The tenured director: Co-opted or invaluable?

Assertions to the contrary, it is not clear that long service is a threat to good governance.

BY DOUG RAYMOND

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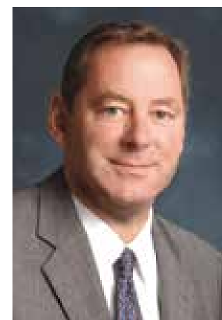

CalPERS, the California Public Employees' Retirement System, recently proposed new Global Governance Principles for public companies. These principles incorporated changes to its approach to board independence. The revised principles advocate annual evaluations of independence for any director who has held that position for 12 years or more. This annual evaluation must be made available to shareholders, highlighting CalPERS's perspective that the independence and objectivity of a director may be compromised after extended board service.

In general, directors had been considered independent if they were not employees of the company and had not engaged in significant related party transactions. Today, the concept of independence is more nebulous. Many groups have argued that directors with no financial ties to management may be less likely to critically evaluate management if they have served as directors for a long period — that after years of collaboration, directors may have a tendency not to question management's decision making and strategy. This concern is echoed abroad, where the European Commission advocates a maximum tenure of 12 years and the United Kingdom employs a "complain or explain" model similar to CalPERS.

Further complicating the discussion is the growth in director compensation. Over the past 10 years, director compensation has grown, on average, more than 5% per year, and now the median yearly total direct compensation for Fortune 500 directors is approximately $250,000. With increasing compensation, some argue that virtually all directors are less likely to rock the boat.

While independent perspectives and integrity are important to good governance, there is not a clear formula to produce this. In fact, many institutional investors have criticized mandatory board refreshment and term limits as artificial and arbitrary. The *Wall Street Journal* recently reported that of the S&P 500 companies surveyed in 2015, only 13 had mandatory retirement policies, and this metric had significantly declined over the last five years. As an alternative to pushing for term limits, other institutional investors consider opposing long-tenured directors only if there is evidence of board entrenchment or insufficient board diversity.

Despite the recent attention on board refreshment and term limits, corporate directors are serving longer. According to the *Wall Street Journal*, in 2005 only 11% of large companies had a board where the majority of directors had served for over a decade; today that figure has more than doubled. In light of this, it is not surprising that the turnover rate for directors is low as well, with the *WSJ* reporting that one-third of individuals who held board seats in 2005 still hold those same seats 10 years later. Corresponding to the low turnover is a rise in median age for S&P 500 directors, increasing from 61 to 63 in the last 10 years, and 20% of all directors are at least 70 years old, nearly twice the same figure 10 years ago. No doubt these trends have in part contributed to the calls for more limited tenure for directors.

On the other hand, long-serving directors bring distinct value to a board, as they often have invaluable organizational knowledge about a company, its competitors, and its industry, which may not be shared by others — sometimes not even by those in the executive suite. The long-experienced director may also engage with management more effectively because of the mutual trust and respect that can take a long time to develop. Indeed, academic studies have come down on both sides of the question whether lengthy board tenure enhances or diminishes board independence.

Given the competing considerations, fixed limits on director service and mandatory retirement policies are unlikely to become the new normal in corporate governance. However, in many ways this broader approach more closely reflects the real world of human interaction, where financial concerns are not the only factors that affect our judgment. More importantly, it raises the question of why "independence" is valued on boards. While most would agree that a director who is financially dependent on another may have difficulty in standing up to that person, it is quite a different thing to assert that long service together or close personal friendships are threats to good governance.

These considerations, however, make it more important that directors consider carefully how their board functions, and whether it has the appropriate balance of knowledge, experience and support of management, as well as objectivity and a healthy dose of skepticism. Ensuring the right balance is a more complex and difficult task than following a rigid guideline, but ultimately should help build a better board, and therefore better governance. ■

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