tier and two-tier board models. This proposition directly builds on the two propositions related to the transformation of one-tier and two-tier boards in the US, the UK and the Netherlands (P.1 and P.2).

Table 9.3
The Comparison of Changing Board Model Attributes

		US	UK	The Netherlands
	Board model	One-tier	One-tier	Two-tier[44]
	Board meetings:	Combined	Combined	Predominantly combined
Board size and composition	Board size:	-	Stable	Stable
	Non-executives:	++	Stable	Stable
	Executives:	--	Stable	Stable
Board leadership	CEO/chairman split:	Modest support	Strong support	Determined by law
	Lead directors:	Strong support	Modest support	Not applicable
The number of board committees	Audit:	++	++	+
	Compensation:	++	++	+
	Nomination:	++	++	+
	Independent committee leadership:	++	++	No data available

Source: part II of this research.
++ = increases strongly, + = increases, - = decreases, -- = decreases strongly.

As stated in paragraph 9.3 of this chapter, proposition P.1 suggests that one-tier boards are becoming more independently composed and organized in the US and the UK. The second proposition (P.2) suggests that integrative board attributes are incorporated in two-tier board structures to facilitate the integration of decision management with decision control.
Developments in the composition and the structure of corporate boards in the US,

[44] Applicable to large structure corporations. Smaller corporations have a choice between a two-tier structure and a structure without a boards of directors (see also chapter 8).

the UK and the Netherlands suggest evidence for the third proposition of this study (P.3). Directors who operate with one-tier boards are increasingly modifying their governance structures to adapt to new corporate governance standards. Developments in the formal organization of two-tier boards in the Netherlands also indicate that supervisory directors apply design strategies that may integrate decision management with decision control. The observed transformation of board models implies that differences between the two major board models are diminishing (see also table 9.3). The implications of this process of board convergence are further explored in the next paragraph.

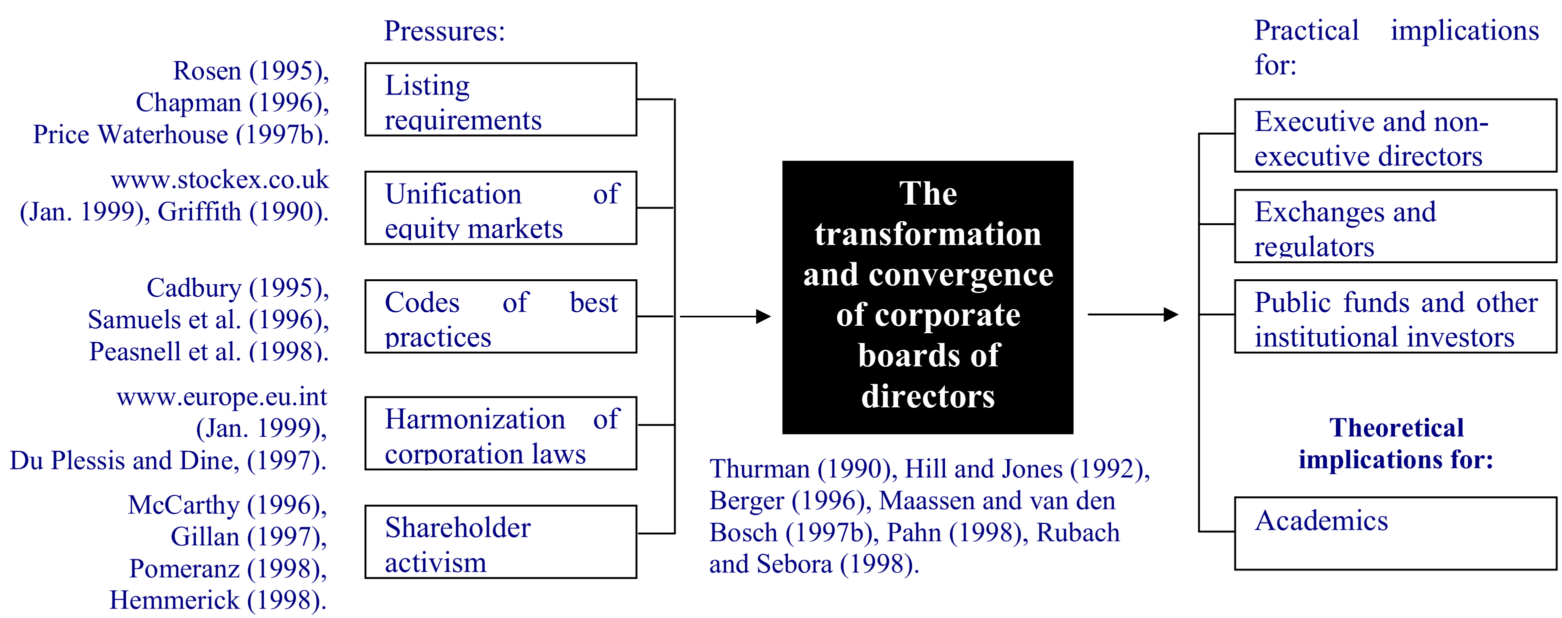
9.5 The Implications of Research Findings

The analyses in chapter five of this study indicate that the importance of corporate governance is not only recognized in the national debates in the US and the UK. The diffusion of self-regulation in corporate governance also has become visible in continental European countries and other financial markets. This study found pressures from the following sources:

- the introduction of codes of best practices and guidelines;
- the modification of listing rules of stock exchanges;
- the globalization and unification of equity markets;
- the harmonization of corporation laws;
- the role of institutional investors in corporate governance.

In general, stock exchanges are putting more weight on new governance standards by means of voluntary codes of best practices and by making amendments to their listing rules. The European equity market is showing the first signs of unification which may result to the harmonization of corporate governance standards in Europe. Governance standards of exchanges in the US and the UK also seem to influence listing requirements of exchanges in other financial regions such as Asia, the Pacific and Eastern Europe. The harmonization of corporation laws has been exemplified by the development in the EU where the Draft Fifth Directive on Company Law may result to the unification of corporation laws that set forth new governance standards in Europe. In addition, institutional investors have become more active in the field of corporate governance. CalPERS, HERMES and others are not only establishing standard principles in their regional market places. Institutional investors also play a role in the development of new global corporate governance principles and standards. The relationship between these pressures and the transformation and convergence of corporate boards of directors is illustrated in figure 9.2. This figure suggests that external pressures lead to changes in the way directors organize their boards of directors. These changes may have both implications for practitioners, exchanges, investors as well as for academics involved in theory building. These implications are presented in the following sections of this paragraph.

Figure 9.2
Research Findings Summarized



Sources: chapter 5 and part II of this study.

Implications for Directors

As previously observed in this study, developments in corporate governance indicate that directors are increasingly adhering to new corporate governance standards. Emerging standards pressure directors to recognize that corporate governance is not only a matter of interest to institutional investors, stock exchanges and regulators. Listed corporations and their directors are also asked to understand the importance for corporations to comply with new corporate governance standards (see also figure 9.3). As such, changes can be observed in the formal organization of boards of directors in listed corporations in the US, the UK and the Netherlands. The globalization of governance standards, the internationalization of corporations and the harmonization of equity markets are also stimulating directors to understand the subtle differences in boardroom cultures, working methods and board organization in different financial regions. The increasing importance of self-regulation in corporate governance is also confronting directors with the responsibility to voluntarily comply with new standards. Directors are also increasingly confronted with the need to generate more openness, disclosure and transparency on their working methods.

Figure 9.3
Implications for Corporate Boards of Directors

Pressures (see figure 9.2)

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The transformation and convergence of corporate boards of directors

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Challenges to Directors

the emphasis on the formation of new board structures;
the introduction of new working methods and skills;
the emphasis on more disclosure of board practices;
the internationalization of board cultures;
the emergence of new board responsibilities and the emphasis on the involvement of non-executive directors in strategic decision making.

Implications for Stock Exchanges and Other Regulators

Seen from a practical point of view, the transformation and convergence of corporate boards may also have implications for public regulators and self-regulatory bodies such as stock exchanges and professional associations. Related to this study, international developments in corporate governance increasingly force exchanges to set forth new corporate governance standards while they fight for a piece of the financial pie (Griffith, 1990). As indicated in chapter five of this study, self-regulation is essential to the initiatives of stock exchanges that aim at the amendment of listing rules and the adoption of codes of best practices. Most exchanges refer to codes of best practices and rely on the professional discipline of directors to comply with new or changing corporate governance standards. In addition, the analyses in chapters six and seven of this study indicate that the governance systems in the US and the UK rely heavily on the disclosure of board practices and not on regulation through litigation.

Figure 9.4
Implications for Stock Exchanges and Other Regulators

Pressures (see figure 9.2)

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The transformation and convergence of corporate boards of directors

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Implications for Exchanges/Regulators

directors increasingly understand the need to comply with new governance standards; directors are increasingly responding to pressures with changes in the governance structure of their boards;

compliance reports suggest that self-regulation through listing requirements and codes of best practices can be effective to regulate the governance structure of corporations.

Although corporation laws seem to dictate the governance structure in more detail in the Netherlands, the Peters Committee's forty recommendations also strongly build on self-regulation. So, what does the transformation and convergence of board models mean for exchanges and other regulators that mainly rely on self-regulation in corporate governance? First, the transformation and convergence of board models may suggest that self-regulation is a mechanism that can effectively change and/or regulate the governance structure of listed corporations when exchanges have the power and the will to penalize "offenders" of the code. Second, changes in the governance structure of corporations may suggest that directors understand the need to comply with international standards to attract investments and to build investor confidence. In addition, it may suggest that directors do understand the potential benefits of self-regulation such as the flexibility of corporations to implement guidelines and to adapt governance structures that meet specific demands and needs not foreseen by statutory regulation.

Although Whittington (1993) indicates that self-regulation can be associated with a potential enforcement problem when new standards conflict with the interests of parties involved[45], the first compliance reports indicate that self-regulation, in conjunction with other pressures, positively contributes to the introduction of international corporate governance standards. Moreover, the transformation and convergence of corporate boards of directors may contribute to the confidence regulators may have in the effectiveness of self-regulation in the field of corporate governance (Cadbury, 1995; Samuels et al., 1996; Conyon and Mallin, 1997; Peasnell et al., 1998).

Implications for Institutional Investors

What does the transformation and convergence of board models mean for institutional investors? First, it may suggest that directors are increasingly responding to pressures from institutional investors to change the governance structure of their boards. Del Guercio and Hawkins (1997) found that institutional investors have been successful in promoting corporate changes in listed corporations. McCarthy (1996) also states that it is hard to ignore the pressures from institutional investors on corporate governance practices of listed corporations in Anglo-Saxon countries. Shareholder proposals from CalPERS and other institutional investors have indeed been followed with changes in the governance structure of listed corporations such as General Motors and other high profile corporations in the US. Yet, corporate governance standards vary between institutional investors. The Russell Reynolds Associates' 1998 International Survey of Institutional Investors found that institutional investors strongly favor the separation of CEO and chair roles in the UK. A total of 85 percent of surveyed

[45] According to Finch (1994:57), "Self-regulatory structures are prone to a number of criticisms – that, for instance, they favour the regulated group and ignore the broader public interest; they are designed with large, well-organised, well-resourced enterprises in mind and fail to deal with those who really need to be regulated; their procedures tend to exclude third parties; they are low on accountability; they have anti-competitive effects; they tend not to enjoy public confidence; and their investigative, enforcement and sanctioning processes tend to be weak."

institutional investors are in favor of such an independent leadership structure. In the US, only 45 percent prefers an independent board leadership structure. In addition to other pressures, these findings are in line with the changes directors have made in the governance structure of their boards in the two countries.

Second, are shareholder proposals that aim at the modification of the composition and structure of boards also effective? In other words, do changes in the governance structure of corporations also result in improvements of the performance of corporations? CalPERS claims that an investment of USD 500,000 in shareholder activism leads to additional earnings of tens of millions of US-dollars (Pomeranz, 1998). As indicated by the literature review in chapters three and four of this study, the relationship between governance structures and financial performance is still a controversial one. The inconclusive findings in the literature suggest support for a consensus perspective of board organization that board structures with dual board leadership structures and insider-dominated boards are not necessarily dysfunctional. In summary, research fails to prove conclusive findings that support a negative relationship between insider-dominated board composition and performance criteria as suggested by a conflict perspective of board organization. In response to these findings, Bhagat and Black (1997:45) propose that ." . . the burden of proof should perhaps shift to those who support the conventional wisdom that a monitoring board – composed predominantly of independent directors – is an important element of improved corporate governance." Seen from a more practical point of view, Donaldson and Davis (1994) state: "We believe that it would be unwise at the present time to go along with calls to require boards of corporations to be dominated by non-executives."

Related to the leadership structure of boards, Baliga et al. (1996:51) report: "Our findings stand in sharp contrast to the recommendations of those who call for the abolition of duality as a primary way to improve firm governance and performance. The finding of no significant difference in the operating performance suggest that a duality status change . . . is more a variant of the 'scapegoating phenomenon' . . . and a symbolic way of 'signaling' that the board is effectively exercising its governance role . . . than an effective way of motivating fundamental change in firm performance." And, related to the composition of board committees, Daily et al. (1988) indicate that they found no evidence of a systematic relationship between the composition of compensation committees and levels of CEO compensation. According to the authors, "these results are particularly intriguing given the emphasis both academics and the institutional investment community are placing on director independence" (Daily et al., 1988:215). As such, these results not only have policy implications for institutional investors. Also exchanges and other regulators are confronted with " . . . the fundamental disagreement between those advocating reform (corporate reformers) and defenders of the status quo (corporate federalists) about the efficacy of market forces in assuring managerial accountability to shareholders" (Malec, 1995:86).

Figure 9.5
Implications for Institutional Investors

Pressures (see figure 9.2)

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The transformation and convergence of corporate boards of directors

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Implications for Institutional Investors

directors increasingly understand the need to comply with new governance standards;

the first initiatives may indicate the start of an inevitable process in which listed corporations are increasingly responding to pressures from institutional investors to transform their board structures into more independent models;

it is too early to indicate that shareholder activism has a positive impact on the formal independence of corporate boards;

the relationship between governance structures and financial performance is still a controversial one.

Although it is too early to indicate that shareholder activism has a positive impact on the formal independence of corporate boards in the US, Europe and other financial regions, the first initiatives may indicate the start of an inevitable process in which listed corporations increasingly are confronted with pressures from institutional investors to transform their board structures into more independent models.

Theoretical Implications

In addition to the practical implications for directors, regulators and institutional investors, the research findings of this study may also have implications for academics and others involved in theory building. First, the review of corporate governance literature shows that competing theoretical perspectives of corporate governance provide contrasting design strategies of board organization. As suggested above, the inconclusive research findings in the literature indicate that there is no clear relationship between the effectiveness of design strategies related to the governance structure of boards of directors and the financial performance of corporations.

Figure 9.6
Theoretical Implications

Pressures (see figure 9.2)

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The transformation and convergence of corporate boards of directors

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Implications for Theory Building

inconclusive research findings on the relationship between the formal independence of corporate boards and the financial performance of corporations suggest that there is no one best way to organize corporate boards of directors;

the applicability of the compelling perspectives of board organization seems to depend on situational factors;

consensus and conflict perspectives are complementary to each other to understand the complex relationship between the organization of corporate boards and the involvement of directors in decision management and decision control;

inconclusive research findings challenge the widespread agency theoretical belief that independent board structures support the separation of decision management from decision control and ultimately firm performance.

Although leading researchers in corporate governance claim that independent structures are superior to dual structures, the first theoretical implication of the research findings of this study seems to be that there is no one best way to organize corporate boards. Demb and Neubauer (1990:156) state: “There is no perfect structure for a board. Each company must put a board in place with a composition and shape – tailored to fit its legal environment, the company’s size and development stage, and the personality of its Chairman and CEO.” This means that the applicability of the compelling perspectives of board organization seems to depend on situational factors (Davis et al., 1997; Muth and Donaldson; 1998).

According to Donaldson (1990:377), the stewardship theory and the agency theory may be valid within their own domains: “For instance, stewardship theory may prove correct as long as the coalition . . . between managers and owners persists and is perceived by managers as persisting. Under conditions where the existing coalition between managers and owners is called into question, such as by a takeover threat, the interests of each party start to diverge; this is when agency theory may prove correct.” Or, as stated by Boyd (1995), both theoretical perspectives are correct under different circumstances. A challenge for future research is to determine these contingent factors. This means that both perspectives are not necessarily non-complementary when researchers try to understand the complex relationship between the formal organization of corporate boards and the involvement of directors in decision management and decision control. Second, the emphasis in the literature on the formal independence of corporate boards suggests that some scholars underestimate the importance of informal mechanisms that support directors’ involvement in decision making. This study demonstrates that supervisory directors can by-pass the formal structure with informal arrangements in the Netherlands. It is a common practice of the supervisory board to organize joint meetings with the entire management board. Supervisory directors have also voluntarily formed board committees composed of managing directors and supervisory directors. Sometimes, formerly affiliated directors are appointed to supervisory boards. These observations challenge the widespread agency theoretical belief that formal structures with independent board leadership and separate management and supervisory boards by definition create independent boards. In practice, this may indicate that boardroom reformers who strongly focus on the alteration of formal board structures, should also consider the limitations of formal board structures that are supposed to support the formal independence of corporate boards.

9.6 Suggestions for Future Research

According to Judge (1989), Zahra and Pearce (1989) and Dalton et al. (1998), corporate governance research and the development of theories in the field of corporate governance have been troubled by the following limitations:

- the literature is fragmented, stemming from different disciplining backgrounds, i.e., sociologists, financial economists, organization theorists and strategic management scholars. In general, however, these disciplines do not read or cite the ideas and/or findings of other disciplines;
- the literature is fragmented within each discipline;
- this fragmentation is manifested in different terminologies and operationalizations that are used for similar constructs. Researchers have failed to operationalize board variables in a consistent manner;
- most empirical studies are not theory driven. There are also countless lists of what boards should do. Only a few theory-based studies exist;
- most empirical studies focus on structural dimensions of the board, and, therefore authors can only speculate on actual board behavior. The nature of board processes over time has not been studied and evidence on what boards actually do is not well documented;
- the few empirical studies of actual board processes which exist have not been very rigorous;
- the impact of contextual forces on board involvement and board organization have been widely ignored in research;
- there has been a tendency among researchers to prescribe desirable reforms without sufficient description of board attributes;
- conflicting evidence exists on the extent and effects of board involvement.

Sources: Judge (1989:24-25); Zahra and Pearce (1989) and Dalton et al. (1998).

Although these limitations challenge the corporate governance research agenda, the possibilities for future research seem to be unlimited. The following suggestions can be made:

The Integration of Theoretical Perspectives This study recognizes the need to incorporate compelling perspectives of board organization in its theoretical framework. Future research could also benefit from the recognition that multi-disciplinary approaches to the formal organization of corporate boards provide a richer, more comprehensive theoretical explanation and understanding of governance structures (Davis, 1991). This may not only stimulate sociologists, financial economists, organization theorists and strategic management scholars to read or to cite the ideas and/or findings of other disciplines. The exchange of concepts, theories and ideas may also eliminate the fragmentation of research and the application of different terminologies and operationalizations that are used for similar constructs (Judge, 1989; Zahra and Pearce, 1989);

The Emphasis on Corporate Governance in Other Countries Rather than just observing developments in board organization in the US, the UK and the Netherlands, a challenge for future research on board convergence would also be to reveal developments over time in the composition and organization of corporate boards in other Anglo-Saxon and continental European countries. International comparisons of governance models may not only generate further evidence regarding the convergence of board models. It may also give scholars a better understanding of the relationship between board model attributes and board involvement in strategic decision making and the relevance of conflict and consensus perspectives of board organization. Moreover, it may also offer insights to practitioners as well as to public policy makers in their effort to reform current practices. (Judge, 1989; Boyd 1995);

The Relationship Between Boards and Other Monitoring Devices Like most studies, this research has portrayed developments in the formal organization of corporate boards of directors in isolation from developments in other monitoring devices and mechanisms such as the market for corporate control and the competition in managerial labor markets that align the interests between shareholders and managers. As such, this research did not investigate the substitution hypothesis which states that the organization and composition of corporate boards of directors may be effected by the existence of other control mechanisms which may account for differences between the corporate governance structures in countries investigated. A suggestion for future research therefore would be to analyze these developments in relation to those in the organization of corporate boards;

The Emphasis on Process Studies Ideally, a study on board independence also looks behind the door of the boardroom to observe the behavior of directors. Although some authors have managed to directly observe the behavior of directors in their boardrooms (Pettigrew, 1985a; Thurman, 1990), process studies are not easily to realize. This study did not have access to the group dynamics of boards of directors either. To measure the independence of corporate boards, this research indirectly measured the behavior of directors in the way they have altered their board structures. Future research projects could try to fill this gap in the literature by building up strategic alliances with directors and practitioners who recognize the need to understand more about board structures and board processes that contribute to the involvement of directors in decision making;

The Board as a “Instrument” for Influencing Strategy Another suggestion for future research relates to the strategic impact of the changing international context on the strategic renewal processes of large European corporations. The scientific and managerial significance can be highlighted by positioning corporate governance as a strategic management “instrument” for influencing strategy and strategic renewal processes of corporations. The analysis, both in theory and practice of different corporate governance structures, and their impact on strategic renewal processes can contribute to a better scientific and societal assessment of the importance of corporate governance;

The Emphasis on the Diffusion and the Effectiveness of Self-regulation Future research could also concentrate on the effectiveness of self-regulation that aims to set forth new (international) corporate governance standards. Most often, researches have focused on developments in the UK where the Cadbury Code and its successor Hampel have dominated the corporate governance debate. Much less is known about the way directors voluntarily comply with codes of best practices in continental European countries and other important financial regions and how Anglo-Saxon codes of best practices have influenced initiatives in other regions. This is also true for research on the contribution of shareholder activism to the improvement of the financial performances of corporations. The few studies have mostly concentrated on shareholder activism in the US. Research on the role of institutional investors in other countries is much less developed in the literature;

The Emphasis on Small Enterprises and Not-for-Profit Organizations There are advantages of a research approach which concentrates on large listed corporations. Perhaps the most important advantage lies in the availability of data. Listed corporations are much more regulated than non-listed corporations and they have to disclose much more information on their governance structure than smaller corporations are legally enforced to. Another advantage that has stimulated this research to concentrate on large listed corporations relates to the relatively large body of research available on listed corporations. This study strongly emphasizes the corporate governance structure of large listed corporations and ignores the contribution of boards of directors in other types of firms and organizations (Wang, 1991). It did not - for example - include non-listed corporations, medium-sized and small enterprises and not-for-profit organizations. As such, another suggestion for future research is to reveal developments in the organization and the composition of boards of directors in small enterprises and not-for-profit organizations.

9.7 Summary

This chapter presents the confrontation of the theoretical model of this study with the analysis of changing board attributes in three countries. The theoretical model in part I of this study is based on several assumptions related to key attributes of one-tier and two-tier boards. The assumptions are developed by means of a conflict and a consensus perspective of board organization. The assumptions give rise to three propositions that suggest that directors are under pressure to change the attributes of their boards. The empirical analyses in part II of this study suggest that changes can be observed in the way boards of directors of listed corporations are composed and organized in the US, the UK and the Netherlands. This process of board model transformation and convergence may suggest that directors are increasingly understanding the need to comply with emerging international corporate governance standards. In addition, amongst other things, it may suggest that self-regulation through codes of best practices, listing requirements and guidelines from institutional investors can be an effective strategy to regulate the governance structure of listed corporations.

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Samenvatting (Summary in Dutch)

Een Internationale Vergelijking van Corporate Governance Modellen.

Een Studie Naar de Formele Onafhankelijkheid en Convergentie van "One-Tier" en "Two-Tier" Systemen van Corporate Governance in de Verenigde Staten van Amerika, het Verenigd Koninkrijk en Nederland.

Hoofdstuk 1: Inleiding

Centraal in dit proefschrift staat de vergelijking van twee belangrijke internationale corporate governance modellen: het one-tier model en het two-tier model. Het verschil tussen de modellen komt tot uiting in de samenstelling van de raad van commissarissen (board of directors) en de wijze waarop commissarissen (non-executive directors) en leden van de raad van bestuur (executive directors) gebruik maken van leiderschapstructuren en commissies. Ten behoeve van de toezichthoudende rol van commissarissen kan vanuit een theoretisch conflict perspectief worden betoogd dat de twee modellen zijn ontwikkeld om een scheiding tussen het toezicht van commissarissen en het dagelijks bestuur van de onderneming te bewerkstelligen. Naast de toezichthoudende rol besteedt dit proefschrift ook aandacht aan de strategische rol van commissarissen. In deze rol wordt vanuit een theoretisch consensus perspectief een integratie van toezicht en het dagelijks bestuur van de onderneming voorgesteld. Het proefschrift betoogt dat beide theoretische perspectieven op de organisatie en taakvervulling van raden van commissarissen elkaar niet wederzijds hoeven uit te sluiten en dat dit in de praktijk aanleiding geeft tot aanpassingen in het one-tier model en het two-tier model. Deze aanpassingen kunnen wijzen op een convergentie tendens tussen beide modellen. Het bovenstaande heeft geleid tot de volgende onderzoeksvraag:

Wat zijn de attributen van het one-tier model en het two-tier model en in hoeverre bevorderen de organisatiestructuur en de samenstelling van raden van commissarissen en boards of directors, en veranderingen hierin, de formele onafhankelijkheid en de convergentie van board modellen in de Verenigde Staten, het Verenigd Koninkrijk en Nederland?

Het proefschrift is als volgt opgebouwd. Eerst wordt in hoofdstuk twee het one-tier model met het two-tier model vergeleken en wordt er aandacht besteed aan de service rol, de toezichthoudende rol en de strategische rol van raden van commissarissen. Daarnaast belicht het proefschrift in hoofdstukken drie en vier op basis van een literatuurstudie de invloed van de organisatiestructuur en de samenstelling van raden van commissarissen op de formele onafhankelijkheid van beide board modellen. Vervolgens worden er in hoofdstuk vijf een aantal situationele omgevingsfactoren geïdentificeerd die een bijdrage leveren aan veranderingen in de formele vormgeving van one-tier en two-tier modellen. Aan de hand van een tweetal beschrijvende studies wordt in hoofdstukken zes en zeven de praktische vormgeving geanalyseerd van one-tier boards in de Verenigde

Staten en het Verenigd Koninkrijk. De praktische vormgeving van het two-tier model wordt in hoofdstuk acht belicht vanuit een Nederlands perspectief. In het laatste hoofdstuk van het proefschrift komen conclusies en aanbevelingen aan de orde die van belang zijn voor het actuele corporate governance debat.

Hoofdstuk 2: Twee belangrijke corporate governance modellen en de rollen van commissarissen.

In Nederland, Duitsland, Zweden, Oostenrijk en Finland zijn de raad van bestuur en de raad van commissarissen van grote beursgenoteerde ondernemingen twee afzonderlijk bij de wet geregelde organen. De raad van bestuur (de management board) bestaat uit de directieleden van de onderneming. De raad van commissarissen (de supervisory board) is samengesteld uit onafhankelijke leden die geen dienstverband hebben met de onderneming. De twee organen (lagen) vormen het zogenaamde two-tier model. In de Verenigde Staten, Canada, Australië en het Verenigd Koninkrijk werken beursgenoteerde ondernemingen met een one-tier board model. Executive directors (directieleden) en non-executive directors (commissarissen) vormen gezamenlijk één board. Deze wordt doorgaans voorgezeten door de CEO. In dat geval is er sprake van CEO-duality: de CEO is tevens voorzitter van de board. De board van een beursgenoteerde onderneming heeft vaak ook een verplichte commissiestructuur (bijvoorbeeld een auditcommissie) waarin de non-executive directors veelal in de meerderheid zijn. De tabel op de volgende bladzijde vat de verschillen tussen de twee modellen nog eens samen.

De literatuur onderkent daarnaast een drietal rollen van commissarissen (Pearce & Zahra, 1992). De rollen zijn gerelateerd aan diverse theoretische perspectieven. (1) De service rol van commissarissen is verbonden met de fondsafhankelijkheidstheorie en de stakeholder benadering. In deze benaderingen wordt de raad van commissarissen gezien als een “linking pin” van de onderneming met haar omgeving. (2) De toezichthoudende rol van commissarissen staat centraal vanuit een principaal-agent perspectief. De aandacht gaat uit naar het toezicht van commissarissen op het besluitvormingsproces van de onderneming. De commissarissen waken hierbij over de belangen van de aandeelhouders en beoordelen de prestaties van het management. (3) In onder meer de strategisch management literatuur wordt aan commissarissen ook een strategische rol toegekend. Commissarissen zijn met deze rol actief betrokken bij de besluitvorming van de onderneming. Zo stelt Zahra (1990:110): “ . . . directors may initiate and develop strategic change without limiting themselves to approving managerial choices.” De strategische rol kan voor commissarissen leiden tot een paradox waarbij distantie en betrokkenheid op gespannen voet komen te staan (Tricker, 1984; Demb & Neubauer, 1992). Immers, hoe kan een commissaris toezicht houden op het beleid van de onderneming als hij/zij ook direct verantwoordelijk is voor de uitvoering hiervan? Het spanningsveld tussen uitvoering en toezicht kan vanuit een tweetal theoretische perspectieven nader onder de loupe worden genomen: het conflict perspectief en het consensus perspectief op de organisatie en samenstelling van raden van commissarissen.

Deze perspectieven hebben betrekking op de wijze waarop de organisatiestructuur en de samenstelling van raden van commissarissen een bijdrage leveren aan de taakvervulling van commissarissen. De twee perspectieven worden in hoofdstukken drie en vier van het proefschrift nader toegelicht.

Tabel 1:
Twee corporate governance modellen: het one-tier model versus het two-tier model

	One-tier boards in de Verenigde Staten en het Verenigd Koninkrijk.	**Two-tier boards** in Nederland.
Voorzitterschap:	CEO kan ook voorzitter van de board of directors zijn.	President-directeur kan géén voorzitter van de raad van commissarissen zijn.
Board commissies:	Auditcommissies zijn veelal verplicht, terwijl de instelling van belonings- en benoemingscommissies sterk wordt aanbevolen.	de instelling van commissies is vrijwillig.
Board organisatie:	een orgaan (one-tier)	twee separate organen (two-tier): een raad van bestuur (management board) en een raad van commissarissen (supervisory board).
Samenstelling:	samengesteld uit zowel executive directors en non-executive directors.	een gescheiden samenstelling. De raad van bestuur is samengesteld uit executive directors. De raad van commissarissen is samengesteld uit onafhankelijke commissarissen (supervisory directors).

Bron: hoofdstuk 4.

Hoofdstuk 3: Een conflict perspectief op board model attributen

Gezien vanuit een conflict perspectief streeft het management haar eigenbelang na en moeten commissarissen toezicht houden op het besluitvormingsproces van de onderneming om de belangen van aandeelhouders te behartigen. Nu blijkt uit de literatuur dat de samenstelling en de organisatiestructuur van het one-tier model in de Verenigde Staten en het Verenigd Koninkrijk op gespannen voet staan met de toezichthoudende rol van commissarissen. Hoofdstuk drie van het proefschrift geeft weer dat de samenstelling en de structuur van raden van commissarissen in deze landen wordt bekritiseerd omdat zowel het management als de commissarissen in het zelfde orgaan belast zijn met het bestuur van de onderneming en het toezicht hierop. Charkham (1994:333) concludeert in dit verband: “If it is desired to put an end to fudge, the logic is to differentiate between the duties of supervisors and managers . . .” Ook Sheridan & Kendall (1992:161) vragen hiervoor aandacht: “There is an uncomfortable untidiness in having one group of directors supervising or controlling another group on the same board, which is meant to be the collective for managing the company.” In het two-tier model is wel een formele scheiding tussen bestuur en toezicht aangebracht. Vanuit het oogpunt van een theoretisch conflict perspectief kan dan ook worden gesteld dat het two-tier model beter is ingericht om de toezichthoudende rol van commissarissen te ondersteunen dan het one-tier model. Dit blijkt in eerste instantie ook uit de praktijk. Er zijn diverse “reparaties” uitgevoerd om het one-tier model in de Verenigde Staten en het Verenigd Koninkrijk onafhankelijker van het management te maken (bijvoorbeeld door de instelling van onafhankelijke audit-, benoemings- en beloningscommissies).

Hoofdstuk 4: Een consensus perspectief op board model attributen

Gezien vanuit een consensus perspectief wordt het management als “stewards” van de onderneming gezien (Donaldson & Davis, 1994). Vanuit het consensus perspectief worden pleidooien gehouden voor de integratie van de service en de toezichthoudende rollen van commissarissen. Dit verschil in perspectief heeft repercussies voor de organisatie en de samenstelling van raden van commissarissen. Zo bevordert de combinatie van de CEO functie met het voorzitterschap van de one-tier board de strategische rol van de board (Finkelstein & D'Aveni, 1994). De attributen van het two-tier board model waarin het management en de commissarissen van elkaar zijn gescheiden door twee afzonderlijke organen bevorderen op zichzelf niet de integratie van de service rol met de toezichthoudende rol van commissarissen en kunnen daarmee de strategische rol van commissarissen in de weg staan. Eén en ander impliceert dat vanuit een consensus perspectief kan worden beredeneerd dat de attributen van het one-tier model de strategische rol van commissarissen bevorderen terwijl de onafhankelijke structuur van het two-tier model een belemmering kan vormen voor de uitvoering van de strategische rol van commissarissen.

Hoofdstuk 5: Naar een convergentie van board modellen?

Het theoretisch kader in hoofdstuk drie geeft aan dat de samenstelling, de leiderschapstructuur en de organisatie van de raad in het two-tier model de scheiding tussen het dagelijks management van de onderneming en het toezicht hierop bewerkstelligen. De attributen van het one-tier board model corresponderen daarentegen meer met het consensus perspectief zoals beschreven in hoofdstuk vier van het proefschrift. Als we veronderstellen dat beide perspectieven ook in de nabije toekomst blijven rivaliseren in de vormgeving van corporate governance vraagstukken, dan ligt het gezien vanuit een conflict perspectief voor de hand dat geschikte attributen uit het two-tier board model in het one-tier board model worden overgenomen ter bevordering van de toezichthoudende rol van commissarissen. Evenzo ligt vanuit een consensus perspectief het overnemen van daartoe geëigende attributen uit het one-tier board model in het two-tier board model voor de hand ter bevordering van de strategische rol van commissarissen. Deze redenatie wordt in hoofdstuk vijf van het proefschrift verder uitgewerkt aan de hand van een theoretisch model.

Hoofdstuk 6: Empirisch onderzoek naar het one-tier board model in de Verenigde Staten

In hoofdstuk zes van het proefschrift wordt stilgestaan bij de formele structuur van boards of directors in de Verenigde Staten. Aan de hand van een formele beschrijving van de structuur en de samenstelling van boards of directors komt dit hoofdstuk tot de conclusie dat er diverse ontwikkelingen hebben plaatsgevonden tussen 1981 en 1997 in de governance structuur van Amerikaanse beursgenoteerde ondernemingen. Boards of directors besteden meer aandacht aan een onafhankelijk leiderschap van de board door de benoeming van “lead directors” en in een toenemende mate door het instellen van een scheiding tussen de taakvervulling van de CEO en de voorzitter van de board. Bovendien wordt er in toenemende mate gebruik gemaakt van toezichthoudende commissies die zijn samengesteld uit onafhankelijk non-executive directors. Ook het aantal executive directors is afgenomen ten gunste van een toename van het aantal non-executive directors. Deze ontwikkeling wijst op een transformatie van one-tier boards naar een meer onafhankelijke structuur ter ondersteuning van de toezichthoudende rol van boards of directors in de Verenigde Staten.

Hoofdstuk 7: Empirisch onderzoek naar het one-tier board model in het Verenigd Koninkrijk

Hoofdstuk zeven van het proefschrift concentreert zich op de samenstelling en de structuur van boards of directors in het Verenigd Koninkrijk. Naast een korte bespreking van de formele structuur van boards in beursgenoteerde ondernemingen richt de analyse in het hoofdstuk zich op “compliance reports” met betrekking tot de aanbevelingen van de Cadbury, de Greenbury en de Hampel commissies. Het hoofdstuk concludeert dat er diverse ontwikkelingen hebben plaatsgevonden tussen 1992 en 1997 in de samenstelling van boards, het gebruik van commissies en de scheiding van de rollen van de CEO en de rollen van de voorzitter van de board of directors. Hoewel de gemiddelde omvang van de board gelijk is gebleven, is er een verschuiving opgetreden in de samenstelling van boards. In toenemende mate nemen non-executive directors posities over van executive directors en boards worden in toenemende mate voorgezeten door non-executive directors. Ook deze ontwikkelingen wijzen op een transformatie van one-tier boards naar een meer onafhankelijke structuur ter ondersteuning van de toezichthoudende rol van boards of directors.

Hoofdstuk 8: Empirisch onderzoek naar het Nederlandse two-tier board model

In hoofdstuk acht van dit proefschrift wordt de ontwikkeling in raden van commissarissen aangegeven aan de hand van een onderzoek naar honderd Nederlandse ondernemingen met een beursnotering aan de Amsterdamse effectenbeurs. Het hoofdstuk concludeert dat ook het Nederlands commissariaat in beursgenoteerde ondernemingen in beweging is. Mede als gevolg van de aanbevelingen van de Commissie Peters maken bedrijven in toenemende mate gebruik van de mogelijkheid om in jaarverslagen gedetailleerd verslag te doen over de samenstelling, de structuur en de werkwijze van de raad van commissarissen. Met betrekking tot de ontwikkeling in de samenstelling van raden van commissarissen kan worden opgemerkt dat de doorstroming van leden van raden van bestuur naar raden van commissarissen opnieuw in de belangstelling is komen te staan. In de praktijk blijkt het aantal voormalige leden van raden van bestuur dat zitting heeft in raden van commissarissen van dezelfde onderneming relatief gering te zijn. Uit de analyse blijkt dat in 1998 in honderd Nederlandse beursgenoteerde ondernemingen 37 posities uit een totaal van 592 posities worden bekleed door commissarissen die vanuit de raad van bestuur zijn doorgestroomd naar de raad van commissarissen. In de omvang van raden van commissarissen heeft zich geen bijzondere ontwikkeling afgespeeld tussen 1987 en 1998. Wel blijkt dat de relatief geringe omvang van Nederlandse raden van invloed is op de instelling van commissies. Met een gemiddelde van zes commissarissen zijn Nederlandse raden over het algemeen te klein om de instelling van audit-, belonings- en benoemingscommissies te rechtvaardigen. Het zijn vooral ondernemingen met zeven of meer commissarissen die de laatste jaren commissies hebben ingesteld.

Het vrijwillig instellen van commissies wijst op de inpassing van one-tier elementen binnen het Nederlands model. Hierbij wijkt de gemiddelde samenstelling van Nederlandse board commissies af van de eerder genoemde Angelsaksische board commissies. Het blijkt gebruikelijk te zijn voor zowel leden van de raad van bestuur als voor leden van de raad van commissarissen om gezamenlijk in audit- en benoemingscommissies plaats te nemen. Zoals commissies de scheiding van rollen en verantwoordelijkheden van executive en non-executive directors kunnen ondersteunen, heeft de gelaagdheid van het Nederlands model een zekere invloed op de formele scheiding van uitvoering en toezicht. Althans, vanuit een conflict perspectief kan worden beredeneerd dat een formele scheiding de onafhankelijkheid van de raad van commissarissen bevordert. Het is dan ook interessant om te constateren dat Nederlandse commissarissen veelal met leden van de raad van bestuur vergaderen.

Hoofdstuk 9: Samenvatting, conclusies en aanbevelingen

Het laatste hoofdstuk van het proefschrift richt zich op de relevantie van de uitkomsten van het proefschrift voor onderzoekers, commissarissen, directors, vertegenwoordigers van aandelenbeurzen, institutionele beleggers en regelgevende instanties. Het hoofdstuk concludeert dat de analyses in hoofdstukken zes en zeven de eerste propositie van het onderzoek ondersteunen. De propositie stelt dat boards of directors in toenemende mate gebruik maken van attributen die de formele onafhankelijkheid van one-tier boards ondersteunen. Ook in Nederland zijn een aantal ontwikkelingen vastgesteld in de organisatie en de samenstelling van raden van commissarissen. Hoofdstuk acht constateert dat audit- belonings- en benoemingscommissies in toenemende mate worden gebruikt wanneer rekening wordt gehouden met de omvang van raden van commissarissen. Bovendien vinden vergaderingen van de raad veelal gezamenlijk plaats met de raad van bestuur. Kortom, deze bevindingen lijken de tweede propositie van het onderzoek te ondersteunen. Deze stelt dat raden van commissarissen gebruik maken van typische one-tier board elementen. Wat zijn hiervan nu de consequenties voor betrokkenen in het corporate governance debat?

Ten eerste lijken de ontwikkelingen aan te geven dat corporate governance niet alleen een aandachtsgebied is voor wetgevers en regelgevende instanties. Ook bedrijven en hun commissarissen geven blijk van de noodzaak tot het hebben van een goed corporate governance systeem. Dit blijkt uit het feit dat directors en commissarissen zich in toenemende mate richten op veranderingen in de organisatie en de samenstelling van boards of directors en raden van commissarissen. De introductie van nieuwe standaarden op het gebied van corporate governance, de internationalisering van ondernemingen, de toenemende aandacht van institutionele beleggers en de harmonisatie van financiële markten en internationale regelgeving lijken dan ook een stimulans voor non-executive directors en commissarissen te zijn om kennis te maken met nieuwe werkwijzen binnen de “boardroom” die geënt zijn op meer openheid en transparantie. Uit de analyse in het proefschrift blijkt ook dat aandelenbeurzen en institutionele beleggers in toenemende mate aandacht besteden aan de corporate governance structuur van beursgenoteerde ondernemingen. Bij de initiatieven van aandelenbeurzen staat het zelfregulerend vermogen van kapitaalmarkten centraal om nieuwe standaarden te ontwikkelen, vast te stellen en na te leven. Vooral de ontwikkelingen in de samenstelling en de structuur van boards in de Verenigde Staten en het Verenigd Koninkrijk suggereren dat zelfregulering een effectief en flexibel middel kan zijn om veranderingen in de corporate governance structuur van beursgenoteerde ondernemingen te bewerkstelligen. Hierdoor kan niet alleen eventuele nieuwe wetgeving voor ondernemingen worden voorkomen. Internationaal opererende ondernemingen kunnen ook een sterkere positie in kapitaalmarkten innemen als zij voldoen aan internationaal geaccepteerde corporate governance standaarden. Naast praktische implicaties worden er ook een aantal theoretische implicaties van de uitkomsten van het onderzoek in het proefschrift aangegeven. Zo blijkt dat er in de literatuur geen eenduidigheid bestaat over de invloed van de structuur en de samenstelling van raden van commissarissen op de financiële resultaten van ondernemingen.