Time's up: Director tenure moves to the front burner

Term limits and age limits are blunt instruments for addressing the real issue: creating and maintaining a high-performance board with the right mix of competencies.

By Matt Aiello and Lee Hanson

Over the past 10 years directors have devoted an enormous amount of time and attention to a long list of pressing concerns, from compliance to risk oversight, succession planning, and more. Now, another long-simmering issue has become one of the latest flash points in board governance: director tenure. Insistent questions about length of director service have been pushed to the fore by four trends that have converged to give the issue new momentum.

First, the bar for independence on the part of directors has been raised considerably. Formerly, an independent director was simply a board member from outside the company. Subsequently, independence also meant that the external director had been appointed by the board, not the CEO. Today, the argument goes, someone who has been on the board for 15 years, working with the same CEO, can become too cozy with management and, for all intents and purposes, can cease to be genuinely independent.

Second, boards, institutional investors, and advocates for good governance increasingly frame director tenure as a question of board "refreshment." They recognize that as a company and its strategy change over time, a reliable mechanism must be found for bringing new ideas and fresh perspectives to the board — an understanding of markets, geographies, business models or functions that have become newly critical for success.

Third, facing the dizzying emergence of new technologies, many boards want and need to tap into the pool of candidates who are on the cutting edge of these revolutions — many of whom are relatively younger than the average director. Just a few years ago, for example, cybersecurity, digital marketing, and big data hardly registered on board radar screens. The convergence of social, mobile, cloud, and information technologies now offers additional complexities. Older board members, especially those who are no longer active executives, may have less feel for these transformational and potentially perilous waves now washing over every industry. Tenure-limiting mechanisms are seen as a means to make way for candidates who are completely at home in this new world.

Fourth, limiting tenure, either by age or term, has also been strongly advocated as a way to make room on boards for traditionally underrepre-

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sented pools of talent, such as women and people of color. By increasing board turnover, tenure-limiting mechanisms increase the opportunities to create more diverse boards. On the evidence of the Heidrick & Struggles Board Monitor, established in 2009 to capture key characteristics of newly elected independent directors of Fortune 500 companies, turnover among board members has remained stable — and low — throughout the past five years. From 2009 through 2013, the number of newly appointed directors of Fortune 500 companies averaged 326 per year, with a turnover rate that ranged from 5.4% to 6.8%. With SEC regulations now calling for more transparency about diversity and the selection of directors, and with quotas gaining ground in the European Union, the push for mechanisms that enable more diverse boards continues to drive much of the conversation around tenure.

Longer tenure and response of the investor community

The evidence does suggest that tenure has grown longer. Public company researcher GMI Ratings, commissioned by the *Wall Street Journal*, found last year that among Russell 3000 companies, 6,457 independent directors — nearly 34% of the total — have served a decade or longer. That's up from 3,216, or about 18%, in 2008.

The investor community and their advisors increasingly see such long tenure as problematic. In ISS's 2013-2014 Policy Survey, 63% of investor respondents specifically cited the worry that long tenure diminishes independence. For its part, ISS is considering whether director tenure should be taken into account when classifying directors as independent or in making recommendations on director elections. And in its ISS Governance QuickScore 2.0, a corporate governance risk scoring tool for institutional investors, director tenure of longer than nine years is included as a weighted factor. Similarly, the Council of Institutional Investors, representing institutional investors whose combined assets total $3 trillion, now includes tenure as a factor in determining director independence. Meanwhile, regulatory bodies in a number of countries around the world have set an upper limit on tenure — typically nine to 12 years — after which a director's independence is regarded as problematical.

Age limits versus term limits

In our conversations with directors and other corporate governance experts on the topic of age versus term limits, we have often encountered a paradox. The use of age limits far outstrips the imposition of term limits, yet few observers think that age limits are as effective as term limits for refreshing a board. Many, though far from all, seasoned board members share this view. Nevertheless, in our experience, about three-fourths of major public company boards have a mandatory retirement policy for independent directors, while only a small percentage of boards employ term limits.

Critics of age limits point to the tendency of boards in recent years to continually push the age limit up – as high as 75 in some instances, and now typically 72. Further, boards often waive the limit for particular directors when it appears desirable to do so. A director approaching retirement age might be in the midst of leading a CEO succession or providing invaluable oversight during a major acquisition, or the director might simply be seen as irreplaceable — a bearer of institutional memory who understands the full context of the company. Nevertheless, critics counter, an easily waived age limit is, in effect, no limit at all. "Age limits is a corporate construct, not an investor-led construct," says one of the leading voices on governance in the investor community. "It hasn't worked."

Advocates for term limits believe that set terms can avoid the potential problems that come with age limits or no limits: erosion of genuine independence over time, inability of the board to refresh itself in a timely manner, and loss of touch as the company's business environment changes dramatically. Further, such limits increase board turnover, offering more opportunities to diversify, in every sense of the word, including securing the competencies that the board needs as the company evolves. Term limits can also address the longstanding reluctance of many boards to appoint young directors. On a board lacking term limits, the appointment of a 40-year-old who could turn out to be an underperformer and remain a director for 30 years might be seen as an unacceptable risk. Term limits could mitigate at least some of that risk.

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Blunt instruments

Though term limits provide greater flexibility in board composition and may inspire more confidence in investors than age limits, many of the interested parties agree that both

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mechanisms are blunt instruments for addressing the real issue: creating and maintaining a high-performance board with the right mix of competencies. For example, when applied consistently both approaches indiscriminately eliminate outstanding performers and underperformers alike. Further, both mechanisms, especially age limits, can allow manifestly poor performers to linger for years. And neither adequately addresses the issue of timeliness in bringing new competencies onto the board.

An alternative to both age and term limits is sometimes seen to lie in using board evaluation, not only as a means of improving performance but also of enabling board refreshment. Through rigorous self-evaluation, perhaps supplemented by a third-party facilitator, boards can identify and replace underperformers, insufficiently independent members, or those with competencies that are dispensable in a changing business environment. We have worked with a number of directors in leadership roles who have taken the evaluation process very seriously and at its conclusion diplomatically and humanely eased members off of the board for the greater good of the company.

In an ideal world, such rigorous director evaluation or some similar process would regularly and reliably enable board refreshment — and with more surgical precision than the blunt instruments of age and term limits. However, putting evaluations to work in that way can be extremely difficult for many boards, especially where members have been pulled from the same network or have established strong personal relationships among themselves over many years of service.

Until that ideal world arrives, term limits appear to be a potentially effective means of satisfying the need for board refreshment, director independence, technology-savvy younger directors, and diversity of all kind. They also give directors sufficient time to render real service. And the length of term need neither be arbitrary nor universal. It is possible that the optimal term may vary by industry, by company, or some other variable like the director's length of service in relation to the CEO's tenure.

There is no perfect solution when it comes to refreshing boards but terms limits will likely continue to gain traction as an effective approach. ■

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