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Renewed Focus on Corporate Director Tenure

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The issue of director tenure recently has garnered significant attention both in the United States and abroad. U.S. public companies generally do not have specific term limits on director service, though some indicate in their bylaws a "mandatory" retirement age for directors—typically between 72 and 75—which can generally be waived by the board of directors. Importantly, there are no regulations or laws in the United States under which a long tenure would, by itself, prevent a director from qualifying as independent.

Institutional Shareholder Services (ISS) and other shareholder activist groups are beginning to include director tenure in their checklists as an element of director independence and board composition. Yet even these groups acknowledge that there is no ideal term limit applicable to all directors, given the highly fact-specific context in which an individual director's tenure must be evaluated. In our view, director tenure is an issue that is best left to boards to address individually, both as to board policy, if any, and as to specific directors, should the need arise. Boards should and do engage in annual director evaluations and self-assessment, and shareholders are best served when they do not attempt to artificially constrain the board's ability to exercise its judgment and discretion in the best interests of the company. In addition, much the same way boards consider CEO succession issues, boards are beginning to address director succession issues as well.

Director Tenure in the United States

According to executive recruiting firm SpencerStuart, the average tenure of directors at S&P 500 companies in 2013 and 2012 was 8.6 years.[1] The average tenure of CEOs was close, at 7.2 years, in both 2013 and 2012.[2] ISS reports that the average tenure of S&P 1500 directors was 10.8 years in 2013, an increase from 10.3 years in 2012.[3] Very few U.S. companies—only 3 percent of the S&P 500—have term limits for directors, none of which is less than 10 years.[4]

There appears to be a recent trend toward raising retirement ages and extending board service as valuable directors grow older. In the S&P 500, over the last 10 years, the percentage of boards with a mandatory retirement age of 70 has decreased from 51 percent to 11 percent, while the percentage of boards with a mandatory retirement age of 75 or greater has increased from 3 percent to 24 percent.[5] Meanwhile, the average age of independent directors in this group has increased from 60 to 63.[6] Board turnover was reported last year to be at a 10-year low; one source reports that 291 board seats turned over at S&P 500 companies in 2012, as compared to 401 in 2002.[7]

Despite these trends, boards are steadily becoming more diverse.[8] Long tenure is often cited as an obstacle to achieving board diversity,[9] yet current patterns of tenure and retirement have not prevented increases in gender and racial diversity on U.S. boards. The number of women directors continues to rise; at S&P 500 companies, the percentage with at least one woman director has grown in the last decade from 85 percent to 93 percent, and the total percentage of women directors has increased from 13 percent to 18 percent.[10] Minority representation has also increased in this timeframe, as has the percentage of independent directors of non-U.S. origin.[11]

In the United States and Canada, regulators have wisely refrained from adopting guidelines regarding director tenure. Long tenure on a corporate board historically has been understood—and demonstrated—to be an asset to board effectiveness and a feature that goes hand-in-hand with solid corporate performance and good management. Having a core group of long-term directors has been seen as beneficial to board dynamics as well as to the relationship between the board and management.[12] According to some estimates, new directors require between three and five years to acquire sufficient company-specific knowledge,[13] with more time required for directors of companies with complex operations and more intangible assets.[14] Long-serving outside directors thus are highly valued for their experience and organizational memory. Often, they have made important and useful industry connections over the course of their careers. Such directors frequently have gained a deep understanding of the relevant industry, and in board discussions they can offer historical context for consideration in corporate strategic decisionmaking. These resources are particularly valuable to a company whose business is highly complex or whose significant projects have unusually long-term horizons for completion.[15]

In recent years, activists' attempts to micromanage the boardroom have begun to complicate the traditional view. Boards with many long-serving directors are now described as "entrenched" and deaf to shareholder concerns.[16] Critics posit that older directors—who are typically the longer-tenured directors—can no longer keep current with respect to industrial or technological developments and are unable to offer new insights into corporate issues; they fear that these directors may hold fossilized positions that are no longer relevant in the changing economic and business environment.[17] Some argue that extended board service can create a culture of undue deference to management, particularly in cases where the chief executive also has held the position for many years. While these may be valid concerns in isolated situations, it is often the case that older directors are among the savviest and most skilled board members, and that long-tenured directors may be in the best position to manage a powerful chief executive by virtue of their shared history and many years of building trust and collegiality together. Whether the advantages outweigh the disadvantages of long tenure for any given director on any particular board ultimately can only be evaluated by considering the specific circumstances. As with many other important elements of corporate governance, in matters of director tenure, one size does not fit all.

Director Tenure Abroad

A growing number of countries have adopted tenure-related guidelines or restrictions for independent directors.[18] With very few exceptions, the "comply and explain" model prevails, and the recommended maximum tenure for a corporate director is between nine and 12 years. The European Commission recommends that independent directors serve a maximum of three terms or 12 years.[19] In the United Kingdom, the U.K. Corporate Governance Code (formerly known as the Combined Code) provides that a board should explain, in its annual disclosures, its reasons for determining that a director who has served more than nine years qualifies as independent.[20] The average tenure of a U.K. director is less than five years.[21] In Hong Kong, an independent director is limited to a three-term, nine-year maximum tenure unless shareholders separately vote on a resolution permitting re-appointment, which should include the board's justification for determining his or her independence.[22] Singapore recommends "rigorous review" of the independence of a director who has served more than nine years, and the board is expected to explain any determination of independence in such case.[23] In France, the only country with a mandatory regime, directors may not be deemed independent after the end of a term in which they reach 12 years of service on the board.[24] The French rule creates an effective term limit, as longer-serving directors are not eligible for audit committee membership or other board roles left to independent directors.

In Australia, a recent move toward a recommended term limit was quashed by significant opposition. The Australia Stock Exchange Governance Council, an advisory committee that includes business, shareholder, and industry groups, last year proposed a "comply or explain" guideline that ASX-listed companies' independent directors be limited to nine years of service.

Reportedly, pressure from several of the country's largest companies resulted in the Council's dropping the tenure restriction in its final guidelines.[25] The final report incorporates references to tenure limits, recommending that one factor to be considered in assessing director independence is whether the individual "has been a director of the entity for such a period that his or her independence may have been compromised."[26] The commentary expands on this point:

> The mere fact that a director has served on a board for a substantial period does not mean that he or she has become too close to management to be considered independent. However, the board should regularly assess whether that might be the case for any director who has served in that position for more than ten years.[27]

According to one source, 21 percent of nonexecutive directors at the top 50 listed companies in Australia have directors who had served at least nine years.[28] The Australian episode demonstrates that strong opposition to director tenure limits still exists abroad despite the increasing international popularity of such policies.

Academic Studies

Academic researchers have examined the question of whether there is an optimal length of tenure for outside directors, with varying results. Studies from the 1980s through the 2000s have shown, for example, that longer tenure tends to increase director independence because it fosters camaraderie and improves the ability of directors to evaluate management without risking social isolation.[29] A 2010 study confirmed that companies with high average board tenure (roughly eight or more years) performed better than those companies with lower average board tenure, and that companies with diverse board tenure performed better than those with homogeneity in tenure.[30] A 2011 study, by contrast, examined a sample of S&P 1500 boards and found that long-serving directors (roughly six or more years)—as well as directors who served on many boards, older directors, and outside directors—were more likely to be associated with corporate governance problems at the companies they served.[31] One 2012 study found that boards with a higher proportion of long-serving outside directors were more effective in fulfilling their monitoring and advising responsibilities,[32] while another 2012 study found that having inside directors increased a board's effectiveness in monitoring real earnings management and financial reporting behavior, presumably due to their superior firm-specific knowledge and operational sophistication.[33] On the related topic of board turnover, a recent study of S&P 500 companies from 2003 to 2013 found that companies that replaced three or four directors over the three-year period outperformed their peers.[34] The study found further that two-thirds of companies did not experience this optimal turnover and that the worst-performing companies had either no director changes at all or five or more changes during the three-year period.[35]

A 2013 study on director tenure by a professor from the INSEAD Business School has received significant attention. The study hypothesizes that there is a tradeoff between independence and expertise for outside directors—a prejudgment that is widely disputed[36]—and examines the effect of tenure on the monitoring and advising capacities of the board.[37] After review of over 2,000 companies, the author finds that the optimal average tenure for an outside director is between seven and 11 years, though industry- and company-specific factors create substantial variability.[38] He concludes that nine years is generally the optimal point at which a director has accumulated the benefits of firm-specific knowledge but has not yet accumulated the costs of entrenchment.[39] As a policy matter, however, he suggests that in light of the significant variations across industries and company characteristics, regulating director tenure with a single mandatory term limit would not be appropriate.[40]

Taken together, the academic studies show that conclusions about optimal director tenure are elusive. Common sense indicates that a board should use tenure benchmarks not as limits but as opportunities to evaluate the current mix of board composition, diversity, and experience.

Activists and Term Limits

Shareholder groups have begun to highlight the issue of director tenure. The Council of Institutional Investors (CII) last year announced a new policy calling for boards to evaluate director tenure when assessing director independence.[41] The statement accompanying the policy change suggested that long tenure can affect a director's "unbiased judgment" and asserted that "[e]xtended tenure can lead an outside director to start to think more like an insider."[42] Nonetheless, CII stopped short of endorsing a tenure limit, noting that "[r]equiring all directors to step down after a certain number of years could rob the board of critical expertise."[43]

Beginning in the 2014 proxy season, ISS offered a new product called Governance QuickScore 2.0, which uses specific governance factors and technical specifications to rate public company governance.[44] Company ratings (based on data that companies may review and correct) were released in February, and the scores are included in proxy research reports issued to institutional shareholders. ISS has stated that it will use corporate public disclosures to update ratings on a continuous basis throughout the year. Director tenure will now factor into a company's rating: ISS views tenure of more than nine years as "excessive" by virtue of "potentially compromis[ing] a director's independence."[45] Having long-tenured directors thus may negatively affect a company's score.

While the factors ISS uses to produce a company's rating are public, the specific calculation methodology is not. There is no reason to believe that a rating generated by this new product will bear any relation to the actual quality of governance or financial performance of a particular company. The very name of the QuickScore metric alludes to the superficiality of its mechanically derived results, generated without regard to the fact-specific circumstances of a board of directors and the real-world needs of the company it supervises.

Governance QuickScore 2.0 is an outlier with respect to director tenure—not in terms of the nine-year limit, which may well have been determined by reference to the policies of some foreign countries and perhaps even to the 2013 study mentioned above—but in considering any longer service to be automatically detrimental. We are not aware of any country whose governance guidelines create a mandatory maximum of nine years for a corporate director. While various countries use the three-term, nine-year time frame as a benchmark, they recognize that boards may indeed have excellent reasons to extend a director's term well beyond that limit. Hence the flexibility of the "comply-or-explain" model, which requires a board to consider director tenure and communicate with its shareholders, yet still preserves the board's ability to make informed decisions for the company using its business judgment.

Outside of the QuickScore product, ISS itself recognizes the wisdom of a more reasonable approach. The ISS 2014 Proxy Voting Manual discusses the pros and cons of limiting director tenure and contains the following, eminently reasonable, language on director retirement age and term limits:

> Rather than impose a narrow rule on director tenure, shareholders gain much more by retaining the ability to evaluate and cast their vote on all director nominees once a year and by encouraging companies to perform periodic director evaluations.[46]

Accordingly, ISS offers the following proxy voting policy for U.S. companies in 2014:

> Vote against management and shareholder proposals to limit the tenure of outside directors through mandatory retirement ages. Vote against management proposals to limit the tenure of outside directors through term limits. However, scrutinize boards where the average tenure of all directors exceeds fifteen years for independence from management and for sufficient turnover to ensure that new perspectives are being added to the board.[47]

ISS endorses—rightly, in our view—a robust director evaluation process, conducted annually by the corporate governance or nominating committee of the board.

Board Judgment

It is unfortunate that the tenure of outside directors may become yet another point of controversy in shareholder activists' ongoing efforts to dictate ever more elaborate standards for director independence and board composition. There is no reason to believe that extended director service does, in and of itself, compromise director independence. Indeed, as the studies mentioned above suggest, factors ranging from industry-wide characteristics all the way to company-, board- and candidate-specific elements can be meaningful in assessing appropriate director tenure. Term limits, like any bright-line rule, may offer superficial appeal, but the potential downside is that valuable directors may be forced off the board in circumstances that would be detrimental to the board, the company, and the shareholders.[48] Moreover, term limits can interfere with the development of effective collaboration among board members, a crucial element of a successful board and one than can be built only over a period of time. "In the end, creating a stellar Board of Directors is part science, part art."[49]

Many arguments both for and against long tenure are valid. The debate can best be resolved in individual cases by reference to the facts on the ground, and no arbiter is better positioned to determine the appropriate length of service of a director than the board as a whole. Companies and their shareholders should resist any pressure to establish term limits, a mandatory retirement age, or another mechanism that would constrain board discretion in evaluating the effectiveness and performance of individual directors. With annual evaluations and self-assessments, most boards monitor and manage their own performance quite effectively, and they should continue to have the latitude to determine the tenure of their directors in light of their conclusions regarding the needs of the company. As a general matter, this country is well served by directors' using their business judgment to act in an informed manner in furtherance of the best interests of the company and its shareholders, and the area of director tenure is no exception.

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Endnotes:

1. SpencerStuart Board Index 2013 at 17.

2. See id.

3. ISS 2014 U.S. Proxy Voting Manual at 37. See also Vipal Monga, "Board Directors Are Extending Their Tenures," CFO Journal, WSJonline, April 1, 2014. An investigation by the Wall Street Journal found that 28 outside directors in the Russell 3000 had served on a single board for at least 40 years. See Joanne S. Lublin, "The 40-Year Club: America's Longest-Serving Directors," Wall St. J., July 16, 2013.

4. See SpencerStuart Board Index 2013 at 15. One oft-cited example of a U.S. company with term limits is Target Corporation, which recently raised its directors' term limit from 15 to 20 years. See Target Corporate Governance Guidelines, §24, November 2013, available at www.target.com.

5. See SpencerStuart Board Index 2013 at 6.

6. See id.

7. See Carol Hymowitz and Jeff Green, "Corporate Directors Get Older, Hold Their Seats Longer," Bloomberg Businessweek, May 23, 2013.

8. As we have previously discussed, while diversity on U.S. boards of directors has improved in recent years, significant additional improvement is both desirable and necessary. See David A. Katz and Laura A. McIntosh, "Developments Regarding Gender Diversity on Public Boards," N.Y.L.J., Oct. 31, 2013.

9. See, e.g., Kimberly Gladman & Michelle Lamb, "Director Tenure and Gender Diversity in the United States: A Scenario Analysis," GMI Ratings, June 2013, available at www.gmiratings.com.

10. See SpencerStuart Board Index 2013 at 6.

11. See id. at 19-20.

12. See, e.g., Judy Canavan et al., "Board tenure: How long is too long?" Directors & Boards, Board Guidelines 2004, at 39 available at www.highbeam.com/doc/1G1-114244181.html.

13. See Raymond K. Van Ness et al., "Board of Director Composition and Financial Performance in a Sarbanes-Oxley World," Academy of Business & Economics Journal10 (5),

56-74 (2010), at 8 available at w
ww.albany.edu/faculty/vanness/AA/ARTICLES/DirectorSOX.pdf.

14. See Sterling Huang, "Zombie Boards: Board Tenure and Firm Performance," July 2013 Draft, at 30, available at papers.ssrn.com/sol3/papers.cfm?abstract_id=2302917.

15. See, e.g., BHP Billiton, Submission to the ASX Corporate Governance Council, Nov. 15, 2013 ("[W]e believe that particularly in a long-cycle business such as ours, governance is enhanced by having a balance of longer serving Directors … . Formulaic considerations of tenure should not override the other considerations of independence and the proven ability of Directors to be able to exercise independent judgement and act in the best interests of the Group and shareholders."), available at www.asx.com.au/documents/public-consultations/bhp_submission.pdf.

16. See, e.g., Hymowitz and Green, supra note 7.

17. See, e.g., Canavan et al., supra note 12.

18. See, e.g., Janet McFarland, "Countries Set out Rules on Directors' Tenure," theglobeandmail.com, Nov. 24, 2013 available at www.theglobeandmail.com/report-on-business/careers/management/board-games-2013/countries-set-out-rules-on-directors-tenure/article15574442/.

19. See Official Journal of the European Union, Commission Recommendation of 15 February 2005, Annex II, "Profile of Independent Non-Executive or Supervisory Directors," Section 1(h), available at eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2005:052:0051:0063:EN:PDF.

20. The U.K. Corporate Governance Code B.1.1 (September 2012), available at www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx.

21. "Investors Focus More Attention on Director Tenure," Society of Corp. Secretaries & Governance Professionals, July 30, 2013 (citing a Grant Thornton survey of 2012 data).

22. HKEx Corporate Governance Code and Corporate Governance Report A.4.3, available at www.hkex.com.hk/eng/rulesreg/listrules/mbrules/documents/appendix_14.pdf (updated per HKEx Consultation Conclusions on Review of the Corporate Governance Code and Associated Listing Rules, Oct. 28, 2011).

23. Singapore Code of Corporate Governance 2.4 (May 2, 2012), available at www.ecgi.org/codes/documents/cg_code_singapore_2may2012_en.pdf.

24. Afep-Medef Code, Corporate Governance Code of Listed Corporations Section 9.4 (June 2013), available at www.ecgi.org/codes/documents/afep_medef_code_revision_jun2013_en.pdf.

25. See Ross Kelly, "Australia Backs Away from Proposed Director-Tenure Cap," Asian Business News, March 25, 2014.

26. ASX Governance Council, Corporate Governance Principles and Recommendations (Third Edition), March 27, 2014, at 16, available at www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-3rd-edn.pdf.

27. Id. at 17.

28. See Kelly, supra note 25.

29. See Van Ness, supra note 13, at 8-9 (citing various studies) .

30. See id. at 18.

31. See Greg Berberich and Flora Niu, "Director Busyness, Director Tenure and the Likelihood of Encountering Corporate Governance Problems," January 2011, at 5, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1742483.

32. See ISS Benchmark Policy Consultation, "Director Tenure (US and Canada)," 2014, available at www.issgovernance.com/file/files/Directortenure-USandCanada.pdf.

33. See Jeff Zeyun Chen et al., "Can Inside Directors Be Effective Monitors?—Evidence from Real Activities Manipulation," Aug. 24, 2012 Draft, available at business.gwu.edu/accountancy/workshops/files/katherine percent20gunny.pdf.

34. See George M. Anderson & David Chun, "How Much Board Turnover Is Best?" Harvard Business Review, April 2014, available at hbr.org/2014/04/how-much-board-turnover-is-best/ar/pr.

35. See id.

36. See, e.g., Van Ness et al., supra note 13.

37. See Huang, supra note 14. The study examined 2009 data.

38. See id. at 30-32.

39. See id. at 4-5.

40. See id. at 7.

41. See Amy Borus, "More on CII's New Policies on Universal Proxy and Board Tenure," Council of Institutional Investors, Oct. 1, 2013, available at www.cii.org/article_content.asp?article=208.

42. Id.

43. Id.

44. For more information on Governance QuickScore 2.0, see David A. Katz et al., "ISS QuickScore 2.0," Wachtell, Lipton, & Katz Client Memorandum, Jan. 28, 2014, available at www.wlrk.com; see also ISS' website, www.issgovernance.com/governance-solutions/investment-tools-data/quickscore.

45. See ISS' website, www.issgovernance.com/governance-solutions/investment-tools-data/quickscore.

46. ISS 2014 U.S. Proxy Voting Manual at 39.

47. Id. at 37.

48. See, e.g., Carnavan et al., supra, at 41.

49. Amy Errett, "The Dream Team: What it Takes to Build an Effective Board of Directors," Maveron Features (2011), available at www.maveron.com/blog/2011/10/the-dream-team-what-it-takes-to-build-an-effective-board-of-directors/.