Board tenure: How long is too long?

There are benefits and risks in lengthy director tenure, but the biggest risk lies in not being strategic in your board talent management.

By Judy Canavan, Blair Jones, and Mary Jo Potter

For years, there has been debate about publicly elected officials' tenure and whether term limits ought to be enforced to prevent their becoming too entrenched and too distant from the people they were meant to represent. Now this type of debate seems to be bleeding over into the boardroom. In fact, all the major ratings agencies other than Institutional Shareholder Services (ISS) include some sort of assessment of board tenure as one of their criteria for evaluating board effectiveness, with longer tenure potentially leading to lower scores. (In its ratings, the Corporate Library's Board Analyst views boards with a broad range in tenure favorably; GovernanceMetrics International examines patterns of longer-tenured directors; and Standard and Poor's Corporate Governance Scores evaluate director tenure on a case-by-case basis.)

Interestingly, in an analysis of 255 companies in the Corporate Library's ratings database, we found that boards rated by the Corporate Library as least effective (a grade of D or F) tend to have the longest-tenured directors (Exhibit 1). Does this finding indicate some board members have potentially been overstaying their useful lives? Yes ... and no. Some companies are undoubtedly in need of new blood. At a minimum, this assessment serves as a warning bell and provides an opportunity for companies to explore the following questions:

- What are the benefits and risks associated with longer-tenured boards, particularly as they relate to a given company's situation?
- Is there an optimum tenure for board membership?
- If managing tenure is not the answer, are boards taking appropriate steps to ensure that they proactively manage and regularly upgrade their director talent?

While tenure probably shouldn't be called out as a significant criterion for continued board membership, boards do need to keep their talent refreshed. Organizations may want to consider the best range of tenure for the future, given their unique characteristics, and include length of service as one element they assess to enhance overall board effectiveness. More important, however, companies could benefit from being more strategic about managing their board talent, just as they are becoming more conscious of managing their employee talent.

Clear benefits, visible risks

Until recently, long tenure was rarely a concern. In fact, it was often a source of pride, particularly for boards with elite membership. Directors joined boards and simply stayed until there was an inciting reason to leave, such as a transaction, a change in management, a change to the corporate structure, or a change in their personal situation. And with this system came benefits, including:

— Continuity of organizational knowledge;
— Credibility in the market;
— Improved board dynamics and collegiality.

In some instances, these benefits have clearly led to improved performance. For example, a study of IPOs found that "greater board stability is associated with improvement in subsequent performance among poorly performing firms."

With the recent scandals and new governance expectations, however, the risks associated with longer

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tenure have become more visible and critical. Many of these risks are the flip side of the benefits. As members of the board become more entrenched, they may:

— Fail to keep up with changes to the business;

— Defend decisions and polices that they supported in the past, that are now of questionable applicability;

— Lack new insights and solutions to the company's challenges;

— Cease to operate independently because of the strong personal ties that they develop.

As Richard Koppes, former general counsel of CalPERS and currently of counsel to Jones Day, indicates, "It is easier for a longer-tenured director to begin to operate as an insider."

Long tenure equals leniency

There is also some evidence that longer tenure leads to more lenient decision making at the committee level. A study of 483 public companies found that compensation committees consisting of the longest-tenured members tended to authorize higher base salary levels for the CEO. Interestingly, the Business Roundtable's recent commentary on executive compensation suggests that "periodic rotation of compensation committee members and the committee chair can bring fresh perspectives to the committee." Presumably, the same would hold true for board membership.

While these are just a few noteworthy observations, utilizing valuable board seats to enhance the reputation and effectiveness of the organization will be more critical in the foreseeable future, and limiting the tenure of individuals occupying those positions has to be a variable that is at least considered.

An optimum tenure?

Current average tenure for directors is approximately three terms (nine years), although this term of service can vary significantly, and average director tenure may range up to 15 to 20 years for some boards. The current environment calls into question whether these long stretches of service are always in a company's best interests, since:

• Businesses are becoming more complex and changing more rapidly, so that it is increasingly difficult for directors to keep abreast of changes to technology, financial dealings, and business strategies.

• Recent scandals and legislation put additional pressures on directors and have:

— increased demands for specific expertise (i.e. financial);

— required more time for key decisions and interactions, especially in committee work;

— increased scrutiny of all activities resulting from the disclosure and compliance requirements.

Despite these environmental changes, many companies have the same directors

Exhibit 1 Average tenure relative to board effectiveness rating

Rating	Minimum Tenure	25th Percentile Tenure	Average Tenure	Tenure Median	75th Percentile Tenure	Maximum Tenure
A and B	1.8	4.2	7.5	6.8	9.9	15.5
D and F	1.1	4.5	9.7	8.4	13.6	20.9

Source: The Corporate Library's Board Analyst. Sample size is 225 companies, which include some of the largest in the banking, biotech/pharma, consumer products, financial services, high-tech, life and health insurance, property and casualty insurance, and utility industries. The sample also included a second group of mid-sized companies between $500 million and $3 billion in annual revenues.

Exhibit 2 Policies and practices to facilitate appropriate board talent management

Criteria that promote 'appropriate' turnover

- Defined skills/competency/experience requirements
- Agreed-upon performance standards
- Articulated independence criteria
- Limit on number of other boards on which a director can serve
- Continuation of current employment status

Policies to facilitate talent upgrading

- Annual performance reviews of:
  - — Individual directors
  - — Committees of the board
  - — The overall board
- Talent gap analyses
- Regular review of director selection criteria and sources

A Director Value Proposition to Attract and Retain the Best Talent

- Policies and practices that protect company value and thereby protect the directors' reputations
- A strong talent profile — the best people want to work with the best people
- Development opportunities
- Effective communications processes (e.g., director intranet site)
- Good board dynamics, ensuring that:
  - — Board members have the opportunity to contribute and their contribution is valued
  - — There is a good working relationship between the board and the CEO
  - — All members are heard, and are willing to take risks
- A strategic compensation plan to reward directors for their contributions

on the board as a decade ago, even though most experts agree that 10 to 15 years of service is probably long enough for most directors. The Director Professionalism report of the National Association of Corporate Directors suggests that at 10 to 15 years of service "it may be desirable to promote director turnover to obtain the fresh ideas and critical thinking that a new director can bring to the board."

That said, it is difficult to nail down an optimum years of service that could apply to every board. In fact, an optimum tenure presumes that up to that time, board members add value and enhance performance, but beyond that period, their value contribution declines. This is frequently not the case.

In reality, the answers to this question are likely to vary according to company leadership, culture, history, business situation, board dynamics, and board talent needs. In a cover story in December 2003, "In Praise of the Family Business," *Business Week* highlighted that many businesses in which a founding family member still plays a prominent role may benefit from their longer tenure. Companies that anticipate significant changes to their business, however, are likely to benefit from fresh thinking brought in from the outside to complement current board membership.

Use of term limits

Some companies have tried to use term limits to enforce an optimum tenure and ensure a regular infusion of new thinking into the board. Target Corp. is one company that has used this approach successfully for a number of years. Term limits have appeal because they are relatively easy to implement politically. However, they carry some risk: Term limits may result in the departure of board members who are making significant contributions and whose departure would be a significant loss to the company. The ISS Proxy Voting Manual sums it up: "Although establishing limits on the number of times a director may be elected to the board provides a mechanical or 'bloodless' means for addressing a real or potential performance issue with a director, it does not take into consideration the fact that a board member's effectiveness does not necessarily correlate with the length of board service."

Ideally, tenure can serve as a checkpoint that companies can use to monitor their current mix of director talent rather than a rigid limit imposed to

Exhibit 3 **Policies and criteria to promote turnover Comparison of 1998 and 2003**

Policies	1998	2003
Evaluation of Individual Board Members	9%	23%
Term limits	5%	7%
Mandatory retirement age	47%	67%
Limitation of number of other boards on which a director can serve	2%	10%
Continued employment status in current position	N/A	28%

Source: The above data are drawn from Conference Board reports on director compensation, Spencer Stuart Board Index surveys, and the Corporate Library's Board Analyst.

Exhibit 4 **Examples of questions to use to assess director performance**

- Do all the directors contribute to a productive mix of cross-disciplinary business perspectives and insights to critical issues and decisions? (Are there significant redundancies or gaps?)
- Does each board committee have the necessary level of expertise?
- Do all members respect the decision rights and decision-making process of the board and its committees?
- Do all members come prepared to meetings having fully reviewed and assimilated all pre-reading material?
- Are all members willing and able to ask hard questions?
- Are all members fully up to date on the issues facing the company and the industry? Do they stay abreast of current trends and issues?
- Do all board members have close to 100% attendance at board and committee meetings?
- Do all board members collaborate? Is there a high level of trust and mutual respect among them?
- Have all board members complied with the board's code of conduct and/or code of ethics?
- Do all board members make themselves available to management?

Exhibit 5 **Director value proposition**

Rewards	Costs
Learning/Pursuit of Knowledge	Time
Contacts	Experience/Expertise
Business Development	Effort
Sharing of Expertise	Risk
Prestige/Affiliation	• Reputation
Cash	• Litigation
Compensation/Benefits/Perquisites/Stock	• Financial

comply with outside opinion. While pundits debate the optimum number of years for board service, boards will find that the more significant opportunity lies not in focusing on tenure management in isolation but instead in focusing more broadly on board talent management.

Upgrading director talent

Companies that manage board talent effectively focus on ensuring that the company has the right number of directors and the right type and quality of director talent at any point in time. This means balancing tenure and skills so that the distribution of length of tenure across board members represents a reasonable mix of "old" and "new" thinking, and skill sets are appropriately diverse. The result is a proactive approach to board rotation and turnover that is governed by relative contribution rather than tenure alone.

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Practices companies are implementing to enhance their board talent management include:

• Developing explicit and mutually agreed upon criteria for election to and continuation of board service. Nell Minow of the Corporate Library suggests a "corporate prenuptial agreement" that spells out the explicit expectations and terms of directorship. See Exhibit 2 for examples of policies that support talent upgrading and Exhibit 3 for the changing prevalence of different practices for promoting board turnover.

• Developing policies that facilitate regular assessment of the board's current and upcoming talent needs, including regular performance evaluations. With the new requirements on governance imposed by the major stock exchanges, performance evaluations are no longer an option, even though up to this point only a minority of companies actually conducted them. See Exhibit 4 for illustrative questions to include in overall board talent assessments.

• Continually reviewing and refreshing the "Director Value Proposition" — the rewards and benefits that a director receives in exchange for his or her services — to ensure the ability to attract and retain key talent (see Exhibit 5).

• Using third-party resources to assist with sensitive transition issues.

'Seat' asset maximization

Continually assessing the mix of skills and experience required by the board now falls mainly to governance committees. As these committees become stronger and more accountable, the evaluation and rotation of board members will likely increase. Criteria like tenure will be placed in a broader context of strategic succession management, for the board as well as the CEO.

While some board members may indeed be overstaying their welcome, companies should not become arbitrarily fixated on tenure as the culprit. Boards will do well to articulate their board composition strategy and plans and ensure that they are using those valuable board seats to enhance the brands and reputations of their organizations as well as they do for the other assets of their companies. ■