Board Composition

Director Tenure: A Solution in Search of a Problem

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Director tenure continues to gain attention in corporate governance as term limits become a cause célèbre. Proponents argue directors should no longer qualify as independent after 10 years of service, even though no law, rule or regulation prescribes a maximum term for directors.

We believe director term limits would be misguided and counterproductive.

Institutional Shareholder Services (ISS) has increased its focus on the issue. ISS' governance rating system, QuickScore, views tenure of more than nine years as an "excessive" length that potentially compromises director independence. ISS' more moderate proxy voting guidelines, while opposing proposals for director term limits and mandatory retirement ages, indicates that ISS will "scrutinize" boards whose average tenure exceeds 15 years.

To their credit, both ISS and the Council of Institutional Investors (CII) reject outright term limits. ISS opposes a specific "narrow rule" for director tenure, recognizing shareholders' need to retain "the ability to evaluate and cast their vote on all director nominees once a year" and acknowledging boards' ability to evaluate their own directors' effectiveness. CII recommends that boards evaluate tenure when considering director independence, while acknowledging that term limits "could rob the board of critical expertise."

As a result, director term limits are perversely misguided. They would arbitrarily prevent shareholders from keeping a company's most valuable directors, forcing those directors into retirement regardless of how acutely the company may need their unique experience and skills. Director term limits would therefore harm the very interests that term-limit proponents claim to protect—the company's shareholders.

In fact, longer-tenured directors often enhance a board's oversight capabilities. Directors must work effectively together. They must coordinate closely with senior management. They must comprehend the company's principal challenges and opportunities. They must monitor and help frame corporate strategy. They must oversee enterprise risk management. They must select the CEO's successor. These challenges present difficult, multidimensional issues.

However, the challenges become easier as directors increase their institutional awareness and familiarity with management. Longer-tenured directors better understand the company's business and management's strategic challenges and opportunities. Often, directors with more seniority have greater business savvy and are better able to manage strong C-suite personalities.

Academic studies confirm directors actually increase their independence from management and the company as they develop closer working relationships over time. Companies whose average director tenure exceeds eight years perform better than companies with lower average tenure.

New directors require five to nine years to gain the company-specific knowledge needed to function most effectively, according to studies.

Moreover, good directors are hard to find. Corporate governance rules should avoid arbitrary limits on the available pool of talent, where only a limited number of people possess both the management experience and industry knowledge required to serve capably as public company directors.

Further restrictions on board service dramatically shrink that limited pool of talent. Antitrust and commercial considerations preclude service by those aligned with competitors. Other commercial relationships create the potential for related-party transactions that could impair independence under stock exchange rules or proxy advisory firms' more restrictive independence standards. Companies limit or prohibit their executives from serving on other companies' boards. And directors can serve on no more than a handful of boards to avoid proxy advisors' overboarding concerns.

Ultimately, optimal director tenure and board composition varies by industry and by company. Individual boards are best positioned to address director tenure as they comply with existing requirements to evaluate and assess their directors' effectiveness. Mandatory term limits would ignore important variations across industries and companies and, all too frequently, deprive companies of their very best directors.

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