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Corporate Governance Update: Director Tenure
Remains a Focus of Investors and Activists

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Director tenure, or "board refreshment," is a corporate governance flashpoint at the moment for institutional investors, boards of directors and proxy advisory firms. One of the top takeaways from the 2016 proxy season, according to EY, is that "board composition remains a key focus—with director tenure and board leadership coming under increased investor scrutiny."[1] Many investors and shareholder activists view director tenure as integral to issues of board composition, succession planning, diversity, and, most of all, independence.

Fortunately, term limits for directors is an idea that, in the United States, appears to have more appeal in theory than in practice. Term limits are in place at only three percent of S&P 500 companies—a decrease from five percent in 2010. Although the sample size is small, term limits in this group range from 10 to 20 years.[2] And, despite the seeming popularity of term limits among investors, during the 2016 proxy season, there were no shareholder proposals regarding director term limits, and during the 2015 proxy season, there were only two.[3] The small number of boards that have mandatory term limits indicates that the vast majority of directors—though they may appreciate the arguments in favor of term limits—determine, as a practical matter, that director tenure is best evaluated on a case-by-case basis, both at the company level and at the level of individual directors. The best way to achieve healthy board turnover is not term limits or retirement ages but a robust director evaluation process combined with an ongoing director succession process.

Board Tenure and Director Independence

For some investors, director term limits represent another avenue to address concerns over director independence. Firmly entrenched as an ideal, yet subject to many

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[1] EY Center for Board Matters, "Four Takeaways from Proxy Season 2016," available at http://www.ey.com/GL/en/Issues/Governance-and-reporting/EY-four-takeaways-from-proxy-season-2016.

[2] Spencer Stuart Board Index 2015, at 14, available at https://www.spencerstuart.com/~/media/pdf%20files/research%20and%20insight%20pdfs/ssbi-2015_110215-web.pdf.

[3] The first was at Barnwell Industries, Inc., and it did not come to a vote. The second was at Costco Wholesale Corporation, and it received supporting votes from less than 5 percent of the outstanding shares.

interpretations, "director independence" remains the linchpin of good corporate governance. Rules on independence generally aim to ensure that directors deemed "independent" have no conflicts of interest with respect to their service on the board, through financial investments, professional or personal connections, recent employment with the company, and the like. It is considered particularly important that members of the key board committees—audit, nominating/governance, and compensation—have no apparent conflicts that would cast doubt on their ability to exercise, or their likelihood of exercising, their business judgment in an objective and professional manner. Notably, having a significant investment in the company as a stockholder (other than a controlling stockholder), generally does not affect a director's independence under the SEC or stock exchange rules, even though such directors may have different interests than other shareholders.

Shareholder groups and institutional investors have begun to incorporate director tenure considerations into their company evaluations and voting recommendations. Globally, mandatory term limits and comply-or-explain regimes are being implemented as the issue becomes increasingly high-profile worldwide.[4] Notably, a 2016 Spencer Stuart global survey of 4,000 directors in 60 different countries indicated that directors in private companies are significantly less likely to be subject to term limits.[5] It is telling that, absent the pressures faced by public companies, private boards clearly choose to maintain their latitude regarding board composition decisions.

One source of these pressures may be that in recent years, the average age of directors has increased, and mandatory director retirement ages have either been increased or eliminated at many public companies. Public companies naturally wish to retain productive, experienced directors—many of whom are staying active later in life than their predecessors in previous generations—as well as a recognition that age is not itself generally a limiting fact for a good director. Companies with robust annual director evaluation programs should not need a mandatory retirement age to weed out poorly performing directors. Similarly, younger directors need to undergo the same evaluation on an annual basis to ensure that their performance is up to par.

Long service as an independent director on a board is viewed by some as creating a conflict on the basis that extended tenure creates too close a relationship among longstanding board members and chief executives. Accordingly, a number of influential investors and proxy advisors include director tenure as a consideration in determining their proxy voting policies. CalPERS, for example, updated its proxy voting policy for 2016 to assert that "director independence can be compromised at twelve years of service," and that after such time, companies should conduct "rigorous evaluations to either classify the director as non-

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[4] See David A. Katz & Laura A. McIntosh, "Renewed Focus on Director Tenure," May 22, 2014, available at http://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.23346.14.pdf, for a discussion of viewpoints on director tenure in the United States and abroad.

[5] Spencer Stuart 2016 Global Board of Directors Survey, at 9, available at https://www.spencerstuart.com/research-and-insight/2016-global-board-of-directors-survey. The survey found that 39 percent of public companies have mandatory term limits, as opposed to 30 percent of private companies. In addition, 33 percent of public companies had mandatory retirement ages, as opposed to 12 percent of private companies.

independent or provide a detailed annual explanation of why the director can continue to be classified as independent."[6]

Equating long tenure with a lack of independence is problematic in several ways. As a statistical matter, the average tenure of CEOs in the S&P 500 is 7.4 years, an increase of less than one year in the last decade.[7] Average director tenure in the S&P 500, meanwhile, has remained stable in recent years at roughly 8.5 years.[8] Long coterminous service of directors and chief executives would appear to be the exception rather than the norm. Moreover, long-serving directors are often the ones that have accrued the expertise and standing to influence and effectively oversee a long-serving or otherwise powerful CEO. Institutional investors surveyed by EY last year expressed reservations about director term limits, indicating their concern that mandatory limits do not adequately account for the valuable contributions of experienced directors. Some of these investors felt that a guideline, rather than a strict requirement, as to director tenure could provide a useful starting point for a discussion of board refreshment.[9]

Some investors and academics have gone so far as to propose that, after a certain length of tenure, directors should be considered not independent for the purposes of serving on the audit and compensation committees.[10] In our view, this would be counterproductive in important ways. First, it would limit the usefulness of a board's most experienced directors by precluding them from serving on the key committees where their expertise may be most valuable. Second, such a ban would impinge upon the board's business judgment and discretion by micromanaging the very organizational structure of the board itself. Ultimately, if a company's shareholders have so little confidence in their directors that they feel the need to intervene in board committee assignments, they could not possibly trust the directors to supervise the company generally. Director tenure is an issue at once too picayune—as it is well within the discretion of the board—and too significant—as it affects the board's latitude to do its job effectively—to be determined by shareholders or outside groups rather than by directors themselves.

We believe that many investors as well as proxy advisory firms are looking at this issue the wrong way. Rather than focusing on simply the longest tenured directors, we believe that it is the *average* tenure of the entire board that is most relevant. This is a more meaningful metric for evaluating board refreshment and director succession.

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[6] CalPERS Global Governance Principles, March 2016, at 16, available at https://www.calpers.ca.gov/docs/board-agendas/201603/invest/item05a-02.pdf.

[7] Equilar Blog, "CEO Tenure Has Increased Nearly One Full Year since 2005," available at http://www.equilar.com/blogs/59-ceo-tenure.html.

[8] Spencer Stuart Board Index 2015, at 5.

[9] EY Center for Board Matters, "2015 Proxy Season Insights: Spotlight on Board Composition," available at http://www.ey.com/Publication/vwLUAssets/EY_-_2015_proxy_season_insights:_board_composition/$FILE/EY-proxy-season-preview-2015-spotlight-on-board-composition.pdf.

[10] See, for example, Yaron Nili, "The 'New Insiders,': Rethinking Independent Directors' Tenure," U. Wis. L. Sch. Research Paper Series, Paper No. 1390 (2016), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2728413.

Boards Must Maintain Flexibility

Boards should, as a general matter, annually perform a substantive self-evaluation, in which director tenure is one element to consider. The directors should review not only the contributions of current directors, but also the ongoing needs of the board. New directors will be essential as the company undergoes natural changes in strategy and management, and as the board ensures that it creates opportunities to benefit from the contributions of directors with diverse professional and personal backgrounds. A significant amount of director turnover happens as a matter of course: For instance, EY estimates that nearly 20 percent of directors in the S&P 100 are set to retire in the next five years.[11] As an indication that the board is aware of tenure concerns among some investor groups, companies may choose to set forth the average tenure of non-management directors as a separate item in their proxy statement disclosures.[12] As noted above, in our view, average tenure is a more appropriate measure.

When considering the adoption of mandatory term or age limits, boards should recognize that waiving the limits often requires disclosure and may result in negative publicity and even negative vote recommendations. Glass Lewis, for example, does not encourage the adoption of what it calls "inflexible rules" regarding director terms; indeed, its 2016 proxy guidelines endorse the position that length of tenure and age are not correlated with director performance. That said, its policy is to consider recommending a vote against directors on the nominating and/or governance committees if the board waives the company's mandatory term limit absent explanations and special circumstances.[13]

Directors would be well advised to consider the approach of BlackRock, whose policy is aimed at the substantive issues to which director tenure is only superficially related. BlackRock focuses not on the number of years of service but instead on "board responsiveness to shareholders on board composition concerns, evidence of board entrenchment, insufficient attention to board diversity, and/or failure to promote adequate board succession planning."[14] BlackRock sensibly observes in its stated policy that long board tenure does not necessarily impair director independence.

As both Glass Lewis and BlackRock note in their policy statements, term limits can be a tool for boards that are having difficulty in moving long-serving members off the board. Though negotiations of this nature indeed can be fraught, boards are far better served in the long

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[11] EY Center for Board Matters, "Five-year Outlook: Nearly 20% of Directors Poised for Board Exit," available at http://www.ey.com/GL/en/Issues/Governance-and-reporting/EY-focus-on-board-retirement-and-tenure-policies.

[12] See, e.g., American Express Co., 2016 Proxy Statement, at 5 (available at http://ir.americanexpress.com/Cache/1500082785.PDF?O=PDF&T=&Y=&D=&FID=1500082785&iid=102700).

[13] Glass Lewis Proxy Paper Guidelines, 2016 Proxy Season, United States, at 20-21, available at http://www.glasslewis.com/wp-content/uploads/2016/01/2016_Guidelines_United_States.pdf.

[14] BlackRock Proxy Voting Guidelines for U.S. Securities, February 2015, at 4-5, available at http://www.blackrock.com/corporate/en-us/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf.

term by working their way through the issue and preserving their own discretion rather than implementing a rule that, while helpful in one instance, may prove undesirable in the future.

In conclusion, we believe that the focus on director tenure is generally misplaced, and that investors would be better served by directly addressing any underlying issues and concerns rather than using board tenure as a proxy. Appropriate board refreshment and director succession plans, accompanied by robust annual director evaluations, are the best means for public companies to ensure that board members are independent, engaged and productive and that they have the relevant experience and expertise to assist the company as it executes on its strategy.