Director Tenure: The Next Boardroom Battle

by William M. Libit and Todd E. Freier

A December article on long-tenured board members in *The Wall Street Journal* drew the governance spotlight to an issue of growing concern. Many activists and funds are starting to question how long-serving directors can really still be considered "independent." Further, sluggish board turnover weakens diversity efforts, and hobbles attempts to refresh boardroom skills.

Director tenure, board entrenchment and board refreshment are corporate governance buzzwords, and increasingly hot-button issues for institutional investors, proxy advisory firms, shareholder activists and other governance advocates. One board's "experienced and knowledgeable" director, however, may be viewed by a shareholder activist as an "entrenched" director.

Although various stakeholder groups may differ as to whether a board should adopt a policy explicitly limiting the number of years (or terms) a director may serve, there is little debate that the issue is under heightened scrutiny. Contributing to that debate are conflicting research findings and persuasive arguments supporting both sides of the issue.

There is growing concern among corporate governance advocates that once a director reaches a particular tenure, independence from management may become compromised.

The focus on director tenure is taking place against a landscape where companies have raised "mandatory" director retirement ages. This trend makes it difficult for companies to respond to calls to increase gender and racial diversity on boards.

Board diversity itself is a hot-button topic for corporate governance advocates, including shareholder activists. Since 2008, such activists have submitted approximately 100 proposals (more than half in 2013 and 2014 alone) requesting that U.S. companies adopt board diversity policies and undertake diversity-related initiatives.

Further contributing to the director tenure debate are survey results showing that despite the fact that two-thirds of directors believe it is important to refresh the board with new members, directors rated themselves least effective in encouraging board turnover to create a board that has a balance of needed skills and diversity.

There is also growing concern among institutional investors, proxy advisory firms, shareholder activists and other corporate governance advocates that once a director reaches a particular tenure, independence from management may become compromised. Institutional Shareholder Services Inc. found that 74 percent of surveyed institutional investors indicated that long director tenure is problematic. Advocates argue that lengthy director tenure entrenches current board members, and inhibits board diversity efforts and new perspectives, skills and ideas. In 2014, the average tenure of directors at S&P 500 companies was 8.4 years, down from 8.6 years in 2013.

Despite this growing focus on director tenure, most U.S. public companies do not explicitly address the issue in their corporate governance documents, or place term limits on their board members. One study revealed that only 16 boards (or three percent) of S&P 500 companies have director term limits in their corporate governance guidelines (none of which is less than 10 years). Sixty-five percent explicitly state that they do not have term limits and 32 percent do not mention them at all. In another survey, 77 percent of directors stated that their board was not

William M. Libit *is a partner and* **Todd E. Freier** *senior counsel with the law firm of Chapman and Cutler LLP. [www.chapman.com]*

even considering or discussing the issue of director term limits.

Although most U.S. public companies lack a formal director tenure policy, many have adopted a mandatory retirement age. Like director tenure, mandatory board retirement policies are a hotly debated corporate governance topic. Companies argue, however, that such policies effectively manage and address many of the concerns associated with lengthy director tenure.

It is vital to stay abreast of developments on the director tenure policies of large institutional investors, proxy advisory firms, and other corporate governance advocates.

Boards and management need to implement corporate governance practices that are best for their company, and which generate long-term value for their shareholders. Thus, it is important that they stay abreast of developments on the director tenure-related policies of their largest institutional investors, proxy advisory firms, and other corporate governance advocates.

☐ ***Institutional Investers: Asset managers.*** The current director tenure position of the country's top five asset managers is as follows:

▫ *BlackRock, Inc.* encourages boards to routinely refresh their membership to ensure that new viewpoints are included in the boardroom. BlackRock typically votes "against" shareholder proposals imposing arbitrary limits on the pool of directors from which shareholders can choose their representatives. BlackRock will, however, generally defer to the board's determination that age or term limits are the most efficient mechanism for ensuring routine board refreshment.

▫ *State Street Global Advisors* may vote "against" certain directors when overall average board or individual director tenure is excessive. Through this policy, it is expected that long-tenured directors will refrain from serving on the audit, compensation and nominating/governance committees.

State Street may vote "against" the chair of the nominating/governance committee for failing to adequately address board refreshment and director succession, long-tenured directors who serve on key committees, or members of the nominating/governance committee and long-tenured directors at companies with classified boards.

▫ *The Vanguard Group, Inc.* has no formal policy. However, Vanguard's chairman and CEO has noted that if a board has a director with tenure considered excessive by State Street, it is conceivable that Vanguard might have similar questions as to why that board member is still serving.

▫ *Allianz Asset Management AG* generally does not support minimum or maximum director age or tenure limits.

▫ *Fidelity Investments* has no formal policy.

☐ ***Institutional Investors: Public pension funds.*** The current director tenure position of several of the country's largest public pension funds are as follows:

▫ *California Public Employees' Retirement System (CalPERS)* maintains that boards should consider all relevant facts and circumstances to determine whether a director should be considered independent, including the director's years of service on the board. CalPERS believes that boards should have routine discussions on director refreshment to ensure they maintain the necessary mix of skills and experience to meet strategic objectives. Boards should also develop and disclose a policy on director tenure.

▫ *California State Teachers' Retirement System (CalSTRS)* does not support limiting director tenure, although boards should review each director's tenure as part of their comprehensive review of the board (as part of that review, boards should ensure periodic refreshment of the board).

▫ *New York State Common Retirement Fund (NYSCRF)* will not support proposals that ask a company to provide for director age or term limits.

▫ *Florida State Board of Administration (FSBA)* votes "against" proposals to limit the tenure of outside directors. FSBA agrees that new outside directors often bring in fresh ideas that benefit shareholders, but does not believe that term limits are an appropriate way to achieve that goal. FSBA maintains that boards should evaluate director tenure as part

Director Tenure Limits—Yes Or No?
Strong Arguments On Both Sides

FOR

- ☐ Such a policy strengthens director independence (as lengthy tenure may foster a culture of deference to management).
- ☐ Such a policy increases the opportunity for new perspectives, skills and ideas.
- ☐ Extended tenure may lead non-management directors to begin thinking like insiders.
- ☐ Such a policy facilitates increased board diversity.
- ☐ Longer-tenured directors may be less inclined to keep current on industrial and technological developments.
- ☐ Less-tenured directors may focus their loyalties on the company and shareholders, not management.
- ☐ Such a policy combats so-called "zombie" directors (directors who have served on a board for so many years they lose energy and enthusiasm for the job and simply go through the motions).
- ☐ Certain institutional investors and shareholder activists support director term limits.
- ☐ Long-tenured directors raise independence concerns by proxy advisory firms.
- ☐ Many foreign jurisdictions support limiting director tenure, and have adopted corresponding laws, or require companies without such policies to disclose why they have not done so.

AGAINST

- ☐ Long-serving directors often possess invaluable experience and industry and organizational knowledge (new directors may require several years to obtain comparable experience and knowledge).
- ☐ Such a policy is unnecessary because board evaluations, director nominations and director succession adequately consider tenure.
- ☐ Such a policy is unnecessary because corporate performance and long-term shareholder value are more influenced by other factors, including the company's management and corporate strategy.
- ☐ A specific term limit would be arbitrary (should directors be limited to 8, 10, 15 or 20 years on the board and, if so, why?)
- ☐ Longer-tenured directors may be more likely to criticize and challenge management (compared to newer, more deferential board members), and may have a better ability to evaluate management.
- ☐ Such a policy may be an excuse for the board to avoid meaningful director evaluations.
- ☐ There is conflicting empirical evidence as to whether director tenure truly affects corporate performance and long-term shareholder value.

of their analysis of a director's independence and overall performance.

☐ ***Proxy advisory firms.*** The current director tenure position of the two prominent proxy advisory firms is as follows:

▫ *Institutional Shareholder Services Inc. (ISS)* feels that limiting director tenure allows new directors to bring fresh perspectives. A tenure of more than nine years potentially compromises a director's independence. In calculating a company's corporate governance "QuickScore," ISS considers the number of non-management directors whose tenure is greater than nine years. Generally, ISS recommends a vote "against" proposals to limit the tenure of outside directors through mandatory retirement ages or term limits. ISS will, however, scrutinize boards where the average tenure of all directors exceeds 15 years for independence from management and for sufficient turnover.

New for the 2015 proxy season, ISS generally recommends a vote "for" independent chair shareholder proposals, taking into consideration a number of factors, including director tenure and its relationship to CEO tenure.

▫ *Glass, Lewis & Co.* asserts that director age and term limits typically are not in shareholders' best interests. Boards should evaluate composition based on an analysis of skills and experience necessary for

the company, as well as the results of an independent board evaluation, instead of relying on arbitrary age or tenure limits.

Glass Lewis states that if a board adopts term or age limits, it should follow through and not waive such limits. If such limits are waived, Glass Lewis will consider recommending that shareholders vote "against" members of the nominating/governance committee.

Glass Lewis includes board tenure as one of several diversity factors that a nominating/governance committee should consider when making director nominations.

☐ ***Corporate governance advocates.*** The current director tenure position of certain corporate governance advocates is as follows:

▫ *Council of Institutional Investors (advocating on behalf of shareholders)* feels boards have an obligation to weigh all relevant facts and circumstances to determine whether a director should be considered independent. This includes the director's years of service on the board.

▫ *The Business Roundtable (advocating on behalf of management)* holds that, as part of the ongoing assessment of board composition and succession planning, boards should plan ahead for director departures, and consider whether to establish procedures for the retirement of board members, such as a mandatory retirement age or term limits. Boards should also consider whether other practices, such as the assessment of director candidates may make a retirement age or term limit unnecessary.

A number of foreign jurisdictions have adopted director tenure-related rules for "independent" directors. This has lowered average tenure, refreshed board talent, and improved diversity.

☐ ***Foreign perspectives.*** In the United States, there are currently no SEC or listing standard requirements which limit director tenure on public company boards. Many large U.S. institutional investors, however, are significant investors in foreign corporations and vote proxies internationally. In addition, foreign investors own a substantial (and increasing) percentage of U.S. companies. The experience of those investors may impact their priorities and views on director tenure matters when voting U.S. proxies.

A number of foreign jurisdictions have adopted director tenure-related rules or limitations for "independent" directors. These have helped lower average board tenure, and have encouraged boards to focus on director skills and refreshment and better plan for director succession. This, in turn, has also contributed to greater board diversity. Similarly, gender diversity mandates have increased female board representation while lowering average director tenure.

Foreign jurisdictions are addressing the issue of director tenure in various ways:

▫ *Canadian Securities Administrators* requires disclosure in a company's annual proxy statement of whether or not the company has adopted director term limits or other mechanisms of board renewal. If so, the company must include a description of those limits or other mechanisms and if not, the company must disclose why it has not done so.

▫ *The U.K. Corporate Governance Code* presumes that board service of more than nine years compromises independence and thus, a board should disclose in its company's annual report the reasons it determines that a director is independent despite such long tenure. Further, it maintains that a non-management director who has served longer than nine years should be subject to annual re-election.

▫ *The European Commission* recommends that European Union-based companies limit director tenure to 12 years, or three terms.

▫ *Hong Kong Exchanges and Clearing Limited* requires that listed companies appointing an independent non-management director beyond a recommended nine-year limit hold a separate vote for the director using a special resolution for shareholder approval. The resolution should include the reasons why the board believes the director is still independent and should be reelected.

☐ ***2015 proxy season.*** During the 2014 proxy season, no shareholder proposal relating to director tenure or term limits was put to shareholder vote.

Further, our review of proxy statements filed by S&P 500 companies during 2014 revealed that only a small number of companies (approximately 40) voluntarily disclosed information relating to director tenure and/or term limits (other than the year each director was initially elected to his or her respective board, as required by SEC disclosure rules).

The debate on board director tenure and term limits is expected to intensify during the 2015 proxy season. Certain shareholder activists are planning to submit shareholder proposals at various companies where more than two-thirds of the directors have served for 10 years or more, and the board shows other signs of stagnation or entrenchment. "Reduce Director Entrenchment" proposals request that the target company adopt a bylaw requiring at least 67 percent of the members of the board have less than 15 years' total director tenure at the company.

☐ ***Best practices.*** As with many hot-button corporate governance topics, it may benefit companies to be proactive and disclose in 2015 proxy statements information on director tenure, director succession planning (including director refreshment), and term limits. If a company does not have such policies, it should disclose why it feels it is unnecessary at this time. Investors increasingly expect enhanced transparency on corporate governance issues.

In addition, companies should identify their biggest institutional shareholders and determine whether these shareholders have publicly disclosed their corporate governance best practices and/or proxy voting guidelines (or whether they follow a particular proxy advisory firm). This information may help in evaluating whether their boards' director tenure might be a problem for their largest shareholders. If tenure may be problematic, companies should engage the shareholders in advance.

Proactive engagement on corporate governance practices identified as important by a company's large shareholders is becoming increasingly important. Constructive engagement on director tenure concerns, for example, may stave off shareholder proposals on director tenure (or other corporate governance practices of the company). It could also shield against "withhold" or "against" votes for company directors.

Companies should also determine and monitor whether their director tenure-related practices are aligned with peer companies and the industry in which they operate.

Director tenure, including the related issues of director independence and board diversity, is an important corporate governance topic that merits serious consideration. Still, boards should not succumb to proxy advisory firms or short-term activist interests with particular agendas. Directors owe a duty to the company and its shareholders to implement director tenure-related policies that are in the best interests of the company and its shareholders, and that will create long-term shareholder value. Regardless of whether you support or oppose limiting director tenure, the time is now for companies to consider this issue, and disclose their processes and plans to address this issue going forward. ■

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4440 Hagadorn Road
Okemos, MI 48864-2414, (517) 336-1700
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