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BOOMERANG EFFECT OF INCENTIVE AND HIGH REMUNERATION ON INDEPENDENCE OF BOARD MEMBERS

Abstract

In this article, the author deals with two issues related to the setting of adequate remuneration of independent members of board of directors. The first concerns the justifiability of negotiating variable remuneration, while the other deals with the issue of providing high pay. In both cases, the remuneration can render stimulative effects on the performance of independent directors. However, apart from the usual problems triggered by variable and high remuneration, these forms of compensation pose an additional problem in the case of independent directors – the possibility of compromising their independence (the so-called boomerang effect). The author of this article does not justify a priori the banning of certain variable remunerations or the provision of high remuneration of independent board members. He merely supports the idea that the extent to which such pay could impair the independence of each individual director should be determined individually.

Key words: *corporate governance, remuneration, variable pay, independent director, board of directors.*

I. IS THERE A NEED FOR THE REMUNERATION OF INDEPENDENT BOARD MEMBERS?

Over the past decades, the independence of board members represented the most significant highlight of corporate governance reforms concerning boards of directors.[1] Of the many changes that have been put on the table, very few gained as much support as the introduction and development of the concept of independent directors.[2] Everyone looks upon this practice of joint stock companies with favor, it inspires great expectations. Regardless of whether institutional investors, multinational corporations, associations of directors or stock markets are involved,

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1 Г. Коевски, *Компаративно корпоративно управување* [Comparative Corporate Governance] (Скопје, Правен Факултет 'Јустинијан Први' 2005) p. 218.

2 V. Brudney, 'The Independent Director – Heavenly City or Potemkin Village', 95 *Harvard Law Review* (1982) p. 597 at p. 598.

the appointment of independent directors is constantly being recommended as a good corporate governance practice.[3] Their expansion is considered to be the most widely accepted corporate governance reform measure in the past decade,[4] which has, due to evident and far-reaching legal consequences, been described as the most aggressive of all existing corporate strategies.[5]

Independent board members have been conceived as a means of settling numerous corporate governance problems.[6] However, time has shown that they themselves have created other problems and have triggered new legal issues. Hence, the issue of independent directors' remuneration stands out as a field in which final stands on the most significant moot points have not been taken in either theory or practice.

Right at the start, certain dilemmas emerge over the issue of whether independent directors should be paid remuneration for their work. The answer to this question reflects two distinct perceptions: traditional and modern.

Traditional perceptions are legally translated into recommendations according to which independent directors should not be remunerated, but should only be granted compensation for work-related expenses.[7] Within the framework of such perceptions, the function of an independent director is deemed prestigious and intellectually challenging, bearing numerous other privileges and great opportunities to build a fine reputation.[8] The desire for a good reputation will motivate independent directors to make decisions that are in the company's interest.[9] Directors presumably do not wish others to associate them with poorly performing companies or with those stigmatized for their corporate scandals, but rather wish their name to be connected to successful companies. Independent directors put their reputation on the line if they serve on the board of directors of a company facing financial problems. In such circumstances, their credibility and anticipated professionalism may be marred by negative performance assessments presented in the media, which in turn may reduce the number of their active memberships in boards of directors.[10]

3 J. J. Lawrence and G. P. Stapledon, 'Is Board Composition Important? A Study of Listed Australian Companies' (September, 1999), available at SSRN : http://ssrn.com/abstract=193528, pp. 2–3.

4 J. Farrar, *Corporate Governance in Australia and New Zealand* (Oxford University Press 2001) p. 346.

5 R. J. Gilson and R. Kraakman, 'Reinventing the Outside Director: an Agenda for Institutional Investors', 43 *Stanford Law Review* (1991) p. 863 at p. 872.

6 М. С. Васиљевић, *Корпоративно управљање – правни аспекти* [Corporate Governance – Legal Aspects] (Београд, Правни факултет Универзитета у Београду, Профинвест д.о.о. 2007) pp. 91–92.

7 Д. Марковић-Бајаловић, 'Управна и надзорна функција у отвореном акционарском друштву' [Administrative and Supervisory Function in Open Corporation], 5–8 *Право и привреда* (2005) p. 186 at p. 191.

8 B. R. Cheffins, *Company Law: Theory, Structure and Operation* (Oxford, Clarendon Press 1997, reprinted 2004) p. 101.

9 More about econimic analysis of this theory see: E. F. Fama and M. C. Jensen, 'Separation of Ownership and Control', 26 *Journal of Law and Economics* (1983) p. 301 at p. 315.

10 See B. R. Cheffins, op. cit. n. 8, at pp. 104–105.

The stimulatory effects of one's reputation are not reflected solely in one's desire to avoid being disgraced, but in reputation-based business opportunities as well.[11] This is something directors do not wish to miss. Through the successful performance of their duties, independent board members gain a reputation that makes them eligible for consultancy work and for appointment to new positions, including that of executive directors in other firms.[12] In case independent directors simultaneously hold positions of executive directors, which is the most common occurrence in practice, they are particularly motivated to avoid having their reputation blemished, because their primary employment depends on it.[13] *Summa summarum*, according to traditional views, the managerial labor market is perceived as a basic mechanism for disciplining independent board members, which does not make remuneration negotiations with such persons necessary.[14]

Modern perceptions rest on the opposite thesis that one should not exaggerate the impact of the position held by independent directors and of the manner in which they perform their work on their reputation-based market positioning. In a certain number of cases, the desire to enjoy a good reputation will most probably explain why independent directors work in the interest of the company. However, many arguments have been voiced against this perception, portending that reputation will have no bearing on a significant number, if not all, independent board members. Arguments listed below are particularly emphasized:[15]

- Signals received by the managerial labor market concerning the performance of individual independent directors are vague, particularly if a board of directors has a large number of members whose responsibilities are not strictly divided. This argument represents the concretization of a greater shortcoming whereby it is difficult to generally determine the extent to which independent directors perform their responsibilities properly.[16] Except in the cases of a small number of board members, the work of independent directors is generally invisible to third parties.[17] If the independent directors' market is inefficient or non-existent,[18] creating

11 J. N. Gordon, 'The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices', 59 *Stanford Law Review* (2007) p. 1465 at p. 1488.

12 B. R. Cheffins, op. cit. n. 8, at p. 104; Д. Марковић-Бајаловић, loc. cit. n. 7, at p. 191.

13 For more information on the fate of a number of independent members of Enron's board of directors in the aftermath of the financial collapse, see L. A. Bebchuk and J. M. Fried, *Pay Without Performance – The Unfulfilled Promise of Executive Compensation* (Harvard University Press 2004) p. 35.

14 See also E. F. Fama, 'Agency Problems and the Theory of the Firm', 88 *Journal of Political Economy* (1980) p. 288 at p. 294.

15 See also L. A. Bebchuk, J. M. Fried and David I. Walker, 'Managerial Power and Rent Extraction in the Design of Executive Compensation', 69 *University of Chicago Law Review* (2002) p. 751 at p. 771.

16 See also C. C. Nicholls, 'The Outside Director: Policeman or Policebo?', 38 *Canadian Business Law Journal* (2003) p. 323 at p. 340.

17 T. Clarke, *International Corporate Governance – a Comparative Approach* (Routledge 2007) p. 55.

18 Some authors believe that there is currently no proof of the existence of an efficient independent directors' market. See R. J. Gilson and R. Kraakman, op. cit. n. 5, at p. 876.

the reputation of a protector of shareholders' interests will not be of great significance.[19]

- The managerial labor market will focus primarily on the board members' primary job, not on their work in the capacity of independent directors.
- One might expect that a major number of independent directors will be less interested in maintaining or building the reputation of someone who protects shareholders' interests than in keeping their existing positions and retaining prospects for appointment to other boards of directors. The reputation of them opposing executive directors may blacklist independent board members and make them undesirable candidates for independent board member positions in other companies, which would vastly reduce their enthusiasm to act in the interest of the company.[20] For example, an independent director's reputation of being strongly opposed to high remuneration of general managers (CEO's) would probably be assessed negatively by appointment committees in other companies.[21]

The above-mentioned arguments unambiguously lead to the conclusion that joint stock companies must not depend exclusively on market forces as a guarantee that independent board members will perform their duties conscientiously. Instead, they need to provide them with adequate compensation.[22] Remuneration will presumably have a stimulative effect on independent board members, inciting them to assume a more responsible attitude towards their duties, which is why most joint stock companies implement this practice.

II. GENERAL POINTS ON THE INDEPENDENT BOARD MEMBER REMUNERATION STRUCTURE

The different structure of executive and non-executive (independent) board member remuneration should reflect all the specificities of the legal position held by these two categories of directors.[23] Remuneration is both a legal and (in economic terms) an incentive mechanism whose use should be adapted to the specific duties and responsibilities of independent board members. In essence, the principles pertinent to executive directors should also be applied to the remuneration of independent board members. Remuneration should primarily be sufficient to attract

19 N. G. Fernandes, 'Board Compensation and Firm Performance: The Role of 'Independent' Board Members' (December 2005), ECGI – Finance Working Paper No. 104/2005, available at SSRN: *http://ssrn.com/abstract=830244*, p. 16.

20 G. Ferrarini and N. Moloney, 'Executive Remuneration and Corporate Governance in the EU: Convergence, Divergence, and Reform Perspectives', in G. Ferrarini, et al., eds., *Reforming Company and Takeover Law in Europe* (Oxford University Press 2004) p. 302.

21 L. A. Bebchuk and J. M. Fried, op. cit. n. 13, at p. 36.

22 For more information on the need to provide independent board members with compensation, see J. B. Jacobs, 'Director Independence: a Moving Target', 10 *Corporate Governance Advisor* (2002) p. 1 at p. 7.

23 Securities Commission, *A Handbook for Directors, Executives, and Advisors* (Wellington, New Zealand 2004), available at: *www.sec-com.govt.nz/publications/documents/governance-principles/print.shtml*, 13.6.2010, Guideline 5.3.

and retain highly qualified individuals in independent board member positions. The remuneration amount for each independent member should correspond to his/her probable workload, job complexity and amount of potential responsibility.[24] Hence, the proportionality principle should be applied in a similar fashion to determining independent directors' remunerations.[25]

Remuneration of independent board members is negotiated in each individual case in line with a joint stock company's current remuneration policy. It is recommended that companies dedicate a separate section of their remuneration policy to independent board members only. In that way, the principles used to determine their remuneration are set in advance, objectively and impartially. In the part related to independent members only, the policy enables the adjustment of remuneration amounts to their specific legal position in the company and also limits the discretion of the company body negotiating remuneration in each individual case.

Remuneration of independent board members may include the following elements:[26]

1. annual fees, which are usually fixed amounts, although proposals emphasizing the many benefits of variable remuneration (primarily in the form of restricted shares and stock options) are voiced with growing frequency;
2. meeting fees for attendance at board of directors' meetings – according to some authors, payment of meeting fees should not become a customary practice, because it is understood that they are included in annual fees. This type of compensation should be provided if meetings are held outside company's seat;[27]
3. fixed (annual) fees for membership in specialized board of directors' committees,[28] provided separately for each individual committee;[29]

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24 D. Higgs, *Review of the Role and Effectiveness of Non-executive Directors* (January 2003) para. 12.24.

25 Certain corporate governance codes explicitly refer to the proportionality principle for independent board members. See UK Corporate Governance Code (June 2010), Provision D.1.3; UK Combined Code on Corporate Governance (June 2008), Provision B.1.3; Italian Comitato per la Corporate Governance (Corporate Governance Code, 2006), Provision 7.C.2.; Corporate Governance – The Ten Principles of Corporate Governance of the Luxembourg Stock Exchange (2006), Recommendation 8.8.; Cyprus Corporate Governance Code (March 2006), Provision B.2.6.

26 See D. Higgs, op. cit. n. 24, para. 12.24.

27 Ernst & Young LLP, *Directors' Remuneration – A Practical Guide to Setting the Pay and Benefits of Senior Executives* (Director Publications Ltd 2005) p. 36.

28 Separate payments for participation in the work of board of directors' committees is not customary in all EU Member States (e.g., Belgium), but is allowed in most of them. See European Corporate Governance Institute, *Directors' Remuneration in Listed Companies: Consolidated Answers for the 15 EU Member States*, 2003, pp. 121–123.

29 Practice in the United Kingdom has shown that membership in auditing committees is the most well paid, followed by that in remuneration committees, while membership in appointment committees is the least paid. Ernst & Young LLP, op. cit. n. 27, at p. 37.

4. fees for attending specialized board of directors' committee meetings;[30]
5. special fees for independent directors who also hold the position of board of directors' president, board of directors' vice president, head of non-executive board members (senior independent director) or chairman of a board of directors' committee – greater duties and responsibilities are additionally rewarded with the introduction of this fee.

Apart from providing the above-mentioned forms of compensation, joint stock companies are expected to cover all reasonable expenses incurred by independent board members in the execution of their duties (e.g., travel and administrative expenses).[31] It would be good practice to specify the right to expense reimbursement in contracts concluded between a company and an independent director.

III. THE BOOMERANG EFFECT OF CERTAIN FORMS OF REMUNERATION ON BOARD MEMBER INDEPENDENCE

Since the establishment of the concept of independent directors, efforts have been made within the corporate governance domain to find and implement mechanisms that would ensure their independence. However, ensuring independence in itself does not necessarily mean that such board members will perform their duties conscientiously. That is why increasing efforts have been made within the field of corporate governance, in the more recent years, to use remuneration as a suitable means of increasing potential benefits for independent board members in cases when they conduct efficient supervision of executive management performance. To that end, negotiation of variable and high remuneration with independent board members takes on a special role. Variable and/or high remuneration has been conceived as a complementary means of ensuring that the presence of independent members in boards of directors renders positive effects. What has not been anticipated is that variable and high pay can and most often does have negative impact on the independence of board members receiving such remuneration. Like a boomerang, the achievement of one corporate governance objective thus backfires in the form of adverse possibilities for the fulfillment of another objective.

IV. DISINCENTIVE EFFECTS OF VARIABLE REMUNERATION ON BOARD MEMBER INDEPENDENCE

Variable remuneration may be negotiated with independent directors in the same manner and for the achievement of the same objectives as in the case of executive directors. It should help link the interests of independent board members with the long-term interests of the company and its shareholders. With this form of remuneration, independent directors are incited to conduct supervision of the

30 A similar argument can be used against this sort of remuneration, as in the case of fees for attendance at meetings of the board of directors.

31 See D. Higgs, op. cit. n. 24, para. 12.25.

company's executive management efficiently, because company success brings them evident and certain material gain.[32] Variable remuneration places independent board members in the position of minority shareholders, rendering them shareholder orientation and ownership interest in the company.[33]

From the theoretical point of view, the answer to the question of whether or not variable remuneration of independent directors should be allowed boils down to one's perception of the role and importance of these board members in the corporate governance system. Those who look upon independent directors as protectors of shareholders' interests see higher variable remuneration as a better solution, because it enables the equalization of independent board members' and shareholders' interests. On the other hand, supporters of the view that independent directors protect the interests of all company stakeholders and not only of the shareholders, do not justify variable remuneration, because it would obviously favor one stakeholder at the expense of others.[34]

Today, under the obvious influence of tendencies streaming from the USA, it is recommended with growing frequency to increase variable remuneration of independent board members, both in the absolute amount and in relative terms with respect to the fixed remuneration. Some believe that all other forms of remuneration lead to the creation of passive board members and a tendency to accept executive managers' proposals unquestioningly.[35] However, despite these recommendations, corporate practice in Anglo-Saxon states shows that, unlike executive directors, a major part of the independent board members still holds a small number of company shares, which is not much of a stimulus.[36] If they were to become bigger shareholders, they would, due to their evident personal gain, be more motivated to do all they can to increase company value (e.g., they would oppose proposals for high remuneration of the company's executive directors more frequently).[37]

In theory, it was first agued that the provision of variable remuneration represented a problematic strategy for independent directors, because this sort of financial incentive had little significance for people holding such positions.[38] According to this (traditional) concept, independent directors accept a position of this kind primarily because it offers possibilities to establish potentially important business contacts, prestige and a good reputation on the managerial labor market.

32 'A shareholding mind-set will stimulate the outside directors to engage in the kind of active management oversight that so many boards fail to exercise.' C. M. Elson, 'Director Compensation and the Management-Captured Board – The History of a Symptom and a Cure', 50 *S. M. U. Law Review* (1996) p. 127 at p. 130.

33 See S. Shen and J. Jia, 'Will the Independent Director Institution Work in China?', 27 *Loy. L.A. Int'l & Comp. L. Rev.* (2005) p. 223 at p. 241.

34 See D. C. Clarke, 'Three Concepts of the Independent Director', 32 *Delaware Journal of Corporate Law* (2007) p. 73 at p. 91.

35 See C. M. Elson, loc. cit. n. 32, at p. 131.

36 See S. Bhagat and B. Black, 'The Uncertain Relationship Between Board Composition and Firm Performance', 54 *Business Lawyer* (1999) p. 921 at p. 951; G. Ferrarini and N. Moloney, loc. cit. n. 20, p. 303; B. R. Cheffins, op. cit. n. 8, p. 101.

37 See L. A. Bebchuk and J. M. Fried, op. cit. n. 13, at p. 35.

38 See also B. R. Cheffins, op. cit. n. 8, at p. 101.

Provided this assumption is correct, variable remuneration could unnecessarily double the already existing incentives for independent directors.[39]

In modern literature, the basic issue concerning the provision of variable remuneration of independent directors boils down to the following dilemma: does variable remuneration compromise the independence of these board members? By obtaining a significant number of company shares or stock options, independent directors become economically dependant on company's success, which has bearing on their impartiality in decision making.[40] They will be more focused on the price of shares than on company operation.[41] In the short-term, the direct link between independent directors' remuneration and company shares will diminish their motivation to discover and publicize all the irregularities in the company executive management's operation, because the market will usually react to such news with a reduction of stock prices. The bigger the independent directors' actual or potential share in capital, the smaller their interest in publicizing bad company news will be.[42] One should also have in mind that certain actions of independent directors may cause the commencement of bankruptcy proceedings, which would automatically destroy the value of their own investment. Therefore, variable remuneration, originally devised as a means of equalizing the interests of independent board members and shareholders, has, over time, become the reason for inefficient control of the executive directors.

Difficulties in finding adequate individuals for these positions poses an additional threat to company's offering variable remuneration. Most frequently, individuals who already hold certain executive positions are nominated for independent directors. The companies in which they are employed expect their full dedication in performing duties. That is why it is to be expected that such companies will take measures to prevent their executive directors from accepting independent director positions in other companies, if they are offered remuneration structured in such a way that they are awarded for their time and performance.[43]

It is well known that variable remuneration, as such, increases the tendency of board members to enter into risky business ventures lightly. Such tendency is particularly problematic and occurrent in the financial (particularly banking) sector, which is inherently characterized by a drive for excessive risk-taking,[44] while the state's role traditionally consists of limiting and discouraging it. Inadequate use of variable

39 The traditional perception of remuneration of independent directors and of limitations stemming from the exclusive reliance on the creation of a good reputation has already been mentioned above.

40 C. C. Nicholls, loc. cit. n. 16, at p. 336.

41 D. Higgs, op. cit. n. 24, para. 12.27.

42 See A. Hamdani and R. Kraakman, 'Rewarding Outside Directors', Harvard Law & Economics Discussion Paper No. 578, January 2007, available at SSRN: *http://papers.ssrn.com/abstract_id=959210*, p. 8.

43 See also B. R. Cheffins, op. cit. n. 8, at p. 102.

44 Among the reasons for the increased desire to take risks, the issue of moral hazard in banks stands out in particular. It gives investors (shareholders) particular stimulus to enter into risky ventures, because they enjoy all the positive effects and share negative consequences with the state which has insured deposits in case of bank bankruptcy proceedings. For further analysis of moral hazard in

remuneration is one of the universally recognizable factors that can inspire excessive risk-taking. The most recent financial crisis has demonstrated this in the best possible way.[45] A company that decides to provide independent directors with some form of stock-based variable remuneration cannot expect such individuals to exert influence on executive managers to refrain from entering into risky ventures. Hence, instead of curbing the urges of executive directors, independent directors themselves become interested in risky dealings due to the structure of their own pay.

Following this and similar lines of thinking, numerous authors, authoritative reports and corporate governance codes advocate the limitation or ban of variable remuneration of independent board members.[46] This can be done directly or indirectly. Some of the most notable ways of directly limiting variable remuneration of independent board members include: the possibility of negotiating that only a negligible portion of the remuneration be variable, the introduction of the need for mandatory prior consent from the company shareholders' meeting, the inability to dispose of shares received as remuneration for a certain period of time (e.g., one year) after the expiry of an independent director's board membership and the ban on the provision of specifically defined variable remuneration (most often stock options).[47] A ban can also be imposed indirectly by establishing the assumption that

banks see Lucian A. Bebchuk and Holger Spamann, 'Regulating Bankers' Pay', available at SSRN: *http://ssrn.com/abstract=1410072*, 1.6.2010, pp. 9–11.

45 Regardless of polarized perceptions of the role of independent board member remuneration in the creation and intensification of the financial crisis, the opinion that remuneration is not the basic cause of the crisis initiated in 2007–2008 is considered to be generally accepted today. However, it is deemed to have been a significant factor stimulating excessive risk-taking and has greatly contributed to the creation of losses in the financial sector. See Commission Recommendation on Remuneration Policies in the Financial Services Sector, C(2009) 3159, Brussels, 30.4.2009, Recital 2.

46 Cf. Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe (Winter Report), Brussels, 4 November 2002, p. 62; Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board (2005/162/EC), *Official Journal L 52/53*, 25.2.2005 (hereafter, Commission Recommendation on directors and committees), Annex II, Provision 1.(c); Cadbury Report (The Financial Aspects of Corporate Governance), 1 December 1992, No. 4.13; Hampel Report (Committee on Corporate Governance – Final Report), January 1998, No. 4.8; UK Combined Code on Corporate Governance, No. B.1.3 in connection with No. A.3.1; UK Corporate Governance Code (June 2010), Provision D.1.3; Austrian Code of Corporate Governance (2009), Rule 51; The 2009 Belgian Code on Corporate Governance (12 March 2009), Provision 7.7; Dutch Corporate Governance Code – Principles of Good Corporate Governance and Best Practice Provisions (10 December 2008), Principle III.7; Finnish Corporate Governance Code (20 October 2008), Recommendation No. 41; The Norwegian Code of Practice for Corporate Governance (21 October 2009), pp. 43–44; Cyprus Corporate Governance Code (March 2006), Provision B.2.6; Portugal – CMVM Corporate Governance Code 2010 (Recommendation), Provision II.1.5.1(viii); Corporate Governance – The Ten Principles of Corporate Governance of the Luxembourg Stock Exchange, Guideline in connection with Recommendation No. 8.8.; Iceland Corporate Governance Guidelines (June 2009), Guideline 2.5.

47 For more information on the need to limit the independent director's ability to sell shares for a set number of months upon leaving the company, see D. Marchesani, 'The Concept of Autonomy and the Independent Director of Public Corporations', 2 *Berkeley Business Law Journal* (2005) p. 315 at p. 339. Other authors believe that it is sufficient for the company to keep the shares until the expiration of the independent board members' mandate. See C. M. Elson, loc. cit. n. 32, at pp.

there is no independence in case a variable remuneration is negotiated. This is a negative assumption *in concreto*, which prevents a person from being considered an independent board member.[48] In other words, a person can be considered independent only if he or she does not receive variable remuneration, i.e., certain forms of variable remuneration.[49]

From a theoretical point of view, variable remuneration compromises the independence of a board member. Such conclusion stems from the very definition of an independent director who is said to be an individual whose function as a board member represents his only link with the company.[50] More specifically, a board member will not be deemed independent if he/she has business, family or other ties with persons he/she should be independent from, ties that influence or can influence his/her objective judgment in decision making.[51] A negative assumption of independence defined in such a manner, *in abstracto*, makes it possible to take into account all of a board member's ties with the company, the company's management and associated companies that can jeopardize his independence.[52] What is truly essential is that the tie will probably bring the board members' interests into conflict with those of the company, i.e., that it will probably direct his decision-making in a direction that may not be in line with company's interests. Variable remuneration fulfils these criteria, because it does or can impact a board member's objective and

130–131. According to some authors, the share holding periods may be shortened, but they cannot fully solve the issue of paying variable remuneration to independent directors. See A. Hamdani and R. Kraakman, loc. cit. n. 42, at p. 9.

48 Based on the level of abstractness, negative assumptions of independence can be classified as abstract and concrete, and their combined use should be regarded as an example of good corporate governance practice. That is why it is very important to first define in principle who will not be considered an independent board member (negative assumption of independence *in abstracto*) and then present the most relevant examples in legal terms (negative assumptions *in concreto*). See also V. Radović, 'Put ka nezavisnom upravnom odboru' [Towards an Independent Board of Directors], 12 *Pravni život* (2008) p. 73 at pp. 86–90.

49 Some corporate governance codes combine several direct and indirect techniques for limiting variable remuneration of independent board members. For example, the British Combined Code stipulates: firstly, that remuneration of independent directors should not include stock options; secondly, if independent directors are, nevertheless, granted option-based remuneration, it should be approved by the shareholders and the stock acquired cannot be disposed of for at least one year after the independent director leaves the board of directors; thirdly, holding stock options serves as a relevant criterion for determining a board members' independence (Provision B.1.3).

50 International Finance Corporation, *Corporate Governance Manual* (Belgrade 2007) p. 101. In states that allow independent directors to hold company shares, stock ownership is considered to be a permissible link with the company. See B. R. Cheffins, op. cit. n. 8, at p. 98.

51 See Corporate Governance Code of the Serbian Chamber of Commerce [*Кодекс корпоративног управљања Привредне коморе Србије*], *Official Gazette of the Republic of Serbia*, No. 1/2006 (hereafter, Serbian CG Code), Art. 140. Cf. Commission Recommendation on directors and committees, Provision 13.1.; UK Combined Code on Corporate Governance, Provision A.3.1; Business Roundtable, Principles of Corporate Governance (2005), p. 14; German Code of Corporate Governance (2009), Provision 5.4.2; Austrian Code of Corporate Governance, Rule 53; The 2009 Belgian Code on Corporate Governance, Principle 2, Provision 2.3; Corporate Governance – The Ten Principles of Corporate Governance of the Luxembourg Stock Exchange, Recommendation 3.5; Croatian Code of Corporate Governance, Provision 3.2.2.

52 See D. Marchesani, loc. cit. n. 47, at p. 338.

independent judgment in decision-making. It can never be said with certainty in advance whether a board member receiving variable remuneration will act in accordance with company's interests, because he/she also has personal ownership-related interests which can prevail in a specific case.

In theory, it is also argued that one should make a distinction between independent board member remuneration in restricted shares and in stock options, in the sense that bans should not apply to share-based remuneration, since it is believed that shares could have a positive impact on independent board members' motivation to supervise the work of other directors.[53] This very solution was, for instance, recommended by the European Commission. However, it broadened its personal scope of application to cover associated directors (i.e., all non-executive directors) and members of supervisory boards as well.[54] Such solution reflects an obvious and excessive fear of stock options as a form of remuneration, with them being considered the main cause of remuneration skyrocketing over the past decades. However, the distinction between remuneration in stock options and that in shares is insufficiently clear from the aspect of impact on board member independence, since both options may have negative impact on independence.

Recommendations to prohibit the negotiation of stock options with independent directors seem to be part of a current trend among large joint stock companies, which substitute stock options more and more frequently with shares remuneration. When Microsoft decided to provide its employees with compensation in the form of restricted (temporarily non-transferable) shares instead of stock options in 2003,[55] captivating headlines flooded the media stressing that the golden age of stock options was over and that an era of restricted shares was around the corner.[56] Since 2000, share-based remuneration has constantly been on the rise, unlike option-based compensation which is characterized by a downward trend.[57] Numerous authors oppose the tendency to substitute remuneration in stock options with

53 See K. J. Hopt, 'Modern Company and Capital Markets Problems: Improving European Corporate Governance After Enron', 3 *Journal of Corporate Law Studies* (2003) p. 221 at pp. 236 and 266.

54 Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies, C(2009) 3177, Brussels, 30.4.2009, Provision 4.4.

55 See Chris Gaither, 'Microsoft Drops Stock Options Workers to Get Shares Outright', *Boston Globe*, 9.7.2003; Todd Bishop, 'Microsoft to End Stock Options Employees Will Get Shares Instead, a Change Many See as Positive', *Seattle Post-Intelligencer*, 9.7.2003; Helen Jung, 'Microsoft Reverses Option Policy, Will Now Give Stock', *Chicago Sun-Times*, 9.7.2003.

56 See Robert A. Guth, Joann S. Lublin, 'Microsoft Ushers Out the Era of Options', *Wall Street Journal Online*, available at: *http://208.144.115.170/salaryhiring/options/20030714-guth1.html*, 24.8.2009; Joann S. Lublin, 'With Options Tainted, Companies Award Restricted Stock', *Wall Street Journal*, 3.3.2003, p. B1; 'Stock option 'golden age' may be over', *HR Magazine*, available at: *http://findarticles.com/p/articles/mi_m3495/is_8_49/ai_n6181409*, 24.8.2009.

57 According to 2007 figures, remuneration in shares makes up 33% of the total remuneration paid to top managers of the largest companies, while remuneration in stock options accounts for 25%. The same trend continued in 2008. See also David I. Walker, 'Evolving Executive Equity Compensation and the Limits of Optimal Contracting' (August 1, 2009), Boston University School of Law Working Paper No. 09–34, available at SSRN: *http://ssrn.com/abstract=1443170*, 15.6.2010, p. 18.

restricted shares remuneration.[58] Defining stock option agreements in a way that would help thwart implementation problems is recommended as a better solution. The same conclusion may be drawn for stock options as independent board member remuneration.

Under the influence of recommendations put forth in the Winter Report, the Corporate Governance Code of the Serbian Chamber of Commerce treats variable remuneration received by board members as a disqualifying criterion in measuring their independence.[59] Namely, a board member cannot be deemed independent if he/she receives remuneration dependent on company's performance (e.g., remuneration in shares, warrants, convertible and participative bonds, share in profit, etc.). Although it is in accordance with European tendencies, such solution completely closes the door on the use of variable remuneration for independent directors. It seems to have been more preferable after all to leave the possibility of negotiating variable pay with independent directors and defining appropriate limitations.

There do not seem to be reasons strong enough to prevent independent directors from receiving all forms and variations of variable remuneration. In fact, there are many types of variable remuneration that can justly be expected not to have negative impact on the independence of management members and that can even encourage them to perform their duties conscientiously. In that respect, one should underline the significance of so-called variable incentive remuneration, which incorporates all performance-based compensations and whose performance criterion is defined in a way that should help stimulate independent members of the management to work in the company's interest. A well-defined performance criterion (measurement) is the key to successful and efficient variable compensation, because errors in that respect can turn a variable compensation into a means of achieving the management's personal goals, while neglecting company's interests.

V. THE AMBIVALENT INCENTIVES OF INDEPENDENT BOARD MEMBERS' HIGH REMUNERATION

In more recent years, increases in the remuneration of independent board members have been common among joint stock companies in developed countries. The United States was in the lead in that respect,[60] but a similar trend was evident

58 See L. A. Bebchuk and J. M. Fried, op. cit. n. 13, at p. 171; C. Choe and X. Yin, 'Should Executive Stock Options be Abandoned?', 31 *Australian Journal of Management* (2006) p. 163 at p. 176.

59 Art. 241 Serbian CG Code.

60 At the turn of the new millennium, joint stock companies earmarked an average of approximately € 200,000 for independent directors' remuneration (€ 530,000 in large companies, € 35,000 in small companies). Non-executive directors receive an average of € 57,000 per year in large companies and € 17,000 in small companies. In major companies, average remuneration for a non-executive director amounts to € 92,000. N. G. Fernandes, loc. cit. n. 19, at p. 6. For details on the increase of remuneration for outside directors' in the top 500 US companies from 1994 to 1996 see: D. Yermack, 'Remuneration, Retention, and Reputation Incentives for Outside Directors', October 2003, NYU Working Paper No. S-CG–02–08, available at SSRN: *http://papers.ssrn.com/abstract=1295258*, 14.6.2010.

on other continents as well.[61] The intention was to make these positions more attractive through high pay,[62] which could help develop the market of candidates for independent directors.

However, the independence of board members can be jeopardized when they are given high pay, regardless of whether it is fixed or variable. That is why the extent to which high compensation impedes the assumption of directors' independence is indicated as a problem.[63] Due to increased expenses of leaving a board of directors, high remuneration stimulates independent directors to do all they can to avoid losing such a lucrative position. Since the CEO and other executives play an important, if not decisive, role in setting remuneration levels, independent directors will hesitate to confront them strongly. Even in case an independent board member believes he/she would increase the value of company shares through more efficient supervision, he/she will desist from such efforts, wishing to secure a seat on the board of directors the following year, including high pay.[64] Due to the potential risk of diminishing the financial independence of independent board members, some authors advise joint stock companies to refrain from negotiating high remuneration in their effort to counter inadequate stimuli.[65]

The nature of the impact of high remuneration on independence cannot be determined abstractly, since it depends on many factors. For instance, high pay promised to a billionaire for appointment to a board of directors in the capacity of independent member does not affect his independence, while high remuneration offered to a university professor with average earnings may create different incentive.[66] That is precisely why attention is drawn to the possibility that the very people we wish to see the most in a board of directors as independent members, i.e., highly competent experts with moderate annual earnings, will not be prepared to accept these positions because of the public perception that they are not independent.[67] Every company must be aware that high remuneration may, in some cases, motivate independent board members to perform their duties more meticulously and successfully. However, in other cases it can have just the opposite effect. The fact that every independent director of Enron received over $ 300,000 a year in stock options alone, while some received over $ 800,000, does not support the thesis that there was a causal link between the remuneration levels and their performance.[68]

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61 Research in the United Kingdom has shown that the average compensation for non-executive directors in the country's top 100 companies stands at £ 44,000, while other companies offer an average of £ 23,000. D. Higgs, op. cit. n. 24, para. 12.20.

62 N. G. Fernandes, loc. cit. n. 19, at p. 16.

63 See J. B. Jacobs, loc. cit. n. 22, at p. 7.

64 See A. Hamdani and Reinier Kraakman, loc. cit. n. 42, at p. 10.

65 See R. J. Gilson and R. Kraakman, loc. cit. n. 5, at p. 875.

66 Some authors find wealthy individuals to be ideal candidates for independent board members, because their wealth serves as a guarantee that they will freely voice opinions that are contrary to those of the company's general manager without fear of losing the position of board member. See B. R. Cheffins and B. S. Black, 'Outside Director Liability Across Countries', 84 *Texas Law Review* (2006) p. 1385 at pp. 1479–1480.

67 See also J. B. Jacobs, loc. cit. n. 22, at p. 7.

68 Idem.

The above-mentioned leads to the conclusion that the level of independent board member remuneration creates a Catch–22 situation, because high pay impedes independence, while low pay implies a lack of adequate economic incentive.[69] Hence, from the aspect of corporate governance, it is very important to take into account all the personal circumstances concerning a specific board member when setting the amount of his/her remuneration, particularly his/her property and earnings from other sources. The concept of high remuneration is of a relative character and cannot be determined in advance. Instead, it is set only in relation to a specific board member. Thus, it may so happen that a company pays different remuneration amounts to different board members for the same job and the same expectations. Wealthy individuals will customarily receive higher compensation, while those of a more modest financial status will receive lower pay. Naturally, in theoretical terms, the personal traits of a certain individual (e.g., conscientiousness, reliability, diligence, honesty, etc.) serve as the decisive factor in determining the remuneration level, so that the financial status may not necessarily be decisive.

VI. CONCLUSION

Independent board members may be expected to respond to the tasks assigned to them only if their independence is ensured and if they are motivated (primarily by way of remuneration) to achieve better results through incentive mechanisms. Practice has shown that, despite the development of potentially strong stimuli to act in the interest of the company, the use of variable and high remuneration has negative bearing on the independence of board members. One cannot say with certainty that persons who receive such remuneration fulfill the condition of being independent.

This paper does not advocate the banning of high pay or of any form of variable remuneration to independent board members. It is an indisputable fact that high and variable remuneration may compromise the independence of directors. However, based on this, one cannot draw the conclusion that compensation of this kind compromises independence in any case. On the contrary, everything depends on the circumstances surrounding a specific case, because independence cannot be determined abstractly – it also depends on the personal traits of each individual board member.

69 S. Shen, J. Jia, loc. cit. n. 33, at p. 239.