THE "NEW INSIDERS": RETHINKING INDEPENDENT DIRECTORS' TENURE

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ABSTRACT

Director independence has been a cornerstone of modern corporate governance. Regulators, scholars, companies and shareholders have all placed a strong emphasis on director independence as a means to ensure that investors' interests in their companies are well served. But what makes a director independent? While regulators and stock exchanges have tackled this elusive standard in different ways, the end goal is always the same – ensuring that the director is able to exercise truly independent judgment and further the best interests of shareholders. Surprisingly, these regulatory bodies have failed to consider the impact board tenure might have on director independence. This Article seeks to fill this void, highlighting the potential effect director tenure has on director independence. Providing novel empirical data that reveals a significant rise in director tenure over the last decade, the Article then strives to place this trend in the larger context of transformations in board structure. Specifically, the Article suggests that the trend of increased director tenure reflects a market attempt to push back against the regulatory emphasis on board independence that has forced companies to remove many of their high ranked executives from the boardroom. This reaction is manifest in the increased prevalence of the "new insider," a hybrid board member who complies with current independence requirements but at the same time, through longer tenure and other attributes, possesses many of the traits that corporate insiders previously brought to the board table. Coupling this market movement with its potential impact on board independence, the Article then explores the benefits and risks of this new insider model and proposes a potential regulatory fix that would address director tenure without sacrificing the benefits that tenure can provide.

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I. INTRODUCTION

Over the last few decades the composition of U.S. public firms' boards of directors has transformed dramatically. Board rooms predominantly controlled by company employees, commonly referred to as insiders,[2] have been replaced with board rooms that are considered to be "independent,"[3] which in many cases consist of the CEO as the lone true insider in the room.

This ongoing shift by public companies from a board structure that relies on a strong presence of directors who are considered insiders, to a board that is considered independent by regulatory standards has accelerated in the last decade. Academic discourse, the trend toward the shareholder franchise approach and corporate scandals that brought about regulatory reforms have all led to this push toward more independent boards. In turn, these changes have further fortified public and market expectations regarding the independence of the board,

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[2] "Insiders" will be used in this Article to mean company executives and employees.

[3] The use of the term "independent" in this Article carries with it two distinct and separate meanings. On the one hand, current rules frame one meaning of independence – term of art defined by what regulators and stock exchanges have deemed to constitute independence. On the other hand, this Article also uses the term "independent" to stand for its intrinsic value – whether a director is truly independent from management in the common sense of the term. While these two meanings often overlap, this Article's main assertion is that the former meaning of the term "director independence," i.e. the regulatory definition of it, fails to truly ensure the latter – the true independence of the directors.

leading companies to surpass regulatory requirements in an effort to meet these expectations.

Indeed, regulators and stock exchanges, academic discourse and corporate practices have all placed a heavy premium on the notion of director independence. What is often lacking in the discussion, however, is an acknowledgment of the disparity between true director independence as a notion that is meant to ensure the ability of the board to effectively scrutinize management's actions, and how current rules and practices actually define it.

Exemplifying this disparity is the failure to consider the impact of director tenure on the independence of boards. Indeed, although legislation, listing rules and state law mandate director independence, none of these rules take into account director tenure. But while the current definitions of director independence ignore director tenure, investors are becoming increasingly concerned with the potential negative impact that long tenure of directors may have on their independence. In a recent survey, ISS found that 74 percent of investors were concerned with the negative impact that long tenure may have on independent directors. Similarly, several institutional investors have recently amended their voting policies and guidelines to address the issue of director tenure.

This Article explores these issues and the potential impact of director tenure on director independence, highlighting the importance and impact board members' tenure may have on their independence. The Article first delineates the key channels through which long director tenure may impact director independence and how this impact is overlooked in the current regulatory and self-governing regimes.

In addition to arguing that long tenure may, in itself, directly impact the efficacy of current board independence standards, the story does not end there. This Article provides new empirical evidence reflecting a steady increase in the average tenure of public companies' boards. This documented increase in average tenure, juxtaposed against additional changes to board structure – such as the increased hiring of directors with strong "insider" background, including retired executives and insiders from other corporations – further underscores the importance of addressing the issue of board tenure and its potential impact on director independence.

While arguing that rising board tenure, in and of itself, may be a concerning development in the context of actual board independence, the Article also situates it within the larger context, connecting this trend to a more general transformation of the board as an institution and of the goals it seeks to achieve. As this Article will contend, in gradually removing insiders from the board room in favor of "independent" directors, public companies have now replaced these "true insiders" with directors who meet the regulatory definition of independence but who serve for longer periods of time and often have a strong preexisting "insider" background elsewhere, resulting in hybrid board members who the Article terms as the "*new insiders*."

By allowing directors to accumulate specific business knowledge and to develop social and professional investment in the firm, public companies can now retain many of the benefits that inside directors brought to the table, while still appeasing regulatory and public requirements. However, at the same time, these long tenures and insider backgrounds might also erode the true independence of the board that the independence rules were intended to ensure.

This transformation in the composition of corporate board rooms and the need for truly independent directors in some key positions begs a rethinking of current independence standards. As this Article suggests, limiting the tenure of directors who are considered independent with respect to specific positions on the board, while allowing them to remain on the board in other capacity, could ensure that the rationale for mandating the independence of directors is safeguarded while at the same time allowing companies to preserve the value that longer tenured directors can provide.

The rest of this paper is organized as follows. Part II provides normative and historical background on the role, function and evolution of the board of directors in the U.S. and describes the emphasis that board independence has received over the last decade. Part III highlights the importance of tenure as a factor when assessing true director independence and the failure of regulators, stock exchanges and investors to properly account for it when considering independence requirements. Part IV provides empirical evidence that board tenure in public U.S. companies is on the rise and highlights other changes in board structure that, as a whole, are indicative of little noticed overarching trend among U.S. companies. Part V addresses the potential lack of ability, will and effectiveness of the market to address director

tenure – justifying a potential need for regulatory intervention. Part VI suggests a possible explanation for this trend: the move toward a new hybrid board member, the "*new insider*." Part VII discusses the normative implications of the trend toward this new insider model and the possible means to address the concerns it entails and Part VIII concludes.

II. THE EVOLUTION OF U.S. PUBLIC COMPANIES' BOARDS OF DIRECTORS

A. Corporate Governance and the Board of Directors

The dispersed ownership structure of U.S. publicly held corporations[4] presents an acute agency cost between management and shareholders.[5] Shareholders' lack of incentive to supervise management due to their dispersed ownership, coupled with free riding concerns, effectively leads to a managerial controlled corporate structure. Having no significant monitoring or removal concerns, managers can divert corporate resources into their own hands, receive high compensation not correlated with their performance[6] and engage in inefficient activities such as empire building.[7]

Thus, the dispersed ownership structure of the widely held U.S. corporation and the agency cost it creates has become a principal concern of many academics, legislatures and courts over the last several decades.[8] During that time, there have been several different approaches

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[4] ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 6 (1932).

[5] Agency cost can be defined as the "costs of structuring, monitoring, and bonding a set of contracts among agents with conflicting interests." *See* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 304 (1983).

[6] *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 3 (2004) (arguing that executives' pay is not adequately correlated with their true performance, enabling them to benefit from industry success rather than their own work).

[7] Empire building is the phenomenon of managers wishing to expand the corporate group under their control by M&A or other methods, even when it is not to the benefit of shareholders. *See* Paul Gompers, Joy Ishii & Andrew Metrick, *Corporate Governance and Equity Prices,* 118 Q. J. ECON. 107, 144-45 (2003); Sharon Hannes, *Private Benefits of Control, Antitakeover Defenses, and the Perils of Federal Intervention,* 2 BERKELEY BUS. L. J. 263, 283 (2005); David J. Denis et al., *Agency Problems, Equity Ownership, and Corporate Diversification,* 52 J. FIN. 135, 137 (1997).

[8] *See* Ronald L. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets,* 108 COLUM. L. REV. 231 (2008). Gilson and Whitehead refer to the seminal paper by Jensen and Meckling as the starting point of this ongoing academic

developed to address these concerns. Some have relied upon free market mechanisms such as the market for corporate control,[9] the capital market for new shares,[10] as well as for trading shares,[11] the market for managers,[12] and the product market[13] as outside mechanisms to minimize this agency cost. Some have relied on debt as an effective constraint on this agency concern by reducing the free cash flow a manager can play with, and subordinating managers to debtors' rights.[14] Some scholars have thought that the increasing involvement of traditional institutional investors[15] in the capital markets could mitigate these agency costs,[16] and later, when those institutions failed to do so, some thought that the emergence of innovative financial institutions could bring about the

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debate. *See* Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Capital Structure*, 3 J. FIN. ECON. 305 (1976).

[9] *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1164 (1981). While the market for corporate control might have played an important role until the mid-80s, it has weakened substantially after Delaware courts allowed the combined use of poison pills and staggered boards and the ability of the board to "just say no" (i.e. to reject offers of hostile bidders). It seems that increasing shareholders' involvement in the corporate life becomes even more of a crucial issue than it used to be due to the ineffectiveness of the hostile takeover market under the new antitakeover mechanisms. *See* Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 410 (2005); Lucian A. Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 889 (2002).

[10] *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 715 (2007).

[11] *See* Kent Greenfield, *The Place of Workers in Corporate Law,* 39 B.C. L. Rev 283, 296-297 (1998)*;* For a general review of the efficient capital market hypothesis, see RONALD J. GILSON & BRENARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 135-81 (2d ed., 1995). Prof. Bebchuk criticizes the validity of this argument. *See* Bebchuk, *supra* note 10 at 715.

[12] *See* Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461 (1992); Arthur R. Pinto, *Corporate Governance: Monitoring the Board of Directors in American Corporations,* 46 AM. J. COMP. L. 317, 330 (1998).

[13] *See* Daniel R. Fischel, *The Corporate Governance Movement,* 35 VAND. L. REV. 1259, 1262 (1982) (noting that inability to compete in the product market will lead corporations to be pushed out of their business altogether).

[14] Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers,* 76 AM. ECON. REV. 323, 325-327 (1986). Jensen took a step further, asserting that the leveraged buyouts of the 80s are the starting point of the eclipse of the public widely held corporation altogether. *See* Michael C. Jensen, *Eclipse of the Public Corporation* (originally appearing in Harv. Bus. Rev., Sep.-Oct. 1989, at 61, revised 1997).

[15] In the Article, I distinguish between "traditional" institutional investors, such as pension funds (public and corporate), mutual funds, insurance companies, and the new institutions: hedge funds and private equity firms.

[16] *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1991-1992); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991).

desired results.[17] Finally, some relied on improved financial incentives given to upper management, in a fashion that would align their interests with shareholders interest.

With efforts spanning from improving market forces to direct regulation, one of the first institutions asked to mitigate this agency issue was the board of directors. In the U.S, with its widely held public corporations, the board of directors serves a major role in the governance of the modern corporation. The board, in the context of agency concerns, has been expected to represent shareholders interests' vis-à-vis management, curtailing management's ability to extract private benefits or act in a suboptimal way with respect to shareholder interests.[18] As this chapter will describe in detail, in order to facilitate these expectations the board itself has gone through dramatic changes, both in the functions it is expected to serve as well as in its structure and the composition of its members.

B. The Board's Dual Role as Monitor and Adviser, and the Move toward Independent Boards of Directors

1. The Board of Directors' Role in the Governance of the Corporation

The board of directors is one of the core organs of the modern corporation. As such, it has been entrusted with several different important roles in the governance of the corporation. First, while most of the operational decision making can be, and is, delegated to management, the board is still required to be an active participant in some of the more important managerial business decisions, such as mergers, stock issuance and change of company governance documents.[19] Second, the board is a resource for management to utilize,

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[17] For a more comprehensive analysis see, e.g., Mark Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 1067 (1991); Edward Rock, *The Logic and Uncertain Significance of Institutional Investor Activism*, 79 GEO. L.J. 445 (1991); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021 (2007).

[18] *See* Arthur B. Laby, *The Fiduciary Obligation as the Adoption of Ends,* 56 BUFFALO LAW REVIEW 99 (2008) (describing directors fiduciary duty to adopt shareholders' ends); Michelle M. Harner, *Corporate Control and the Need for Meaningful Board Accountability*, 94 MINN. L. REV. 541, 583-584 (2010) (focusing on the boards' broader duties in the context of a controlling shareholder).

[19] *See* STEPHAN BEINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS 45 (Oxford University Press, 2012).

providing insight and advice as well as networking benefits, and facilitating the firm's access to various resources.[20] Third, the board is charged with a monitoring role, making sure that shareholder interests are fully served, in an effort to constrain the agency costs associated with a managerial centric corporation model. While each board serves all of these functions, the primary role and purpose of the board in the governance of the corporation has changed significantly over the years.

While in the early 20th century the board's main function and expectation was to serve in an advisory role, providing insight and guidance to management along with networking benefits, the last few decades have seen the emergence of the "monitoring board structure."[21] This board structure in which the board's primary role is monitoring management has become the predominant model for boards in the U.S.[22] The tipping of the scales, moving from a predominantly advisory role to a predominantly monitoring function, has also led to a rethinking of the proper composition of the board. Because the different functions of the board also require different attributes from its members, a corresponding change in the composition of the board has taken place. The ability to provide networking, business advice and other insight is no longer the most valued set of skills. Rather, the ability to, or at the very least the perception of an ability to, effectively scrutinize management has become increasingly important. As such, the presence of directors perceived by the corporation and the public to be "independent" has become essential.[23]

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[20] *Id.* at 47.

[21] *See* MELVIN ARON EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 139–41 (1976); *see also* STEPHEN BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 155 (Oxford University Press, 2008) (detailing the emergence of the monitoring structure over the last few decades).

[22] *See* AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3.03(a) (Tent. Draft No. 1 1982); Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 Geo. WASH. L. REV. 1034 (1993) (reviewing these principles in detail); Bainbridge, *supra* note 21 at 161.

[23] Indeed, calls for board independence were embraced in the American Law Institute Principles of Corporate Governance, for example, requiring that independent directors comprise a majority of the board, and that, as a matter of good corporate practice, the independent directors should not have outside employment or other commitments that would interfere with the performance of their duties. As detailed by Eisenberg, *supra* note 21, and Bainbridge, *supra* note 21, the monitoring model required directors to take on an active role in the corporation but one that was to monitor the performance of the senior executives of the company. For a description of a competing approach, see Miriam Baer, *Corporate Policing and Corporate Governance: What Can We Learn from Hewlett-Packard's Pretexting Scandal*, 77 U. Cincinnati L. Rev. 523 (2008)(describing the cultural theory of corporate governance).

2. The Impact of the Shareholder Franchise Approach

The shift in the perception and expectation of the board as an advisory institution at the disposal of management to a monitor and final decision maker[24] defending shareholders' interest, has evolved against a larger backdrop of a shift in corporate thinking toward a "shareholder franchise" approach[25] and the greater reliance on stock markets to reflect accurate information. As part of the conceptual movement of the narrative of U.S. corporate governance discourse to a shareholder centric model, where the firm's end is to maximize the return to its shareholders, a natural step has been to contemplate means of empowering shareholders vis-à-vis management. Under current law, and because of the structure of shareholders' equity interests, shareholders face several obstacles,[26] which often result in a passive approach that leaves incumbent management free to maximize its own interests. However, some shareholders try to challenge the ultimate discretion held by the board of directors and management by actively using their rights to create some form of checks and balances structure.

The shareholder franchise movement has embraced this notion, calling for the breakdown of some of the barriers limiting shareholder intervention in corporate governance. Among these barriers are the legal and proxy rules regarding board elections and shareholders' resolutions,[27] the staggered board and poison pill[28] and other legal

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[24] Section 141(a) of Delaware corporate code states that "the business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors." DEL. CODE ANN. tit. 8, § 141(a) (2006).

[25] *See* Bebchuk, *supra* note 10.

[26] In this regard, examples include: the proxy rules and reimbursement policies, the lack of binding power of shareholders resolutions, and costs related to nominating board candidates. *See* Bebchuk, *supra* note 10 at 688.

[27] *See* Bebchuk, *supra* note 10 at 688-694; *see also* Lucian A. Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW., 43-66 (2003); Melvin Eisenberg, *Access to the Corporate Proxy Machine*, 83 HARV. L. REV. 1489; Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations and Poison Pills*, 3 BERKELEY BUS. L.J. 205 (2005); William K. Sjostrom, Jr. & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV., 459 (2007).

[28] The combination of the staggered board (i.e., a charter provision that provides for the replacement of only a portion of the board, usually one third, in each annual shareholders' meeting) and a poison pill that can only be revoked by the board of directors (a mechanism that prevents a hostile buyer from taking control by giving cheap purchase options to all shareholders other than the bidder, thus diluting his share in the corporation) leads a hostile bidder, even if he has the support of shareholders, to wait for two to three years until he gains control of the board, a fact that in reality prevents the hostile (i.e., without the consent of the board) takeover altogether.

barriers limiting shareholder involvement. The proponents of breaking down these barriers, led by Professor Bebchuk,[29] assert that giving shareholders an effective say in the governance of the corporation will limit managerial slack and lead to more efficient corporations. Indeed, recent years have seen some successes on behalf of such movements. The SEC has implemented a reform to its proxy rules that eases the ability of shareholders to voice their opinion,[30] while Congress has passed an extensive bill that furthers the impact shareholders can have on the governance of the corporation.[31]

The convergence of these movements, the view of the board as an internal watchdog of management actions and the larger shift in the perception of the role of shareholders in corporate governance, has led public companies to gradually move from a board that was dominated by insiders to a board that is mostly classified as "independent" according to current regulatory standards. Indeed, while in the 1950s 49% of board members were company insiders, by 2005 only approximately 25% remained insiders.[32]

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[29] Professor Bebchuk has published several papers advocating this change. *See* Bebchuk, *supra note 10;* Lucian A. Bebchuk, *The Case for Increasing Shareholder Power,* 118 HARV. L. REV. 83*;* Lucian A. Bebchuk, *Reply: Letting Shareholders Set the Rules,* 119 HARV. L. REV. 1784 (2005)*; see also* Amicus Brief of Harvard Law School Faculty, AFSCME v. AIG (2nd Cir. 2005), *available at* http://www.law.harvard.edu/faculty/bebchuk/pdfs/Amicus%20Brief.pdf; Michael S. Kang, *Shareholder Voting as Veto*, 88 IND. L. J. 1299 (2013)(reviewing and defending some aspects of the calls for greater voting power for shareholders).

[30] *See* SEC, *Facilitating Shareholder Director Nominations*, File No. S7-10-09, *available at* http://www.sec.gov/rules/final/2010/33-9136.pdf; *see also,* SEC PRESS RELEASE, *SEC Adopts New Measures to Facilitate Director Nominations by Shareholders* (Aug. 25, 2010), *available at* http://www.sec.gov/news/press/2010/2010-155.htm; *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).

[31] Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R.4173. For a review of the main provisions of the act see *Brief Summary Of The Dodd-Frank Wall Street Reform And Consumer Protection Act, available at:* http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf.; DAVID A. SKEEL JR., THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES, (Wiley, 2010). For a critical review of the act see Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779 (2010).

[32] *See* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1473 (2007); Urska Velikonja, *The Political Economy of Board Independence*, 92 N. CAROLINA L. REV. 855 (2014).

C. *Mandating "Independent" Directors – SOX and Dodd Frank's Contribution to the Shift in Board Composition and Roles*

While the movement toward "independent" boards was mainly[33] "market driven" until the early 2000s,[34]and to that point was not mandated by the regulator or by self-regulating bodies, this shift was further driven by the corporate scandals of the early 2000s. The backlash from the Enron and WorldCom scandals led to the enactment of the Sarbanes-Oxley Act of 2002 (SOX)[35] and subsequent stock exchange listing standards, and the 2008 financial crisis led to similar reactive legislation in the form of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).[36] These legislative acts and listings standards have not only transformed the voluntary shift in board composition into a mandatory one, but have also laid increasing responsibilities at the board's feet, further cementing its primary role as a monitor and not as an adviser.

1. Mandating Independence Part I – the Sarbanes-Oxley Act

In the aftermath of the Enron scandal, the regulatory requirements for public corporations were overhauled by comprehensive legislation, the Sarbanes-Oxley Act (SOX).[37] The empowerment of the board and the need to ensure its effectiveness as a monitor were an important part of the reform.[38]

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[33] State law has developed to require the approval of self-dealing transactions by disinterested directors, often independent directors. This requirement along with the need for special independent committees pushed companies to include more independent directors in their board room.

[34] *See* Gordon *supra* note 32at 1473 (showing a decrease in the percentage of inside directors from 49% in 1950 to 21% in 1995 and to 16% in 2000 well before the SOX requirements were put in place).

[35] Sarbanes-Oxley Act of 2002, 107 P.L. 204, 116 Stat. 745.

[36] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, *supra* note 31.

[37] *See* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L. J. 1521, 1523-1542 (2005); Roberta Romano, *Does the Sarbanes-Oxley Act Have a Future?* 26 YALE J. ON REG. 229, 235-239 (2009); John C. Coates IV, *The Goals and Promise of the Sarbanes-Oxley Act*, 21 J. OF ECON. PERSPECTIVES 91, 91-92 (2007); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 11-18 (2002); Dana Brakman Reiser, *Director Independence in the Independent Sector*, 76 FORDHAM LAW REVIEW 795 (2007).

[38] *See* Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards* (working paper, 2002) (quoting *Wall Street Journal* editorial regarding the corporate governance proposals by the New York Stock Exchange, stating that they "anointed boards of directors, especially 'independent directors' as the capitalist cavalry").

SOX directly regulated several aspects of the audit committee of the board,[39] mandating independent audit committees that are comprised of independent directors, and prohibiting members of such committees from accepting any "consulting, advisory, or other compensatory fee" from the company except for directors' fees.[40]

In addition, all major exchanges, including the New York Stock Exchange (NYSE) and NASDAQ, were mandated to amend their listing requirements to require that a majority of the members of the board of directors of listed companies be independent,[41] to expand the duties and powers of the independent directors, in particular in the context of the audit committee, and to reformulate their definition of independence.

Accordingly, in its post-SOX listing standards, the NYSE mandated that all listed companies "must have a majority of independent directors" with a specific definition of independence as discussed below. In addition, listed companies are required to have an audit committee comprised solely of independent directors. The committee has to have at least three members, all of whom are to be "financially literate" and at least one of whom has to have expertise in accounting or financial management. Finally, the NYSE requires that "[t]o empower non-management directors to serve as a more effective check on management, the non-management directors of each listed company must meet at regularly scheduled executive sessions without management."[42]

Relatedly, in July 2006, the SEC amended its disclosure rules to require disclosure of: (1) whether each director and each person nominated to be nominee is independent of management; (2) any

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[39] *See* 17 CFR § 228, 229, 240, 249 & 274; Annemarie K. Keinath & Judith C. Walo, *Audit Committee Responsibilities Focusing on Oversight, Open Communication, and Best Practices* (Nov. 2004), *available at* http://www.nysscpa.org/cpajournal/2004/1104/essentials/p22.htm; Ganesh M. Pandit et al., *Audit Committee Reports Before and After Sarbanes-Oxley: A Study of Companies Listed on the NYSE,* MANAGERIAL AUDITING JOURNAL (Oct. 2005), *available at* http://www.nysscpa.org/cpajournal/2005/1005/essentials/p42.htm.

[40] For a detailed analysis of the stock exchange rules prior to and after the SOX, see Bainbridge, *supra* note 21 at 161.

[41] This is true unless a company is a "controlled company," a limited partnership, is in bankruptcy proceedings or lists only preferred or debt securities. *See*, *SEC Approves NYSE and NASDAQ Proposals Relating to Director Independence,* FINDLAW (Mar. 2008), http://corporate.findlaw.com /finance/sec-approves-nyse-and-nasdaq-proposals-relating-to-director.html.

[42] While no mandatory number of meetings is required, in practice such meetings take place regularly. *See* Bainbridge *supra* note 21 (referring to an 1996 Korn/Ferry survey that found that the boards of 62 percent of respondents met in executive session at least once a year and that, by 2005, that figure had risen to 94 percent).

transactions, arrangements, or other relationships considered by the board of directors in determining if an individual satisfied the applicable independence standards; and (3) the names of any members of the audit, nominating, or compensation committees who are not independent. The NASDAQ standards are substantially similar.[43]

The post-SOX stock exchange listing standards also strived to tighten the definition of director independence as compared to the standard that existed under state law. State corporations law has traditionally used a fairly vague standard to decide whether a given director is independent of management inquiring whether "through personal or other relationships the directors are beholden to [management]."[44] In contrast, the new NYSE and NASDAQ listing requirements enacted post-SOX adopt rules for deciding whether a director is adequately independent to count toward the requisite majority that include both specific requirements[45] as well as a determination by the board that a nominee has no material direct or indirect relationship with the listed company.

Finally, while post-SOX all listed companies were required to have an audit committee,[46] the NYSE also mandated the establishment of a

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[43] However, NASDAQ expressly states an expectation that executive sessions of the outside directors will be held at least twice a year. *See* NASDAQ Listing Rules 5605, *available at* http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp_1_1_4_3_8

[44] *See* EDWARD P. WELCH, et al., FOLK ON THE DELAWARE GENERAL CORPORATION LAW 254 (Aspen Publishers, 5th Ed. 2006) (citing the Delaware court in the matter of *Odyssey Partners, LP. v. Fleming* Cos., 735 A.2d 386 (Del. Ch. 1999)).

[45] Among the specific requirements are that directors are not allowed to be an employee of the listed company or an immediate family member of an individual who has been an executive officer within the last three years or to receive more than $120,000 in direct compensation from the listed company, other than in director and committee fees *see infra* note 65 and accompanying text.

[46] While state law allows the board to set up committees, it does not mandate formation of any specific one. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(c)(2).

nominating and corporate governance committee[47] and a compensation committee.[48]

2. Mandating Independence Part II: Dodd-Frank and the Expansion of Director Independence

In the wake of the collapse of the financial industry in 2008, federal legislatures have reacted with the Dodd-Frank Act, which some might call[49] a "catch-all" legislative reform dealing with various, and seemingly unrelated, issues: from the regulation of the financial industry and the shadow banking system to derivative trading and whistleblowing.

Part of the reform[50] addressed the issues of compensation committee independence, its authority to retain and be directly responsible for the consultants and advisers it retains, its analysis of the independence of compensation consultants and advisers, and the disclosure of any conflicts of interests concerning compensation consultants. Accordingly, the stock exchanges have filed with the SEC suggested listing rules[51] that comply with the new requirements without going beyond them.[52]

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[47] The nominating committee is in charge of nominating director candidates and is often also selecting new CEOs and selecting peer directors to the other board committees. While some treat the formation of an independent nominating committee as a weakening of the power management has on director election, in reality company management still holds significant power over the board nomination process. *See* Bebchuk, *supra* note 27; Joseph V. Carcello et al., *CEO Involvement in Selecting Board Members, Audit Committee Effectiveness, and Restatements*, 28 CONTEMPORARY ACCOUNTING RESEARCH 396, 401 (2011).

[48] The compensation committee is tasked with setting the compensation of senior executives and generally oversees the corporation's compensation policies. Under NYSE Listing Rules the committee must be comprised solely of independent directors. *See* N.Y.S.E. Listed Co. Manual §303A.05.

[49] For a critique of the Dodd-Frank Act see Bainbridge, *supra* note 31; for a more general critique of legislation in the wake of a crisis see Roberta Romano, *Regulating in the Dark* (working paper, 2012).

[50] Section 952 of the Dodd-Frank Act and Rule 10C-1 of the Securities Exchange Act of 1934 direct the national securities exchanges to adopt new listing standards applicable to compensation committees and compensation advisers. *See* 17 CFR 240 §10C-1.

[51] NASDAQ currently requires executive compensation decisions to be determined either by (i) a compensation committee comprised of independent directors or (ii) independent directors constituting a majority of the board's independent directors. NASDAQ's Proposed Standards provide that listed companies be required to have a compensation committee comprised of two or more independent directors.

[52] Rule 10C-1 *supra* note 50 directs the SEC to require the national securities exchanges and associations to adopt listing rules that implement the requirements of Rule 10C-1. On September 25, 2012, each of NYSE and NASDAQ each filed proposed listing rules with the SEC (collectively referred to throughout this commentary as the Proposed Standards) to implement the requirements of

The SEC rules and the proposed listing requirements of the stock exchanges require boards to take into consideration the following when assessing the independence of compensation committee members: (1) the source of compensation of the director, including any consulting, advisory or other compensatory fee paid by the issuer to the director; and (2) whether the director is affiliated with the issuer, its subsidiaries or their affiliates.[53] These requirements are specific to the compensation committee and are added to the general rules as to director independence described above.

Indeed, through private ordering and legislative and listing rules, director independence has become a corner stone of modern corporate governance of public firms. This emphasis on independence is reflected not only in the requirement to have a majority of independent directors on the board as a whole, and mandating independence of specific committees of the board, but also in the more detailed, "bright-line" component of the definition of director independence.

D. Voluntary Changes Leading to Greater Independence of Board Members

As discussed above, the last decade has seen major transformations in the structure of the board of directors. Aside from the mandatory and listing rules requiring a minimum threshold presence of directors considered to be independent, S&P 500 companies have voluntarily contributed to this ongoing shift in board structure by taking further steps to enhance the perceived independence of the board. These overall trends are recited by practitioners and academics alike when

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Rule 10C-1. In general, the Proposed Standards closely track Section 952 and do not contain major changes or heightened requirements to the SEC's Rule 10C-1

[53] These two factors are specific to the compensation committee members and are in addition to the so called "bright-line" independence tests currently required by the respective exchanges. NYSE's Standards require that the two above factors be "considered" with all other relevant factors in determining "whether a director has a relationship to the listed company which is material to that director's ability to be independent from management in connection with the duties of a compensation committee member." NASDAQ's Standards prohibit a compensation committee member from accepting directly or indirectly any consulting, advising or compensatory fee from the issuer (subject to certain limited exemptions). NASDAQ's Standards further provide that the board must also consider whether the director is affiliated with the company and "whether such affiliation would impair the director's judgment as a member of the compensation committee." *See* Nasdaq Listing Rules §5605(d)(2)(A).

discussing the increased movement toward director independence and accountability to shareholders.

This voluntary shift toward "enhanced" board independence has manifested itself in several structural changes to the public U.S. board. First, while only a majority of the board is required to be independent in order to comply with regulatory requirements, independent directors, as currently defined, now make up 84% of all board members, the highest share ever.[54] This percentage reflects an ongoing increase in the ratio of independent directors to non-independent directors from 3.6:1 a decade ago to 5.4:1 today. In addition, the number of fully independent boards in the S&P 500, where the CEO is the only non-independent director, have radically increased from 22% in 2000 and 39% in 2005 to nearly 59% of boards nowadays.

Second, in 2014 47% of S&P 500 boards had separate CEO and chair roles, up from 23% in 2000, and 28% of chairs were independent, versus just 9% in 2005. Third, board members dependency on shareholders' confidence and approval[55] has dramatically risen in the last decade due to the increased rate of majority voting requirements and declassification of boards: currently 84% of the companies in the S&P 500 have a majority voting/resignation policy in place, up from 79% in 2011, 65% in 2009 and 56% in 2008. The percentage of boards serving one-year terms has also risen every year and currently stands at 93%, more than double what it was a decade ago (40%).[56] Fourth, only 22% of the directors who started their tenure in 2014 are active CEOs, down from 53% a decade ago, a trend that is also true with respect to other executives.[57] Fifth, director compensation has been on the rise, enabling

[54] Data used in this part was collated from several reports, *See e.g*., *Spencer Stuart Board Index Survey* (2014), *available at* http://www.spencerstuart.com/research/articles/1621/; *Shearman & Sterling LLP's 10th Annual Survey of Selected Corporate Governance Practices of the Largest US Public Companies (2013), available at* http://corpgov.shearman.com/about-the-survey; *PwC's 2012 Annual Corporate Directors Survey (2012), available at* http://www.pwc.com/us/en/corporate-governance/publications/annual-corporate-directors-survey.jhtml; *Georgeson 2014 Annual Corporate Governance Review (2014),* available at http://www.georgeson.com/us/resource/Pages/acgr.aspx; *Korn/Ferry 33rd Annual Board of Directors Study (2006), available at* http://www.kornferryinstitute.com/reports-insights/33rd-annual-board-directors-study.

[55] The greater dependence of directors on the approval of shareholders is perceived as another sign of increased independence and responsiveness to shareholders.

[56] The Author has served as counsel at the Shareholder Rights Project at Harvard Law School, a clinical program that represented institutional investors in an effort to declassify boards.

[57] Fewer active executives are coming onto boards as well. In 2012, the ratio of active to retired new directors was 59:41; in 2006, it was 66:34. *See* Spencer Stuart reports, *supra* note 54.

and incentivizing directors to truly engage in their role.[58] Sixth, restrictions on other corporate directorships are increasingly the norm. In light of the time and commitment required for effective service, 75% of S&P 500 companies now limit other corporate directorships, versus 27% in 2006.[59] Finally, the financial literacy of the board has improved: in 2003, only 21% of boards reported having a financial expert while today every S&P 500 board reports having at least one financial expert, and the percentage of chief financial officers, treasurers or other financial executives serving as audit committee chair increased from 4% in 2002 to 37% in 2014.

E. The Implications

The transition that the board of directors has made in recent years, from an advisory focused role to a monitoring oriented role and from an insiders' board to an "independent" board raises two separate issues. First, a question arises as to whether the right balance between the advisory role and the monitoring role has been struck and, secondly, whether current independence criteria actually serve the monitoring role of the board well. As further developed in Parts III and IV, this Article suggests that the answer to both of these questions might be less certain than commonly assumed.

III. THEORY VERSUS REALITY: HOW CURRENT RULES FAIL TO FULFILL THE INTENT BEHIND THE INDEPENDENCE STANDARD

The regulatory emphasis on independence as a corporate governance cornerstone raises a question as to the effectiveness of current regulation and listing standards in achieving the goal of director independence in the common sense of the term. As further discussed below, current definitions of director independence suffer from numerous flaws that jeopardize the realization of the legislative intent behind mandating director independence.

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[58] *See infra* note 110 and accompanying text. However, as discussed later, while standing on its own this may be a positive trend, in the context of increased tenure higher compensation may aggravate the concern for director independence. *See infra note109* and accompanying text.

[59] According to the Spencer Stuart survey, *supra* note 54, such limitations include a cap (which ranges from two to five other positions) on the number of additional boards for all directors or only for directors employed by public companies or a request that directors notify the chairman in advance of accepting an invitation to join another company board.

First, current definitions suffer from lack of uniformity and consistency, as state law and listing rules differ as to the exact definition of director independence, and both sets of rules leave too much interpretive room to the board itself in determining its independence. Second, and the main argument developed in the Article, current definitions of director independence ignore the impact that long tenure potentially has on director independence.

A. *Are All Independent Directors Created Equal? The Lack of Uniformity and Consistency*

As described above, federal law and listings rules have developed to require the presence of independent directors on several of the board committees as well as to require that a majority of directors on the board be considered independent.[60] However, SOX and Dodd-Frank were not the first to require board independence in certain contexts. Rather, the term "independent directors" arose out of a larger backdrop of existing state laws requiring director independence in numerous situations, such as the approval of interested transactions and in derivative suits and litigation committees.

Delaware law, for instance, requiring independent directors' approval of related party transactions to preserve the business judgment rule standard, has treated the issue of director independence as a factual issue to be determined on a case by case basis. Specifically, Delaware law examines "whether the director's decision is based on the corporate merits of the subject before the board, rather than extraneous considerations or influences,"[61] or whether a director is, for any substantial reason, incapable of making a decision "with only the best interests of the corporation in mind."[62] This in turn, could, and has, led to different outcomes in particular cases,[63] depending on procedural issues

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[60] *See* N.Y.S.E. Listed Co. Manual §303A.

[61] *Beam v. Stewart,* 845 A.2d 1040 (Del. 2004); *see also* Maureen S. Brundage & Oliver C. Brahmst, *Director Independence: Alive and Well Under Delaware Law*, GLOBAL CORPORATE GOVERNANCE GUIDE (2004); Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. LAW, 447-496 (2008).

[62] *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 938 (Del. Ch. 2003) (defining independence such "that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences."), *see also Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984).

[63] For instance, in the Oracle case it was determined that personal connections rose to the level of impeding independence, while in the Martha Stewart case the opposite was held.

such as the burden of proof, the specifics of the case and the availability of admissible facts. Most importantly, Delaware law suggests that even when a director is independent as to some issues, she might not be for others.

Compared to the ad-hoc nature of state law independence standards, which require independence to be assessed on a case by case basis, based on numerous factors, it is no surprise that the stock exchange rules following SOX and Dodd-Frank are widely perceived as "bright-line" rules[64] as they contain specific prerequisites for director independence, explicitly prohibiting directors from being considered independent if they were employees of the company, received compensation over a certain threshold that is not a director fee, had ties to the company's auditor, or had business or compensation interlocks with the company above a certain threshold.[65]

However, while these prerequisites are effective in eliminating doubt in specific, common instances, the mere fact that a director does not fall into one of the listed disqualifications in the listing rules does not automatically render him or her to be independent, even under the current stock exchanges definition of "independence." The listing standards start with a general requirement that "[n]o director qualifies as independent unless the board of directors affirmatively determines that the director has no material relationship with the listed company." The question of what is a "material relationship" was left to the board to decide, thus, in practice, leaving a considerable gray zone as to the definition of this term and discretion as to the classification of a director as "independent" by the company.[66]

Thus, the lack of uniformity and consistency in defining independence that allows different companies to adopt different standards stems not only from the fact that state law and listings

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[64] *See* Bainbridge *supra* note 21; *see also* N.Y.S.E. Listing Co. Manual *supra* note 60.

[65] For a more detailed commentary on each requirement see N.Y.S.E. Commentary on Final Rules, *available at* www.nyse.com/pdfs/finalcorpgovrules.pdf. For further explanation see FindLaw, *supra* note 41.

[66] A nice illustration is the case of Penny Pritzker, one of America's richest and most powerful businesswomen, who was an independent director of Hyatt Hotels until her status changed. *See* John R. Emshwiller and Alexandra Berzon, *Hyatt Director Gets a Status Makeover*, THE WALL STREET JOURNAL (2010), *available at* http://online.wsj.com/article/SB10001424052748703649004575437713243128990.html. For a more detailed critique see *What is an Independent Director Anyway?* THE CONFERENCE BOARD GOVERNANCE CENTER BLOG (Sep. 10, 2010), http://tcbblogs.org/governance/2010/09/10/just-what-is-an-independent-director-anyway/.

requirements differ on some of the specific prerequisites for independence but is also exacerbated by the fact that each definition ultimately leaves the question of *who is* independent to the judgment of the board or the court. The use of standards such as "material relationship" or "control" invariably leads to questions of judgment and fact finding, and when such judgment lies with the board[67] different companies can vary in their outcomes.

B. *Are All Independent Directors Created Equal II – The Inadequate Attention to Board Tenure*

Aside from the diversity in prerequisites and standards of different regulatory bodies and the way in which the application of the same standard, by different bodies, can lead to different outcomes, this Article seeks to turn the spotlight to a separate issue relating to the definition of the director independence. While prior work has critiqued the perception of independence and the effectiveness of monitoring by independent directors,[68] these critiques have also approached independence as a snap-shot in time rather than treating it as an ongoing evaluation.

While tenure of board members has been explored to some extent in academic literature,[69] academic discourse has mainly focused on its impact on board performance.[70] The potential impact of board tenure on board independence has not been adequately explored in academic literature and up until recently has escaped the public eye.[71] In addition,

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[67] Although courts might have final say on these matters, if challenged, their tendency to interfere with such judgment calls is likely to be limited.

[68] *See* Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 145-175 (2010) (describing a myriad of factors that might make independent directors less effective in their expected role as monitors); Rodrigues *supra* note 61(Arguing that director independence should be examined on a case by case basis and highlighting the limited value of outside directors aside from the monitoring function).

[69] *See e.g.,* Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921 (1999); Chandra S. Mishra & James F. Nielsen, *Board Independence and Compensation Policies in Large Bank Holding Companies*, 29 FIN. MGMT. 51, 52-55 (2000) (finding that tenure and pay for performance incentives are substitutional in improving firm's accounting and that when pay for performance arrangements are set the value of insiders increases); Nikos Vafeas, *Length of Board Tenure and Outside Director Independence*, 30 JOURNAL OF BUS. FIN. & ACCOUNTING 1043 (2003) (examining the impact of tenure on board structure attributes and directors positions inside the board for a sample of companies in 1994).

[70] *See* Sterling Huang, *Zombie Boards: Board Tenure and Firm Performance* (working paper, 2013); *see also* Vafeas, *supra* note 69.

[71] *See infra* note 120 and accompanying text.

despite its potential importance to independence, the issue of tenure has escaped the legal reforms of SOX and Dodd-Frank and the ensuing listing requirements definitions of independence, as well as the state law definition of independence. This Part seeks to explore the impact that director tenure potentially has on director independence.

1. Tenure, Social Connections and Structural Bias

Social ties are already considered a potential disqualifying factor under Delaware state law,[72] but are missing from the "bright-line" prerequisites for independence in stock exchange rules, which instead focus on directors' financial ties to the corporation. While pre-existing social ties to the upper management of the corporation is an issue that in itself could threaten true independence, long tenure could also exacerbate the impact that such ties have on director independence. Additionally, even without pre-existing ties, long tenure could result in the cultivation of newly formed relationships with management to the point where they might undermine independence.

Similarly, tenure could also impact the intra-board environment. As directors spend more time on the board, they not only gain experience and knowledge, but also foster social interaction with their peers on the board and with upper management. As tenure increases, these ties are likely to grow stronger, leading to a "structural bias":[73] the bias resulting from board members' interactions with one another after joining the board. This bias could potentially compromise directors' ability to act independently of their social bias, or at the very least, such close ties might cloud directors' ability to detect wrongdoing.

Importantly, tenure potentially affects not only pre-existing and newly formed social ties with management but also increases this structural bias, making it less likely that any single director would be willing to voice an opinion if such opinion might jeopardize the close-knit atmosphere of the board room. Indeed, anecdotally, congressional

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[72] *See* Lisa M. Fairfax, 31 OHIO N.U. L. REV. 381, 391-396 (2005) (discussing the *Oracle* and *Beam* cases in the context of Delaware courts' willingness to consider social and professional ties in the independence inquiry); *see also Beam v. Stewart, 845 A.2d 1040 (Del. 2004)* (focusing on social and professional ties); *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 938 (Del. Ch. 2003) (holding that the independence analysis should pay heed to personal and social relationships among directors and finding that such relationships negated directors' independence).

[73] *See* Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L.Q. 821, 831 (2004).

investigation into the Enron and WorldCom cases, the scandals that jumpstarted the increased attention to board independence, concluded that Enron's CEO, Conrad Black, had longstanding social, business, and political ties with directors that undermined the directors' ability to be diligent and detect the CEO's fraud.[74]

Granted, social science[75] and corporate governance[76] literature has pointed out that a close-knit board can be beneficial for board performance, increasing trust and openness between board members. However, the same social science literature has also acknowledged that these benefits do come with a price tag of decreased independence and increased difficulty in impartially assessing another director's work.[77] Perhaps more importantly, a close-knit board can tend to avoid conflict if and when action would undermine the friendship one has formed.[78]

While critics of current definitions of director independence have already voiced concern over the impact social interaction might have on independence – and while Delaware law has acknowledged the potential effect it might have on independence (although in a very limited

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[74] *See* Richard C. Breeden, *Restoring Trust: Report to the Hon. Jed S. Rakoff on Corporate Governance For The Future Of Mci, Inc.* 817–18 (2003), *available at* http://www.sec.gov/Archives/edgar/data/723527/000119312503044064/dex992.htm. Regarding the issue of board dynamics and fraud see Hatice Uzun et al., *Board Composition and Corporate Fraud*, FIN. ANALYSTS J. 33, 41 (2004).

[75] *See* James D. Westpahl & Edward J. Zajac, *Defections from the Inner Circle: Social Exchange, Reciprocity and the Diffusion of Board Independence in U.S. Corporations*, 42 ADMIN. SCI. Q. 161, 163–64 (1997).

[76] *See* John F. Olson & Michael T. Adams, *Composing a Balanced and Effective Board To Meet New Governance Mandates*, 59 BUS. LAW. 421, 445–46 (2004).

[77] *See* Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 598–99, 612–13 (1982); Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233 (2003).

[78] *See* Karen A. Jehn & Priti Pradhan Shah, *Interpersonal Relationships and Task Performance: An Examination of Mediating Processes in Friendship and Acquaintance Groups*, 72 J. PERSONALITY & SOC. PSYCHOL. 775, 778 (1997); Janine Nahapiet & Sumantra Ghoshal, *Social Capital, Intellectual Capital, and the Organizational Advantage*, 23 ACAD. MGMT. REV. 242, 245 (1998); Reed Nelson, *The Strength of Strong Ties: Social Networks and Intergroup Conflict in Organizations*, 32 ACAD. MGMT. J. 377, 380 (1989); J. Goodstein and W. Boeker, *Turbulence at the Top: A New Perspective on Governance Structure Changes and Strategic Change*, 34 ACAD. MGMT. J. 306 (1991) (finding that the longer the members of a board of directors have worked together, the more likely they are to resist change); S.C. VANCE, CORPORATE LEADERSHIP: BOARDS, DIRECTORS, AND STRATEGY (McGraw Hill, 1983) (finding that the longer the members of a board of directors have worked together, the more likely they are to tolerate poor performance on the part of senior management); R.D. Kosnik, *Effects of Board Demography and Directors' Incentives on Corporate Greenmail Decisions*, 33 ACAD. MGMT. J. 129 (1990).

fashion)[79]– the impact of tenure on the equation has evaded a similar treatment. Since tenure in not a fixed element, but rather increases with time, the impact of social ties, both pre-existing and newly formed, is expected to grow as the tenure of any director grows longer. A board member who has served with the same close group for 10 or 12 years is likely to suffer from more "social bias" than when she had served for two or five years. As tenure increases, old social ties grow stronger and new social ties are formed, all of which exacerbate the potential threat to independence.

A related issue stems not from the direct impact tenure has on the independence of a long tenured director but rather from the impact long tenured directors have on the independence of incoming directors and the ability of the board room to foster "open to all ideas" atmosphere. Since longer tenured directors arguably carry more clout and influence in the board room, they might inhibit and restrain, intentionally or inadvertently, the ability and willingness of the less tenured directors to act independently, encouraging conformity to group thinking.[80] Although, in many cases a unified board could better counter managerial entrenchment, in cases where tenured members of the board are captured by management or in cases where the interests of shareholders might diverge from the interests of some board members, such unity could pose a serious threat to effective and objective decision making.

2. Tenure, Human Capital and Financial Stake

While courts and regulators treat financial ties with a company as an important factor in assessing director independence, they do not consider director fees as part of such financial ties.[81] This approach

[79] *See Beam v. Stewart, 845 A.2d 1040 (Del. 2004)* (emphasizing that evidence regarding social, professional, or business relationships would normally be insufficient to discredit a director's independence). *See also In re Walt Disney Co. Derivative Litig*., 731 A.2d 342, 352 (Del. Ch. 1998) (establishing that Ovitz and Michael Eisner, the CEO of Walt Disney, had been friends for 25 years before Eisner recruited Ovitz to serve as president and director, but reasoning that such friendship did not impact Eisner's ability to be deemed independent for purposes of assessing the derivative action against Ovitz); *Litt v. Wycoff,* No. Civ. A 19083-NC, 2003 WL 1794724, (Del. Ch. Mar. 28, 2003) (noting that even longstanding personal friendships would not impede a director's independence); *Crescent/Mach I Partners, L.P. v. Turner*, 846 A.2d 963, 980–81 (Del. Ch. 2000) (stating that a 15 year personal relationship is insufficient to impact an independence inquiry).

[80] *See* Einer R. Elhauge, *Are Term Limits Undemocratic?* 64 U. CHIC. L. REV. 83 (1997) (describing the impact tenure has on power, clout and influence in the political sphere).

[81] For a critique of the exemption of director fees see J Robert Brown Jr., *The Myth of Director Independence Under Delaware Law: The Payment of $376,733 Does Not Result in a Loss of Director*

would seem to be reasonable when compensation is given nominally for the service a director provides, as proper compensation could better incentivize a director to invest the required amount of time in the job. However, true financial dependency cannot be narrowed to just ties outside of director fees. Indeed, some academics have already voiced concern[82] that the not trivial payments to directors might incentivize them to hold on to their seat, at the price of voicing their opinion, if those two choices were to clash.

Director tenure exacerbates this concern. As further detailed in Part V, director compensation has not only risen in absolute terms in recent years, but has also changed in structure, moving from cash payments to equity compensation in the form of options and restricted stock.[83] These trends of increased compensation in general, and equity compensation in particular, are widely regarded as good governance practices – better aligning directors with shareholder interests.

However, when factoring tenure into the equation serious concerns as to director independence can arise. As directors serve on the board for longer periods, they accumulate an increasing portion of the company's equity, some of which they can only sell when they leave the board. Having their human capital and reputation invested in the corporation and also possessing an increased financial stake in the corporation might put their willingness to act independently at risk if such action could significantly damage the value of their equity. In other words, while equity compensation will generally incentivize directors to maximize firm value, they might refrain from acting diligently and independently when such actions would have a negative impact on firm value, and in turn on their equity, in the short to intermediate term, even if such action would potentially improve long term value.

Moreover, one can argue that one of the main duties of a director is to assure the accurate conveyance of information to the market, regardless of the impact such information would have on firm value. Tying director compensation to performance is counter effective in

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Independence, THERACETOTHEBOTTOM.ORG (Apr. 25, 2011) http://www.theracetothebottom.org/independent-directors/the-myth-of-directorindependence-under-delaware-law-the-pay.html. For the regulatory landscape, see Fairfax *supra* note 68 (detailing Delaware and federal treatment of fees).

[82] *See* Brown, *supra* note 81.

[83] For anecdotal evidence regarding director compensation and the proportion of equity compensation with respect to Apple Inc., Wal-Mart Stores, Inc. General Electric Company and other large corporations, see THERACETOTHEBOTTOM.ORG DIRECTOR COMPENSATION PROJECT, http://www.theracetothebottom.org/home/director-compensation-project.html.

ensuring the fulfillment of such duty, and tenure, as detailed above, further exacerbates this concern.

Finally, in assessing director compensation, one must also factor in executive compensation. When both managers and directors hold sizable equity interests in the corporation, their interests might be better aligned to maximize firm value. However, at the same time, aligning managers' and directors' interests might also put shareholders' interests at risk by over aligning the monitor's interests (the board) with management's interests, carrying the risk that such over-alignment would lead to cases of earnings management[84] and a monitoring failure.

3. Tenure and Re-election

While directors must earn shareholder approval in order to be elected to the board, though in some cases the approval threshold for reelection is very minimal,[85] their true dependency lies with management and their peers. Since the overwhelming majority of director elections are uncontested, inclusion in the company's ballot is paramount to a director's ability to be elected and to subsequently hold her seat. Moreover, in some instances incumbent directors may continue to hold

[84] Earnings management is the use of accounting techniques to produce financial reports that may paint an overly positive picture of a company's business activities and financial position. *See, e.g.*, Biao Xie et al., *Earnings Management and Corporate Governance: The Role of The Board and The Audit Committee*, 9 JOURNAL OF CORPORATE FINANCE 295 (2003). Similar concerns of conflicts of interests have been raised with respect to the firm's outside auditor. *See e.g.*, Tamar Frankel, *Accountants' Independence The Recent Dilemma*. 2 COLUM. BUSINESS LAW REVIEW 261-274 (2000).

[85] In many U.S. firms the standard of election is a simple plurality resulting in a need for minimal support. Even in those firms that adopted majority rules, the lack of a slate of challenging candidates, as is usually the case, leads to very rare instances where directors are not elected. Even in those cases the board usually retains the power to keep such director in the board nonetheless. For a review of the issues with current director voting see The United Brotherhood of Carpenters and Joiners of America, *Petition for Rulemaking Concerning Rule 14a-4 Requirements, available at* www.sec.gov/rules/petitions/2011/petn4-630.pdf; *see also* Jay Cai, et al., *Paper Tiger? An Empirical Analysis of Majority Voting,* 21 J. OF CORP. FIN. 119 (2013) (questioning the impact of current majority voting policies); Yonca Ertimur et al., *Does the Director Election System Matter? Evidence from Majority Voting* (working paper, 2013) (finding that majority voting is associated with abnormal return in comparison to plurality system); *City of Westland Police & Fire Ret. Sys. v. Axcelis Techs., Inc.*, 2009 Del. Ch. LEXIS 173 (Del. Ch. Sept. 28, 2009) (finding that he refusal of a board of directors to accept the resignation of a director who fails to obtain a majority vote under a "Pfizer-style" majority vote resignation policy is largely immune from judicial review). For analysis of the case see Lawrence A. Hamermesh, *Delaware Decision Defers to Retention of Directors Under a "Majority Vote Resignation Policy"*, THE HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (Oct. 30, 2009), http://blogs.law.harvard.edu/corpgov/2009/10/30/delaware-decision-defers-toretention-of-directors-under-a-majority-vote-resignation-policy.

their seat, despite shareholder lack of support, if their peers on the board so determine.[86]

This current structure of director election, where management effectively controls director nomination, puts directors in a potentially compromised position, and forces them to consider the ramifications for their reelection if they choose to confront management or their peer directors. Ironically, the recent trend toward annual elections, a positive trend in itself from a governance perspective, might aggravate this concern. If in the past most directors were guaranteed a three year term due to the staggered board structure that prevailed in the S&P 500, due to the declassification of most boards they now face annual elections. The continued dependency on management, and the current lack of reforms to the proxy system, could potentially make these directors even more concerned about their re-election and securing management and peer support, as they now are granted only one year terms.

While tenure might not seem directly relevant to this issue of dependency on management support, it does have an indirect effect. In a world where directors may serve indefinite terms, their willingness to risk their position would be smaller than in a world where directors' terms are finite. Because director elections in the U.S. are rarely contested, each director not only controls the level of her pay but also the duration of it – so long as she stays in the good graces of her peers and management. This provides directors with higher expected value for the position, since they can decide for how long they will get the pay stream it entitles. In a world where tenure is restricted the expected value of a director position is smaller. Having less at stake may incentivize directors to act in the best interests of shareholders.

Similarly, limiting tenure may also foster more scrutiny from directors nearing the end of their term. Just as presidents tend to be more active on controversial issues in their second term, when they can no longer run for reelection, directors might be willing to be more proactive in confronting issues if their term is limited.

4. Can Tenure Strengthen Independence?

While it is clear that tenure can impact director independence, some argue that it is not always the case that such impact is negative, as tenure may strengthen director independence in certain cases. As a

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[86] In most cases, even under a majority election system, the board retains the power to reject a director's resignation.

board's member tenure grows, her confidence, networking and knowledge of the company may make her more independent, the argument goes. This argument is often raised in the context of the relationship between the board and the CEO. Since CEO tenure is, on average, shorter than that of a director, an argument can be made that the more tenured directors are more independent vis-à-vis the CEO and not the other way around. This might be particularly true when a director remains on the board after the CEO who has appointed her has departed.

However, while in theory this argument may seem appealing, it falls short of resolving the issue. First, treating the benefits of tenure as a linear function is misguided. While a first year director may need time to immerse herself in the corporation, and thus may be expected to act less independently or effectively than a fifth year director, after some number of years the marginal benefit of tenure decreases as tenure increases. In other words, past a certain point the benefits tenure provides in the context of a director's ability to act independently decrease. At the same time, the marginal costs of increased tenure, as described above, rise.

Second, while tenure might lead a director to feel more entrenched and thus act more independently vis-à-vis a particular member of management, it must not be confused with her ability to be independent from management as a whole. While a director may feel less threatened by an incoming CEO if she is long tenured, it does not mean that the director is independent of management as a whole nor does it mean that the director is empowered to act independently *from the company*. As detailed above, many of the factors that threaten director independence are not tied directly to a single relationship but rather to organizational concerns. Compensation, social ties and nomination are not a function of any single individual and thus lack of attachment of a director to any single CEO does not translate to lack of attachment to director peers on the board or the company as a whole.

Third, while many directors see more than one CEO during their tenure, it does not mean that the incoming CEO is not already strongly connected to the board. In many cases CEOs are promoted from within, making a tenured director more, rather than less, likely to have a preexisting relationship with the CEO. Even in cases where the incoming CEO is hired from outside the company, she often enters the company from a negotiating position of power and not weakness, and is often

granted the leeway to shape the board as she sees fit, making such tenured directors less likely to stir the pot.

Finally, even if we accept that tenure may, in limited instances, strengthen director independence, it is still likely to reduce director independence in a number of other instances, as argued above, and thus warrants proper recognition and examination.

C. Anecdotal Evidence Illustrating The Potential Impact of Tenure on Governance

While social science theory suggests that board tenure could play an important role in the way the board acts, it is also important to illustrate the potential impact of tenure in a real world setting. Two contrasting examples, one in which long tenure brought about one of the biggest corporate scandals of the last decade and one in which reducing board tenure contributed to a potentially positive ousting of management, illustrate the core argument made in this paper – that tenure is an important factor in considering director independence.

1. Long Tenure and "Compromised Independence": The Enron Case

The Enron scandal was a pivotal turning point in public and regulatory views on corporate America and corporate governance.[87] As detailed above, the Enron case led to significant changes to the regulatory regime of publicly traded companies. On December 2, 2001, Enron Corp., then the nation's seventh largest corporation, declared bankruptcy following months of shareholder and regulatory rage over accounting fraud that had been uncovered.[88] The ensuing months revealed many details about Enron's practices and the failure of the safeguards that were aimed at preventing such activities from happening. One of these safeguards was Enron's board of directors.

On paper, Enron had a model board, even by current standards. It was comprised predominantly of outsiders with significant ownership stakes and a talented audit committee.[89] Enron's May 1, 2001 proxy statement listed 14 board members, only two of whom were internal

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[87] Jeffery N. Gordon, *What Enron Means for the Management and Control of the Modern Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233 (2002).

[88] Stuart L. Gillan & John D. Martin, *Financial Engineering, Corporate Governance, and the Collapse of Enron* (working paper, 2002).

[89] *See* Gordon, *supra* note 87.

executives (Chairman of the Board and former CEO Kenneth L. Lay, and President and CEO Jeffrey K. Skilling), and 12 of whom were non-employee outsiders. Enron's board structure was also ahead of its time, with audit and compliance, compensation, management development, executive, finance, and nominating and corporate governance subcommittees, a practice that was not common among large firms at that time.[90] Similarly, the audit, compensation, and nominating committees were comprised solely of outside directors.

However, in reality most of the outside directors were not independent at all. A special report by the U.S. senate issued in 2002 detailed the many failures of the board of Enron and expressed concern as to its independence.[91] Among the findings were significant financial ties[92] to Enron and high equity holdings of Enron's stock as part of the director compensation plan.[93] Notably, Enron had five directors who had served on the board since the merger that created it in 1985 – tenure of 16 years. In addition, only four of the remaining board members had tenure of less than nine years, resulting in an average board tenure of 11.6 years at the time of the collapse (the S&P 500 averaged 7.65 years at that time).

The special committee report indicated that despite the board's "wealth of sophisticated business and investment experience and considerable expertise in accounting, derivatives, and structured finance" management's earning manipulation was not detected. Accordingly, the report questioned the board's independence and willingness to challenge

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[90] During the late 1990s, fewer than 60% of large firms had separate nominating committees, fewer than half (46%) had a separate finance committee and fewer than 25% had corporate governance committees. *See* Gillan *supra* note 88.

[91] *See* PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS, UNITED STATES SENATE, THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE (Jul. 8, 2002*), available at* www.gpo.gov/fdsys/pkg/CPRT.../html/CPRT-107SPRT80393.htm.

[92] The US Senate investigation into the role of the Enron board of directors in the company's collapse highlighted numerous financial ties between Enron and six directors who had potential conflicts of interest through financial ties with the company: where they were paid consulting fees in addition to board fees, where there were transactions with entities in which directors played a major role, and where there were donations to groups with which directors were affiliated.

[93] Directors owned significant amounts of Enron stock ranging in value from $266,000 to $706,000,000, and it has been suggested that some board members' financial interests may have attenuated any inclination to aggressively monitor management's practices – practices that sought to preserve the firm's debt ratings, supplement reported earnings, and maintain the firm's growth and stock price through the use of complex derivative transactions. *See* Gilan *supra* note 88; *see also* Joanne S. Lublin*, Inside, Outside Enron, Audit Committee is Scrutinized*, WALL STREET JOURNAL (Feb. 1, 2002).

management and found that the board "routinely relied on Enron management and Andersen [the outside auditor] representations with little or no effort to verify the information provided, readily approved new business ventures and complex transactions, and exercised weak oversight of company operations."[94] In addition, the report found that "[h]igh risk accounting practices, extensive undisclosed off-the-books transactions, inappropriate conflict of interest transactions, and excessive compensation plans were known to and authorized by the Board" with little to no challenge from the Enron board.

The report also delved in detail into the board's personal relationships and decision making, describing a reality in which dissenting opinions from directors were almost nonexistent. Equally importantly, the report portrayed the board as overly trusting of management, with whom some directors had strong personal relationships:

> Enron board members uniformly described internal Board relations as harmonious. They said that Board votes were generally unanimous and could recall only two instances over the course of many years involving dissenting votes. The Directors also described a good working relationship with Enron management. Several had close personal relationships with Board Chairman and Chief Executive Officer (CEO) Kenneth L. Lay. All indicated they had possessed great respect for senior Enron officers.[95]

Finally, the report also refuted the claim that the mismanagement by Enron officers came as a true surprise to the board. The report listed more than a dozen incidents over the three year period prior to the collapse that should have raised concerns about the activities of the company, yet the board did not act or investigate any of these issues.

The Enron case epitomizes the need for true monitoring in the board room. It is also a clear reminder of what happens when directors, even those regarded as "independent," suffer from potentially compromising factors affecting their independence. While there were many factors that reduced the independence of the Enron board and it is impossible to segregate one from the other, the role of the Enron

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[94] *See* THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE, *supra* note 91, at 23.

[95] *Id.* at 14.

directors' tenure, as an amplifying factor, cannot be ignored. If large equity stakes in the company, which increase with tenure, and close personal relationships with management, which also strengthen over time, influenced the board's ability to ask the right questions, then the long tenure of the majority of the board played an important role in bringing about Enron's demise.

2. The Impact of Reduction in Board Tenure: The Citi Case

In an abrupt move in October of 2012, after Citi Group reported that its underlying profits in the third quarter were strong and its outlook was improving, then CEO Vikram Pandit surprised both Wall Street and bank employees when he said he was stepping down and also relinquishing his seat on the board.[96] It is a common practice to allow the CEO to portray resignation as his own initiative, and several reports have attributed the move to a demand from the chairman of the board, Michael O'Neill, for Pandit to tender his resignation.[97] While many reports focused on the power play the relatively new chairman had orchestrated, it is also important to highlight the board room landscape that allowed this maneuver to happen.

O'Neill joined the board in 2009, after Pandit was already serving as CEO, and was appointed as chairman in April 2012, only six months before asking Pandit to step down. Pandit was not his choice and a number of other board members were relatively new as well. Table 1 below details the average tenure of Citi's board since 1999, showing an increasing tenure on the board until the financial crisis in 2008 and then a drop in tenure from an average tenure of 10.07 years during the first year of Pandit's tenure in 2008 to 3.44 years at the time he was ousted.

Table 1: CitiGroup's Average Board Tenure Since 2003[98]

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[96] *See* Adam Shell & Matt Krantz, *Citigroup CEO Pandit Steps Down*, USA TODAY (Oct. 16, 2012), *available at* http://www.usatoday.com/story/money/business/2012/10/16/citigrouppandit/1635999/; Steven Mufson & Danielle Douglas, *Citigroup CEO Vikram Pandit Quits*, THE WASHINGTON POST (Oct. 16, 2012), *available at* http://www.washingtonpost.com/business/economy/citigroup-ceo-vikram-pandit-quits/2012/10/16/9c33e1a2-1797-11e28792cf5305eddf60_story.html and Jessica Silver-Greenberg & Susanne Craig, *Citi Chairman Is Said to Have Planned Chief's Exit Over Months,* THE NEW YORK TIMES (Oct. 25, 2012), *available at* http://www.nytimes.com/2012/10/26/business/citi-chairman-is-said-to-have-planned-pandits-exit-for-months.html.

[97] Carrick Mollenkamp, Jed Horowitz & Rob Cox, *Citi's CEO Pandit Exits Abruptly After Board Clash*, REUTERS (Oct. 25, 2012), *available at* http://www.reuters.com/article/2012/10/16/us-citigroup-pandit-idUSBRE89F0O420121016.

[98] Data was derived from the company's proxy statements (DEF14-A), available at https://www.sec.gov/edgar/searchedgar/companysearch.html.

	Date	Average Board Tenure
Citigroup Inc	2003	11.6
Citigroup Inc	2004	12.2
Citigroup Inc	2005	10.3
Citigroup Inc	2006	10.66
Citigroup Inc	2007	10.46
Citigroup Inc	2008	10.84
Citigroup Inc	2009	6.07
Citigroup Inc	2010	3.8
Citigroup Inc	2011	4.9
Citigroup Inc	2012	3.4
Citigroup Inc	2013	3.57

Table 2 compares the tenure of the directors considered to be independent at Citi in October 2012 versus October 2008. This table reflects not only an average tenure of 3.44 years – roughly a third of the average tenure in an S&P 500 firm (9.8 years) – when Pandit was ousted, but also that in 2012 only one director had served for more than five years, the tenure of the CEO Pandit. In comparison, in 2008 seven out of 12 directors had served for longer than five years, making the Citi board in 2012 particularly suitable for such action against management.

Table 2: Board Members' Tenure in October 2012 vs. October 2008

Directors in 2012	Tenure		Directors in 2008	Tenure
Franz Humer	0.6		Alain J.P. Belda	11
Bob Joss	3.1		Winfried Bischoff	1
Michael O'Neill	3.6		Kenneth T. Derr	19
Larry Ricciardi	4		John M. Deutch	12 (+6 years prior)
Judith Rodin	8		Roberto H Ramirez	7
Robert Ryan	5.1		Andrew N. Liveris	3
Anthony Santomero	3.6		Anne M. Mulcahy	4
Joan Spero	0.6		Richard D. Parsons	12
Diana Taylor	3.1		Judith Rodin	4
Bill Thompson Jr	3.6		Robert E. Rubin	9
Ernesto de Leon	2.6		Robert L. Ryan	2
			Franklin A. Thomas	38
			Michael Armstrong	19

The data shown above implies that, when O'Neill took over as the chairman, the board had only two directors appointed with or before Pandit, and thus could avoid the problem of fairly evaluating someone they had chosen and in whom they were invested professionally and personally. It seems then, that at least in part, injecting new blood into

the board room proved critical to the move to force out the CEO. While one can argue about the full spectrum of factors behind a decision to oust an incumbent CEO, the reality is that it is not that often that the board chooses to act in such aggressive way, shocking Wall Street and bank employees alike. It is also likely that this move would not have happened so swiftly and decisively with a board that felt attached to a CEO it had elected and fostered relationships with.[99] Indeed, the Citi case was considered according to a WSJ report as "an extraordinary flexing of boardroom muscle at Citigroup, a company that until recently had a board stocked with directors handpicked by former CEO Sanford Weill who rarely challenged management decisions."[100]

While the shake-up took the market by surprise, it was generally welcomed as a positive and needed change to Citi's management, coming after a series of missteps that left some directors feeling that the company wasn't being managed effectively and that the board was not kept adequately informed.[101] Citigroup shares dropped 89% during Mr. Pandit's tenure, although the financial crisis contributed greatly to such drop, and the company was hit by a shareholder revolt over executive pay, by the Federal Reserve's rejection of its plan to buy back stock and by a $2.9 billion write-down of a brokerage joint venture with Morgan Stanley. Since Pandit's exit, Citi stock has gone from trading at levels of $38 to trading at $52 at the end of 2013, a 41% return. While many factors play into company performance, it is noteworthy that Citi stock outperformed both the S&P500 (41% vs. 18%) and the BKX banking index (41% vs. 30%) for the October 20 2012 to July 20, 2013 time period.

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The Enron and Citi cases both serve as examples of the potential impact of tenure on the corporate governance of a firm. While tenure may not have been the sole or even the main force behind either of these

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[99] Ben W. Heineman, Jr., *Citigroup: A Symbol of Board Resurgence?* HARV. BUS. REV. (Nov. 5, 2012), *available at* http://blogs.hbr.org/cs/2012/11/citigroup_a_symbol_of_board_re.html.

[100] David Enrich, Suzanne Kapner & Dan Fitzpatrick, *Pandit Is Forced Out at Citi*, THE WALL STREET JOURNAL (Oct. 17, 2012), *available at* http://online.wsj.com/article/SB100008723963904438542045780602802014885 30.html.

[101] *Id.*; *see also* Jessica Silver-Greenberg & Susanne Craig, *Citigroup's Chief Resigns in Surprise Step*, DEALBOOK (October 16, 2012), *available at* http://dealbook.nytimes.com/2012/10/16/pandit-steps-down-as-citis-chief.

examples, it appears that it was at the very least a contributing factor. Further, not only is tenure an underutilized factor when assessing board independence, as discussed above, tenure on U.S. boards has in fact increased since the independence requirements were mandated as part of SOX. This trend, coupled with other changes in board structure, is explored in Part IV.

IV. THE RISE IN AVERAGE TENURE AND OTHER CHANGES TO BOARD COMPOSITION

Thus far this Article has focused on the common perception, in academic and public discourse alike, of the transformation of boards of directors in the U.S. into predominantly independent organs. In doing so, this Article has described the shift in the "job-description" of the board and the recent trends and regulatory changes epitomizing this shift, trends that are commonly regarded as enhancing director independence. The Article has also highlighted the potential impact director tenure might have on director independence and the lack of current attention to this potential impact.

This Part seeks to provide empirical data on board tenure in recent years as well as to highlight other recent trends in the structure of public U.S. boards. By presenting a more nuanced and complete picture of the transformation board structure has undergone, the Article posits that regulatory and public demands might have forced public firms to reach an undesirable equilibrium in their board structure. The Article further suggests that, as a result, these firms have created a modified version of the "old-structure" insider board while still meeting current regulatory requirements and public demand.

A. Rising Board Tenure: An Empirical Examination

The change in board structure – with insiders being replaced by directors who meet the regulatory independence requirements – is not the only trend that has occurred in board rooms over the last decade. While independent directors' share of the board room has increased, so has the average tenure of directors overall. As reflected in table 3 below, tenure has been on the rise and interestingly, not only as a temporary spike after the regulatory shocks of SOX and Dodd-Frank, but rather as an ongoing trend with a greater magnitude over the last five years.

Table 3: Average Board Tenure by Year for S&P 500 firms[102]

Year	Average Board Tenure in S&P 500 Firms (years)
2001*	7.930
2003	7.931
2004	7.934
2005	7.938
2006	7.945
2007	7.953
2008	7.961
2009	8.156
2010	8.451
2011	8.494
2012	8.644
2013	8.710

* Based on hand collected data of a limited sample of 300 companies of the S&P 500

Indeed, the rise in tenure in the years 2003-2013 does not reflect a simple market correction or a regression to the mean, after SOX regulatory demands came into effect. One might hypothesize that the rising tenure is a byproduct of a large turnover of board members caused by SOX requirements in 2002 and 2003 that led to an initial temporary sharp decrease in boards' average tenure and then a subsequent period of slowly increasing tenure. However, using hand collected data of over 300 companies of the S&P 500, I found that the average board tenure in 2001, prior to the Enron fallout and the SOX discussions, was 7.930 years, which is very similar to the average tenure in 2003 of 7.931 years. Accordingly, SOX did not lead to a sudden decrease in board average tenure, and the upward trend is not a mere "return to average."

Similarly, since the average board size has remained approximately the same, standing at 11 seats and even decreasing slightly in recent years, the documented increase in tenure cannot be attributed to an increase in the average board size.

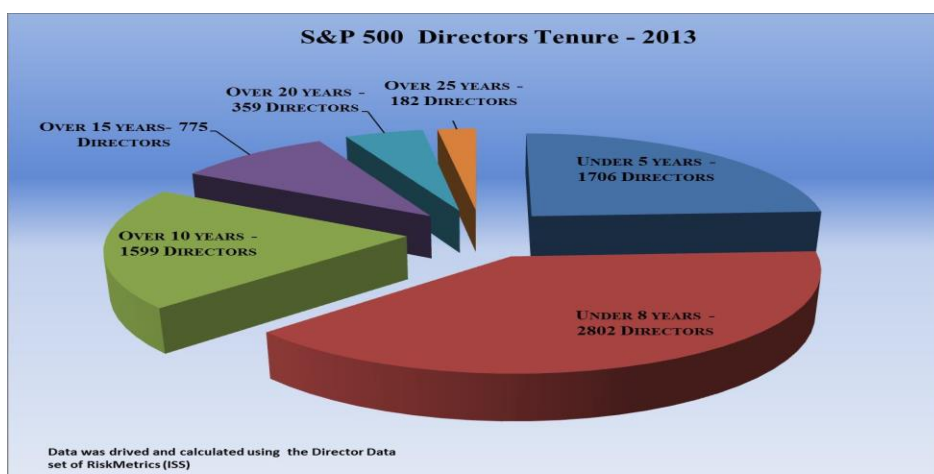
The rise in the average tenure is even more striking when taking the skewed distribution of tenure into consideration. Specifically, when director turnover occurs, the departing director's tenure is replaced with tenure of zero years by the incoming director. The fact that the

[102] Data was obtained from the BoardEx database and is valid through March 28, 2013. The BoardEx data file contains various statistics on all public companies in the U.S., including average board tenure for the years 2003-2013. This data was further corroborated by similar data that was obtained from the Risk-Metrics data file for the years 2007-2013.

introduction of a new director, by definition, resets tenure to zero means that the loss of longer tenured directors cannot be smoothed out by the appointment of a director with similar tenure. In practice, this means that an increase in the average tenure of the board, as a whole, is even more significant.

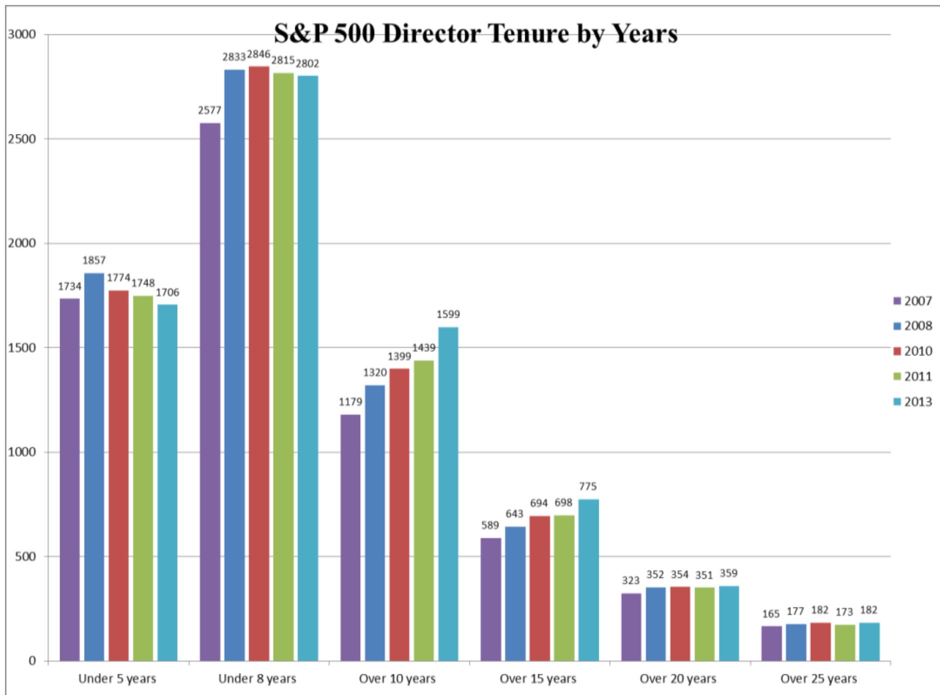
Examining the data from a different perspective, the number of directors in the S&P 500 with very long tenure is also significant. As Figure 1 shows, for the year 2013 the number of S&P 500 directors with tenure exceeding 15 years was 775, which was approximately 14.6% of the directors sampled.

Figure 1: Director Tenure in the S&P 500 for 2013



This data for 2013 represents an increase in the number of long tenured directors from earlier years, as reflected in figure 2. While, in 2007, 589 directors among S&P 500 companies had tenure exceeding 15 years, that number rose to 698 in 2011, an increase of close to 20%, and 775 in 2013, reflecting an increase of over 31%. Similarly, the number of S&P 500 directors with tenure of over 10 years rose by 35% from 2007 to 2013.

Figure 2: S&P 500 director tenure by year (2007-2013)



This ongoing trend is further corroborated by running regressions on the average board tenure for the S&P 500 companies for the years 2001-2011.[103] As table 4 illustrates, the regression confirms that tenure has been increasing over time with a coefficient of 0.1055, meaning that the average board tenure for an S&P 500 company has been increasing by slightly over a month each year. This correlation is highly significant. In addition, while the yearly average reflect that tenure increased more significantly after 2008, another regression over the interval 2001 to 2007 reaffirms the results for the entire duration with a coefficient of 0.09160 (significant), meaning that even for this interval, board tenure in the S&P 500 went up by over a month per year.

Table 4: Regression Results

[103] Data was obtained from the BoardEx database and is valid through March 28, 2013. The BoardEx data file contains various statistics on all public companies in the US, including average board tenure for the years 2001-2013. In order to prevent distortions to the regression analysis, only S&P 500 companies that were in the S&P 500 throughout this time period were included in the regression, to prevent distortions related to annual turnover in the S&P 500 due to IPOs on the one hand and going private/bankruptcy transactions on the other.

The table presents results from OLS regressions where the dependent variable is a board's average tenure. The first column presents OLS results for all company years. The second column focuses on the years 2001-2007. *** (**, *) indicates significance at the 1% (5%, 10%) level.

	Entire Sample	**For the 2001-2007 period**
(Intercept)	7.8517***	7.90118***
Time	0.1055***	0.09160**
Number of observations (in company years observations)	4,114	2,618
Adjusted R-squared	0.008723	0.002083

Furthermore, in order to control for firm size and industry, a two-way fixed effect linear regression model, controlling for year and sector dummies fixed effects with standard errors clustered by firms, was performed. Table 5 reports the results of the regressions and shows that firm size is not a driving force in the increase in the average board tenure. Additionally, when separating the average tenure of insiders and independent directors in each company's board, the results further show that a connection between the tenure of insiders and independent directors exists. Specifically, an increase of a year in the average tenure of the insiders would result in a 0.3358 year increase in the average tenure of the independent directors on the board.

Table 5: Regression Results Controlling for Firm Size, Industry and Directors' Independence

The table presents results from OLS regressions where the dependent variable is a board's average tenure. A two-way fixed effect linear regression model, controlling for year and industry dummies fixed effects with standard errors clustered by firms was performed. The first and second column present OLS results for the total board tenure. The third and fourth columns focus only on the average tenure of the independent directors on the board. *** (**, *) indicates significance at the 1% (5%, 10%) level.

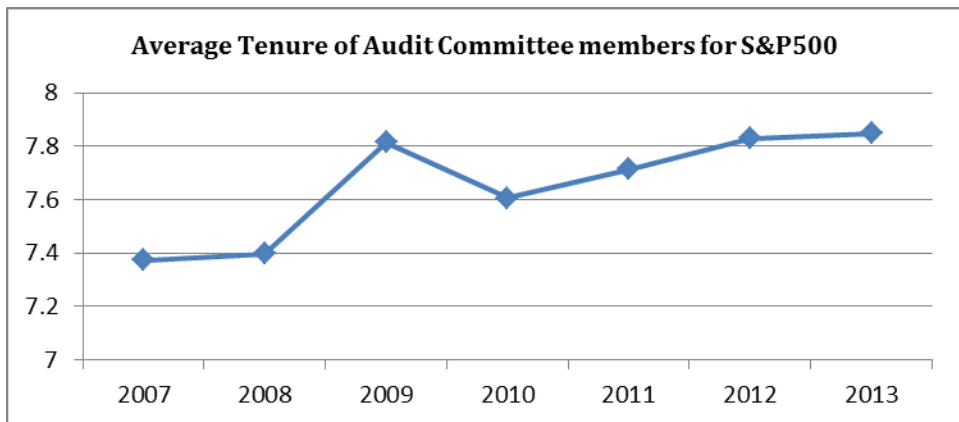
	Total Board Tenure	**Total Board Tenure**	**Independent Directors Tenure**	**Independent Directors Tenure**
Company Market Cap	-0.0000 (0.00)	-0.0000 (0.00)	-0.0000 (0.00)	-0.0000 (0.00)
TimeBrd		0.2068*** (0.02)		0.3358*** (0.02)
Year FE	Yes	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes	Yes
constant	7.9895***	7.1525***	8.3443***	6.2599***

	(0.22)	(1.13)	(0.22)	(0.68)
R-sqr	0.005	0.179	0.006	0.408
N	5685	5587	5689	5591
BIC	30985.9	29604.6	31061.7	27850.9

B. Similar Trends in Audit and Compensation Committee Members' Tenure

The upward trend in board tenure is not limited to the board as whole. Key committees of the board where independence is particularly important, such as audit and compensation committees, have also experienced increases in their average tenure. As Figure 3 below shows, the average tenure of audit committee members in the S&P 500 has increased from 7.38 years to 7.85 years over a seven year period.

Figure 3: S&P 500 Audit Committee Director Tenure by Year (2007-2013)

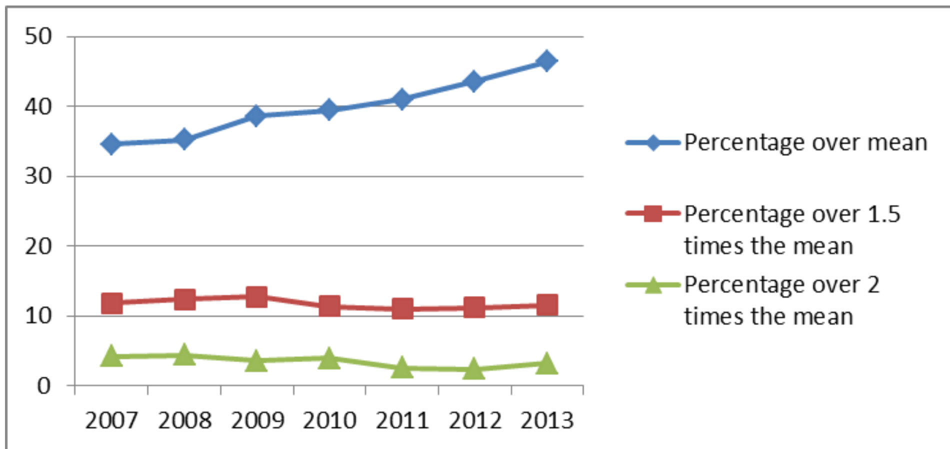


Looking more closely at the data, in addition to the rise in the average tenure of audit committee members, the number of companies in the S&P 500 with average audit committee tenure above the average is also on the rise. This is particularly important since this data rules out the possibility that the rise in audit committee members' individual tenure could be attributed to a few outlier directors.

As figure 4 demonstrates, the number of companies in the S&P 500 with average audit committee members' tenure (the average of all members of the company's audit committee) that is above the average tenure has been increasing over time from 34.6% in 2007 to 46.4% in

2013. While the percentage of companies with over 1.5 or two times the average has slightly declined over time, their absolute numbers are still significant, as close to 12 percent of S&P 500 companies have average audit committee tenure of over 11.8 years and three percent have an average that is over 15.7 years.

Figure 4: S&P 500 Company Average Audit Committee Director Tenure Trend by Year (2007-2013)

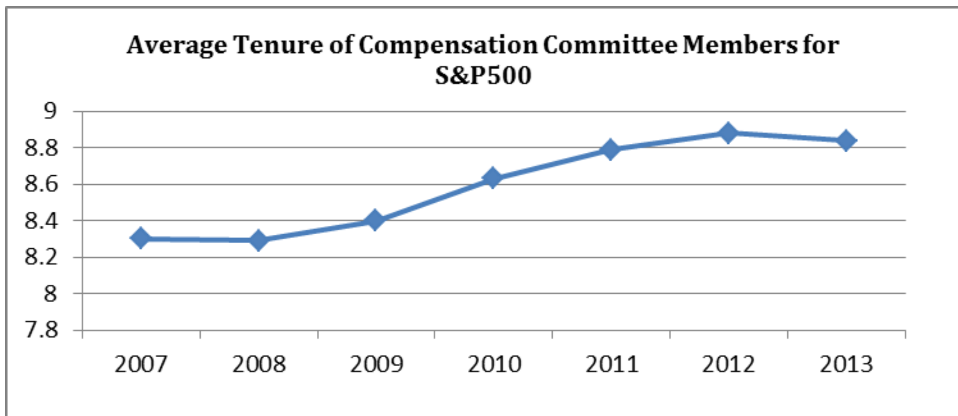


Numerous companies have exemplified this phenomenon. For example, in 2011, ACE LTD's audit committee chair had served for 20 years while two other members of the committee had served for 20 and 25 years respectively. In 2013, one of the directors left, leaving the committee with a chair with tenure of 22 years and one member with tenure of 27 years, along with the newcomer. Similarly, Actavis PLC had four directors on its audit committee in 2013 with tenures of 28, 27, 19 and 13 years. In 2010, The Coca-Cola Company had four audit committee members with tenures of 31, 29, 24 and 19 years. In 2013, only one member had retired leaving the committee with three members with tenures of 32, 27 and 22 years in addition to a newcomer with two years tenure. These examples may be outliers in the overall statistics but they illustrate how some companies may have audit committees with extremely long tenured members, raising all of the concerns that long tenure may entail.

As Figure 5 below illustrates, a similar trend is also observed among compensation committee members, where the average tenure of an S&P 500 director who serves on a compensation committee rose by

six months from 2007 to 2013 (from 8.3 to 8.84 years). Cases of extreme tenure are present here as well. Ametek, Inc., for example, had committee members with tenure of 33, 26, and 19 years and Urban Outfitters, Inc. had members with 37, 28 and 11 years of service.

Figure 5: S&P 500 Compensation Committee Director Tenure by Year (2007-2013)



Therefore, it is clear from the data that the rise in board tenure is a trend that has been present not only on boards as a whole, but also on key board committees, such as the audit and compensation committees. While the federal regulators and stock exchanges have focused on the independence of these committees as part of the SOX and Dodd-Frank reforms, signaling the importance of true independence on these committees because of their performance of vital monitoring functions, the effect of rising tenure on the independence of these committees has not been addressed.

C. *Other Trends Reflecting a Move toward Longer Tenure*

The empirical findings in regard to tenure are further supported by other trends in board structure, reflecting and corroborating the tendency on the part of companies to keep directors for longer periods of time.

First, the average turnover of board members and appointment of new directors has decreased in recent years. Indeed, the number of new appointees has dropped by 12% over the past five years and by 27% over the past 10 years. Initially, as boards recruited additional independent

directors and "financial experts," in order to comply with SOX requirements, there was an increase in the number of new directors added to S&P 500 boards, peaking in 2004 with a total of 443 new independent directors. By 2012, however, the number of new independent directors fell to 291, the lowest number documented since 2001, and in 2014 the number was still low, standing at 371.[104]

In addition, while nearly three-quarters of S&P 500 boards have adopted mandatory retirement policies for directors — up from 58% in 2000 — the retirement age is rising. Of S&P 500 companies, 73% currently set it at 72 or older versus 37% in 2000 and 30% at 75 or older, versus 1% in 2000. Similarly, and not surprisingly, considering the rising tenures of boards, the average age of independent directors on S&P 500 boards is also on the rise and currently stands at 63.1, three years higher than a decade ago. The average age of the board as a whole is also higher: 45% of all S&P 500 boards have an average age of 64 or older, almost triple the share 10 years ago. In addition, while 73% of all S&P 500 boards — up from 58% in 2000 — set a mandatory retirement age for directors, many retain the discretion to make exceptions to the rule.

Finally, the average size of S&P 500 boards stands at 10.8 directors, about the same as in recent years but down from 11.5 in 2000. Since smaller boards combined with longer tenure of the existing members reduces the chances of new blood entering the board room, this in turn further exacerbates the independence concerns raised above.

V. CAN THE MARKET SELF CORRECT?

So far, this Article has detailed the importance of director independence to the governance of the firm, the potential impact board tenure may have on director independence and the recent rise in board members' average tenure. Of course, a critical reader of this Article may ask why, as a practical matter, tenure is of concern: if the market were to value shorter tenure, one would expect that companies would move toward such arrangements on their own. Similarly, some voluntary movements by companies could be construed to mitigate the impact an increase in director tenure might have on board independence.

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[104] *See* Spencer Stuart Survey, *supra* note 54. Indeed, potential alternative explanation attributes the decline in the number of new director appointments in recent years to rising retirement ages, fewer voluntary resignations due to lingering effects of economic uncertainty and less urgency to appoint new directors with Sarbanes-Oxley compliance requirements having been fulfilled in the mid-2000s.

However, as further developed below, there are several reasons for concern as to the awareness and willingness of the market to address director tenure, as well as to the effectiveness of other market trends in mitigating the issue, making regulatory intervention potentially necessary.

A. Majority Voting, Director Interlocks and Remuneration: Voluntary Movements by Companies That Fail to Sufficiently Resolve Director Independence Concerns

As discussed above, recent years have seen many changes to the composition of the board. While many of them contribute to board independence, some of them fail to mitigate, and may even exacerbate, the impact the increasing tenure of directors has on their independence.

The issue of majority voting has been gaining steam in corporate governance,[105] and some institutional investors consider it to be the focal point of their governance strategy. Making directors more accountable to shareholders – not only by having the entire board stand for election annually, but by also presenting a realistic possibility of directors losing their seat – is an important corporate governance tool. While majority voting has been successfully promoted by several institutional actors such as CalSTRS and The United Brotherhood of Carpenters, its true effectiveness is in question since directors can still be retained by the company even if their resignation is tendered.[106] Since management's support is still the best way to secure such majority support, and board support is needed in cases where the director fails to receive a majority of the votes, the perception of greater dependence on shareholder approval, and thus more accountability, might not be fully accurate, as directors may feel an increased need to appease management and their peers.

An examination of the issue of director interlocks reveals a similar dissonance between the benefits of this trend and the particular negative impact it might have in the context of board independence and

[105] Roughly 80% of the S&P 500 has a majority voting policy in place. *See* WEIL, GOTSHAL & MANGES LLP, *Trends in Director Elections, Key Results from the 2012 Proxy Season* (Sep. 2012).

[106] For a critique regarding the current affair of majority voting, see The Council of Institutional Investors, *Letter to NYSE on Majority Voting for Directors* (June 20, 2013), *available at* http://www.cii.org/files/issues_and_advocacy/correspondence/2013/06_20_13_cii_letter_nasdaq_majority_voting.pdf. Recent empirical studies are conflicted as to whether majority voting in its current form even carries value. *See supra* note 85.

tenure. More boards are setting explicit limits on the number of other public-company directorships their directors and CEOs may hold. Seventy five percent of S&P 500 companies now limit other corporate directorships in some way, versus just 27% in 2006.[107] While director interlocks pose concerns of conflicts of interest and call into question the amount of time directors can dedicate to each of the companies on whose boards they serve, the fact that the ability to serve on numerous boards has decreased leads to more dependence on the part of directors on the board position that they do hold. Since the ability to diversify one's human and equity investment in board positions is now reduced, if a director holds only one position instead of a few, she is much more likely to have greater dependence and stronger motives to maintain her position for a longer period of time.

Finally, similar concerns lie with the remuneration for the positions a director holds. While, as mentioned above, a director needs to earn a sufficient amount to encourage monitoring,[108] higher compensation also leads to greater dependence of the director on her compensation – in what is termed in behavioral economics as *loss aversion*.[109] This is further exacerbated by the way compensation is awarded. As further detailed in table 6 below, the majority of the average director compensation package is paid in equity that is tied directly to the company's performance — as stock grants and options. This equity position in the company serves as a good incentive to improve value for shareholders but might also reduce the ability and willingness of directors to take steps that might be value reducing in the short term, even if important to the long term health of the company. Moreover, in extreme cases, on the order of Enron and WorldCom, where the company might collapse if a director were to act as diligently as she should, directors might be unwilling, or at the very least dis-incentivized, to dig deep into potential misconduct of management.

Table 6: Nonemployee director compensation[110]

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[107] *See* Spencer Stuart Survey, *supra* note 54.

[108] *See infra* Part III.B.2.

[109] In economics and decision theory, loss aversion refers to people's tendency to strongly prefer avoiding losses to acquiring gains. Some studies suggest that losses are twice as powerful, psychologically, as gains. *See* D. Kahneman & A. Tversky, *Choices, Values, and Frames,* 39 AMERICAN PSYCHOLOGIST 341, 342–350 (1984).

[110] Data for this table was taken from the Spencer Stuart Survey, *see supra* note 54.

	2014	**2012**	**2007**	**2002**
Total average compensation	$263,748	$242,385	$211,179	n/a
Average annual retainer	107,383	$96,649	$68,560	$39,538
Boards paying board meeting fee	25%	33%	52%	70%
Average board meeting fee	$2,229	$2,224	$2,027	$1,596
Boards offering stock option program for directors	18%	25%	42%	77%
Boards paying equity in addition to retainer	76%	76%	72%	42%

B. Private Ordering and Board Tenure

Still, if tenure is an important factor in assessing independence, as this Article contends, then why can't the market address it directly? As detailed below, there is a strong reason to believe that private ordering will not suffice in this instance. First, the vast majority of companies deliberately choose not to address tenure, and even the very small portion of the S&P 500 companies that do address tenure do it in a limited and potentially ineffective way. Second, private players who could pressure companies to address tenure have just recently begun to acknowledge the impact tenure might have on independence but have mainly bundled it with other factors, making it a case by case decision and casting doubt that the market will self-correct.

1. The Companies Themselves

Some S&P 500 companies do recognize the impact board tenure may have on director independence. The problem however is that despite the increased attention to board tenure, only 3% of S&P 500 companies specify term limits for directors in their corporate governance guidelines.[111] Of the remaining companies, 65% explicitly say they do not have term limits, and 31% do not mention term limits at all. These

[111] *See* Spencer Stuart Survey, *supra* note 54.

figures have actually declined over the past five years (16 companies currently have these arrangements down from 24 companies in 2010), making it appear unlikely that companies would address it on their own.

Even in the small subset of companies that have addressed board tenure, the design of the arrangements varies significantly. Of the 16 boards that do specify term limits, five set the limit at 15 years, four at 10 years, two at 12 years and the rest range from 18 to 30 years. Therefore, the instances in which a director must leave due to a term limit provision may be limited given an average tenure of less than nine years. In addition, many of these companies provide for exception to the term limits that can be invoked by the board at its discretion.[112]

For example, **Varian Medical Systems, Inc.** has the following self-imposed limitation on tenure:

> The Board has adopted a guideline for director retirement that provides that a director should not serve on the Board for more than 15 years or after a director reaches the age of about 75. This guideline may be adjusted as the Board deems appropriate.[113]

However, while Varian uses this limitation on tenure as an argument in favor of its governance standards and, in particular, in an effort to battle proposals for board declassification,[114] in reality this arrangement is very limited as directors can still serve for up to 15 years on the board, roughly double the average board tenure in the S&P 500 (or even longer if the board chooses to adjust the policy).

Furthermore, while a few companies acknowledge the impact of tenure by limiting the tenure of the chairman of the board, they refrain from expanding this policy to the other directors on the board or to any of its committees. For example **Pepco Holdings,** Inc.'s corporate governance guidelines limit a chairman's tenure to five years, but have no limitations on the tenure of other directors.[115]

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[112] Information was obtained from Spencer Stuart Survey, *see supra* note 54.

[113] *See* Varian Medical Systems, Inc. proxy materials, *available at* http://www.sec.gov/Archives/edgar/data/203527/000119312514456296/d837594ddef14a.htm.

[114] See *id.* (including board recommendation against a shareholder proposal to declassify the board and stating that such policy ensures directors' accountability to shareholders).

[115] *See* Pepco Holdings, Inc. Corporate Governance Guidelines (Mar. 6 2015), *available at* http://www.pepcoholdings.com/services/governance/guidelines/#d.

In sum, while tenure limits due to private ordering can be found among some S&P 500 companies, they are scarce. More importantly, even when such arrangements are adopted they vary greatly in their length and design, and their potential effectiveness.

2. Institutional Investors

Institutional investors' voting policies similarly generally fail to address board tenure. While a 2014 survey by ISS[116] found that 74 percent of investor respondents indicated that long director tenure is problematic and 63 percent indicated that lengthy director tenure can diminish a director's ability to serve as an independent steward, these concerns have not been fully translated to voting policies and standards. Surveying the corporate governance standards of some of the major institutional investors reveals that the majority of these institutions ignore tenure as a factor that is important to corporate governance.

In surveying the voting policies of the top 50 U.S. pension funds[117] and the top 50 U.S. mutual funds, this Article found that only 30% of the mutual funds have a policy regarding board tenure (up from 24% in 2013). Of the 30%, most have policies that decline to support shareholder proposals for limiting director tenure. The justification for such opposition to term limits almost always stems from a concern that good directors would be forced out. However, as further developed below, this is not necessarily the case, even with some limitation on tenure in place.

Similarly, only 50% of the pension funds surveyed have a policy regarding board tenure in place. Of those funds with a policy in place, only three have a policy supporting term limits while 22 oppose such limits based on similar arguments to the ones asserted by mutual funds.

Table 7: Voting Policies of Institutional Investors

	Support Term Limits Proposals	Against	Ignore
Mutual Funds	3 (but only if management supports)	12	35
Pension Funds	3	22	25

[116] *See* ISS report, *Director Tenure (US and Canada) (2014)*, *available at* http://www.issgovernance.com/files/Directortenure-USandCanada.pdf.

[117] See Appendix A for the list of the surveyed funds.

Interestingly, a closer look at the minority of institutional investors that do address tenure reveals that they view term-limits as a means to refresh the board rather than as a tool to protect board independence. For instance, Blackrock states that it objects to term limits because:

> While we support regular board refreshment, we are not opposed in principle to long-tenured directors nor do we believe that long board tenure is necessarily an impediment to director independence.[118]

In the limited cases where an institutional investor does acknowledge the importance of tenure, their approach is often tentative and discretionary. For example CalStrs adopted a case by case approach to tenure:

> Director Tenure: An effective board should have both short- and long-tenured directors to ensure that fresh perspectives are provided and that experience, continuity and stability exist on the board. CalSTRS does not support limiting director tenure but believes the board should review the director's years of board service as part of the annual board review.[119]

Although this approach is noteworthy in its recognition of the importance of tenure, it leaves the discretion to limit tenure to the board itself and raises issues of evaluation and uniformity.

Recently, in a positive development, several institutional investors have amended their voting policies and guidelines to address the issue of director tenure. For instance, the Council of Institutional investors (CII) now encourages boards to weigh whether a "seasoned director should no longer be considered independent." State Street amended its voting guidelines to now state that it may withhold votes from directors when overall average board tenure is excessive and/or individual director tenure is excessive. Similarly, on December 16, 2015, CalPERS' Global Governance Policy Ad Hoc Subcommittee approved

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[118] *See* Blackrock, *Proxy Voting Guidelines for U.S. Securities* (Feb. 2015), *available at* http://www.blackrock.com/corporate/en-no/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf.

[119] California State Teachers' Retirement System Corporate Governance Principles (April 2015), *available at* http://www.calstrs.com/principles.

proposed revisions to the pension fund's Global Governance Principles to require that companies take a comply-or-explain approach on the issue of long-tenured directors. Under the proposed revised principles, a company would have two options with respect to a director who has served on the board for more than 12 years: either classify the director as non-independent or annually disclose a basis for continuing to deem him or her independent.

Therefore, while more and more institutional investors have recognized the importance of tenure and its impact on director independence as exemplified by the Council of Institutional Investors' 2013 statement that it may soon urge shareholders and boards to look more skeptically at the independence of long-serving directors,[120] and the subsequent changes to the voting policies of CII, State Street and CalPERS to date this recognition has not translated into wide scale policy changes within the institutional investor community.

3. Proxy Advisors

ISS, one of the prominent shareholder proxy advisory firms, has just recently moved away from a long standing policy of ignoring tenure. After soliciting input regarding the potential inclusion of tenure as a factor in its voting recommendations, ISS has decided to recognize the impact of tenure albeit in a very limited fashion, through the following:

> Vote against management proposals to limit the tenure of outside directors through term limits. However, scrutinize boards where the average tenure of all directors exceeds 15 years for independence from management and for sufficient turnover to ensure that new perspectives are being added to the board.

Although this policy is praiseworthy for its recognition of the importance of director tenure, it holds very little power in reality, as (1) ISS requires that the average tenure of the entire board would be over 15 years and therefore allows for some directors to serve for extremely long periods as long as the average of the entire board is 15 years or less, and (2) even then ISS only promises to "scrutinize" the board.

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[120] *See* Joann S. Lublin, *The 40-Year Club: America's Longest-Serving Directors*, THE WALL STREET JOURNAL (July 16, 2013), *available at* http://www.wsj.com/articles/SB100014241278873236642045786079240559673366.

ISS has also modified its quick score for companies' governance practices. The quick score grades companies on several parameters.[121] In its latest iteration, the quick score will consider non-executive directors with tenure that is greater than nine years.[122]

Glass Lewis, another leading shareholder advisory firm, presents a stark contrast, outright objecting to the inclusion of a limitation on board tenure:

> Glass Lewis believes that director age and term limits typically are not in shareholders' best interests. Too often age and term limits are used by boards as a crutch to remove board members who have served for an extended period of time. When used in that fashion, they are indicative of a board that has a difficult time making tough decisions…. Some shareholders support term limits as a way to force change when boards are unwilling to do so.
> While we understand that age limits can be a way to force change where boards are unwilling to make changes on their own, the long-term impact of age limits restricts experienced and potentially valuable board members from service through an arbitrary means.

Therefore, while some advisory firms, such as ISS, have recognized the importance of board tenure, that recognition is far from universal and, even in the case of ISS, has only resulted in voting recommendations that address tenure in a very limited fashion.

Importantly, while the private market in the U.S. has yet to fully and effectively address the issue of director tenure and director independence, tenure has been recognized as an important governance factor elsewhere in the world, and institutional investors and advisory firms do consider tenure in the context of their foreign investments. For example, the U.K. has adopted term limits for independent directors and, indeed, the average tenure in the U.K. is half that of the U.S.;[123] several

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[121] The ISS quick score grade companies on four categories: board structure, executive compensation, shareholder rights and audit-related practices. For a full description see ISS QuickScore 3.0, *available at* http://www.issgovernance.com/quickscore.

[122] *See* ISS, *Description of ISS Methodology*, *available at* http://www.issgovernance.com/file/products/1_quickscore-3-techdoc.pdf.

[123] *See* David A. Katz, *Renewed Focus on Corporate Director Tenure*, THE HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (May 22, 2014), http://blogs.law.harvard.edu/corpgov/2014/05/22/renewed-focus-on-corporate-director-tenure.

other EU countries as well as Asian countries have also added term limits for independent directors.

Therefore, there are real concerns as to the private market's current ability to address board tenure in the U.S. Most investors are either agnostic to tenure as a governance issue or even oppose such limitations. While changes in policy and perceptions have started to percolate, they are limited in scope and seem to fail to truly tackle the issue.

4. Externalities and Collective Action Issues

Even if the impact of tenure on independence was fully acknowledged by shareholders, the question would still remain as to whether we could rely on shareholders to correctly value the impact of tenure on independence. Significantly, private ordering might be challenging since the value of true director independence is not easily observable. Since tenure interacts with other factors, private players might not be able to fully observe its impact on independence and may prefer to focus on the benefits of tenure, such as experience and knowledge (as they currently do). Moreover, even if tenure's impact on independence were fully observable, there is a question as to whether the market would fully internalize the cost of long tenure. Since director independence and tenure are not necessarily associated with performance, the market might undervalue the long term benefits of independence in favor of the short term benefits of long tenure. Indeed, such market failure was the one that necessitated mandating independence in the first place through SOX.

Additionally, tenure could reflect collective action issues, particularly what is termed in political science literature as the seniority clout penalty.[124] In cases where a board's composition reflects a compromise between different factions of management, shareholders or unions, or even direct representation of these factions, it is likely that directors would continue to be nominated and reelected even if all parties agreed that new directors would be the better choice. This phenomenon occurs because the replacement of a long tenured director with a new director entails loss of clout within the boardroom and therefore each interested party has an incentive to maintain their relative power by re-

[124] *See* Elhauge, *supra* note 80.

nominating or reelecting the more tenured director, even when that director is no longer fully aligned with their interests.

Finally, and perhaps most significantly, in the overwhelming majority of cases, the organ of the company with the authority to adopt a resolution limiting tenure is the board itself. Asking directors to voluntarily limit their own tenure is a complicated task. Even if such a move were desirable for investors, the board's self-interest could result in failure to adopt it.

VI. THE "NEW INSIDERS"

The documented increase in director tenure, which, as the previous Part argued, has gone largely unaddressed by market participants, coupled with the increasing tendency of firms to hire directors with preexisting "insider" backgrounds, has turned many so-called "independent" directors into what this Article terms the "*new insiders*." While these directors are "independent" by the black letter of the law, as they are not employed by the company and do not have direct business connections with the company, they do bear a remarkable resemblance to the old corporate insiders.

First, these directors are increasingly current or retired corporate insiders in other firms. In fact, only 21% of new independent directors are first-timers on outside public-company boards. While corporate governance reports praise the reduction in the number of active CEOs serving on other companies' boards, these spots are being filled with more retired CEOs and lower level executives.[125]Additionally, while more new incoming directors are retired, overall 47% of the new "independent" directors are still active executives or professionals. The demand is particularly high for active CEOs and COOs followed by retired CEOs and COOs.[126] In having these individuals on their board, companies maintain the firm control that "corporate insider background" has on board membership. While every company has different corporate

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[125] *See* Spencer Stuart Survey, *supra* note 54 (stating that 54% of all S&P 500 CEOs do not serve on an outside board and that only 25% of the 2012 new directors are active CEOs, down from 53% a decade ago, but that new appointees include more retired CEOs (17%, up from 9% in 2000) and more division presidents and functional leaders (18%, up from 10%)).

[126] *Id.* According to Spencer Stuart Governance Survey, active CEOs and COOs are in the highest demand, with 58% of respondents saying they sought active executives for board seats. Executives retired from these roles are also in demand, although not to the same degree. Thirty-five percent of respondents said their boards seek to recruit retired CEOs and COOs.

culture and dynamics, being a corporate executive is the type of common denominator that carries vast implications for a board's member interaction with, and monitoring of, the firm's management.

Second, directors' long tenure makes their resemblance to the traditional corporate insiders even more robust. Their intimate knowledge of the corporation, the attachment they develop to the corporation and to its culture, and the intimate connections that have been built over time with peer directors and with company executives move long tenured directors even closer to a state of mind of an insider employee. Finally, increased tenure also aligns the financial stake an insider has in the corporation with that of a long tenured board member. Since longer tenure increases the amount of equity a director holds in the company, it further deepens the ties with the corporation and, in some cases, the dependency[127] that such directors may have on the corporation.

The increasing presence of these "new insiders" on corporate boards throughout the country begs the question of what may explain this trend and why companies may be effecting these changes in their boards. This Article posits that the increasing use of board members who serve for longer periods and come with a predisposed background as corporate insiders elsewhere is not accidental, but is in fact an effort on the part of companies to import the benefits that an "insider" board would have produced but that were removed with the shift to an "independent" board that was stripped of the traditional insiders presence.

Indeed, situating the "new insiders" trend within the larger context of the board's place and function as a corporate organ, it is likely that, by having directors who are regarded by state law and stock exchange rules as independent but at the same time serve sufficient time in their roles to accumulate specific business knowledge and understanding relating to the company, while also developing a social and professional investment in the firm, public companies try to gain many of the benefits the inside directors brought to the table in the advisory role of the board while still appeasing regulatory and public requirements.

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[127] While any employee of a corporation invests and risks her human capital in the corporation's successes, it is usually the case that the employee diversifies her savings and the capital equity and thus bears less risk than if all of her capital were to be invested in the company in addition to her human equity (her employment and name).

The value of tenure that companies perceive is further corroborated by the recent ISS survey finding that while institutional investors are increasingly concerned with the impact of tenure, albeit without much action,[128] companies' sentiments are strikingly different, with 84 percent of surveyed companies indicating that a director's tenure should not be presumed to indicate anything problematic.[129]

This trend toward longer director tenure, when viewed as a potential reaction on the part of companies to director independence requirements, raises the question of whether current regulation mandating the preference of independent directors over insiders *has gone too far*, potentially pushing public corporations to find "second best" solutions to their missing insiders in the board room. The same question also suggests that it may be necessary to think carefully about how to structure any effort to restrict tenure so as to preserve the value companies see in long tenured directors.

VII. RETHINKING INDEPENDENT DIRECTORS' TENURE

This Article has highlighted the importance of board tenure to director independence and the potential adverse impact of long tenure on independence. Through the empirical data presented above, this Article demonstrated that tenure has not remained constant in the wake of the regulatory reforms that were aimed at improving director independence but rather has increased over the last decade, further promoting the need for attention to board tenure. Coupling the rise of board tenure with other trends in board structure, the Article has sought to offer a potential explanation for these trends, arguing that in the wake of the mandated push for director independence companies have begun to push back, appointing directors who fulfill these independence requirements but also carry with them some of the attributes of the inside directors who once dominated U.S. board rooms.

As discussed above, this in turn calls for a rethinking of director tenure, balancing the goals and benefits of longer tenure with the concerns it may entail. This Part suggests that unlike some of the approaches that are currently offered, ignoring tenure all together, capping it indiscriminately, or using an ad-hoc assessment that is hard to

[128] *See supra* note 116 and accompanying text.

[129] *Id.*

apply uniformly, any solution must balance not only the impact tenure may have on independence but also the importance of tenure to the other functions of the board, and specifically the advising/decision-making role.

Therefore, this Part strives to reconcile these two opposing forces with a proposal that, on the one hand ensures that the regulatory emphasis on board independence is fulfilled, but at the same time takes into account what the market has been signaling regarding the importance of the old, advisory, function of the board.

A. The General Framework

The changes to board structure and tenure and the introduction of the "new insiders," as detailed above, carry positive attributes, allowing companies to compensate for the loss of the advisory role of the board in the early years of the transformation toward independent boards. However, taking the importance of true director independence as a given,[130] the trend toward "new insiders" carries with it several concerns that might require intervention. Indeed, this "private market" adjustment may come at the expense of ensuring that the other role of the board – monitoring – would remain uncompromised.

If policymakers were to conclude, as advocated by this Article, that tenure is more likely to compromise independence than to strengthen it, then, a case can be made for some restriction on director tenure as part of director independence requirements. Of course, if policymakers were to believe the opposite – that tenure actually improves independence, than an opposite case could be advanced, introducing tenure as a prerequisite to some positions on the board.

However, even if tenure negatively impacts independence, any proposed limitation on tenure should be structured in a way that is limited both in its scope and in the chosen threshold. Such a structure will serve the goal of preserving director independence but at the same time ensuring that the general benefits that long tenure may provide to directors' contributions to the company are not fully surrendered. Thus, minimizing the impact on the ability of firms to structure their board in a

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[130] Some doubt the impact independent directors have on firm performance. *See* Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 232-233 (2002). The impact of board tenure on firm performance is also in dispute. *See supra* note 70.

manner that also provides for the lost role of advising becomes a pivotal focal point in any suggested reform.

B. Limited in Scope

While board independence is important, and mandating limitations on board terms could aid in achieving greater independence, a full scale cap on tenure for the board as a whole would carry too many costs. Boards would have to lose qualified members, even if they are still valuable members of the board, and companies might again lose the elusive insider attribute they were trying to mimic by extending tenure. Similarly, costs of training and familiarizing directors with the company would go up.

If, however, a tenure restriction for director independence purposes was limited to the audit and compensation committees, such costs would be minimized while the lion's share of the motivation behind independence requirements would still be achieved. Specifically, any director who serves on these committees and would like to be considered independent would have to satisfy a tenure requirement. Importantly, while a director who does not satisfy the tenure requirement would not count as an independent director, she could still serve as a non-independent director on the committee (if permissible under the governing regulations and the company's rules) and would be fully able to continue to serve on the board.

The rationale for limiting the tenure requirement to these two committees is two-fold. First, as discussed in detail below, these committees are at the heart of the monitoring function of the board and were the focus of the regulatory reforms ushered in by SOX and Dodd-Frank. Second, the costs associated with higher turnover on these committees are significantly smaller than for the other committees or for the board as a whole.

The audit committee is the cornerstone of the board's monitoring role. Examining financial reports and certifying them is not only important in the intra-company setting but it also carries great importance for the general public and investors. It is no surprise, then, that SOX has focused its attention on the audit committee and that the firms' outside auditor has already been required to have a mandatory cap on tenure. By ensuring that the audit committee is as independent as possible, the monitoring role of the board would be properly fortified.

Indeed, recent empirical studies have shown that an independent audit committee is the most effective means of curtailing corporate fraud.[131]

Similarly, the compensation committee has been targeted in the Dodd-Frank reform as an organ of the board that requires independence. Limiting excessive pay and optimizing executive incentives through proper compensation is a cornerstone of good governance. Long tenure, as detailed in Part III, could jeopardize the ability of directors to effectively scrutinize management's actions as well as their ability to negotiate and set management's compensation at an optimal level.

At the same time, limiting the scope of a tenure restriction to independent directors on the audit and compensation committees, each of which usually include three directors, would allow the company to retain seasoned directors, whether they previously served on the audit and compensation committees and have hit the tenure restriction or not. This ability to retain directors who can provide the necessary "insider" input, but not at all costs, could properly balance the dual hats of a board – monitoring and advising – and the need for different types of directors to function in each role.

Limiting the restrictions on director tenure to the audit committee provides additional benefits. Audit committee members already possess, and in some respects are required to possess, specific skills that are important to their role. While a cap on their tenure would force audit members to leave their position and thus will inevitably require a learning curve for an incoming director, their skill set is much more transferable than the skill set of other board members. Indeed, every company is different and every industry is different, but audit guidelines and general practices are the same across the board.

This uniformity in audit practice would reduce the associated costs of mandating a tenure restriction with respect to both the company and the director. On the company side, companies will be able to quickly replace a departing director's audit knowledge with that of a director selected from a pool of directors who have either served as audit committee members elsewhere – a pool that is expected to be larger if a tenure cap is put in place – or with a new director with an extensive background in accounting. While company-specific attributes are important, the learning curve for audit members could still be expected

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[131] Vikramaditya Khanna et al., *CEO Connectedness and Corporate Frauds* (working paper, 2014).

to be lower. The directors themselves would also mitigate their costs by having a skill set that would easily translate into a productive role in other companies, in the same industry (which will even reduce costs further) or elsewhere.

In addition, having a healthy circulation of audit members could actually improve firms' quality of financial reporting in the long run. While knowledge of company-specific attributes cannot be discounted, so is the value of fresh eyes and fresh approaches. Making sure that directors on the audit committee are not serving for too long ensures that their understanding of the business does not turn into color blindness to some accounting issues and further ensures that new directors with more current knowledge of accounting are infused into the committee, further strengthening the review of the financial reports and the work of the auditing firm.

C. Limited in Length

Tenure's effect on director independence increases with time. Thus, in theory, limiting the tenure of audit and compensation committee members' to a low number of years would result in the least dependence of directors on management and thus provide maximum independence. However, the costs associated with such a limit may outweigh the benefits. By setting the tenure threshold in a manner that best balances between the need for impartial monitoring and the advantage of knowledge and a productive relationship with the company, such an outcome could be avoided.

While average board tenure has been on the rise, the outliers are of the greatest concern. Directors who serve for 12, 15, 20 or 40 years[132] are much more likely to be complacent than directors who serve for shorter periods. Since average tenure is skewed due to the effect of incoming directors, in many cases the presence of a very tenured director could be camouflaged and offset by newly appointed directors when looking at board tenure averages.

Thus, setting the exact limit on tenure is a delicate task. One potential solution is to set the limit at the current average tenure of directors or at some multiplier of it (i.e. 1.3 of the average). On the one hand, cases of extremely long tenure would be prevented while on the

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[132] *See* Lublin, *supra* note 120 (featuring the longest tenured directors in the S&P 500).

other hand the majority of directors would not even face the restriction as they would depart before such limit is ever reached.

An alternative solution would allow each company to select and set, with shareholder approval, a specific limit from a predetermined range, allowing for different limits for different industries and different companies (e.g. mature companies vs. high growth recently public companies).

Finally, a “comply or explain” rule could be chosen, setting limits on tenure as a default rule, while allowing companies to opt-out by explaining why such a restriction would not benefit its shareholders, with shareholder approval.

As a starting point, regulators should strongly consider setting the term limitation at one and a half times the current average tenure (13 years), which would capture only directors who exceed the average by 50%. As part of this requirement, regulators should allow companies, with the approval of their shareholders, to deviate from this figure, going as low as eight years and as high as 15 years – allowing for better sensitivity to market demands.

The combination of a term limits mandated for audit and compensation committee members and a reasonable and flexible limit in length should result in a relatively small number of directors who currently serve on boards that would be required to step down from the audit or compensation committees, while at the same time enhancing the monitoring role the board is entrusted with.

D. Means of Implementation

While a case for limited tenure restrictions can be made, the question then turns to what extent such restrictions should be mandatory. One potential critique of mandating tenure caps would revolve around the private ordering option. However, as discussed above, the private ordering argument suffers from several flaws, potentially making mandatory arrangement necessary.

The most promising option for voluntary adoption lies with proxy advisory firms. These firms have the ability to change the current landscape in the boardroom in a manner that can alleviate many of the private market failures. By adopting voting policies that reflect the impact tenure has on independence they could push the majority of institutional investors to act on their concerns. Moreover, these voting

policies are independent of any specific company and thus can more accurately internalize the value of independence to shareholders as a group. While companies would still not be likely to initiate effective term limits, these voting guidelines could effectively create such limits by providing a negative recommendation to specific long tenured directors, thus reducing their reelection likelihood. This could provide an effective, shareholder driven, mechanism for curbing director tenure. Importantly, this would also allow shareholders the ability to weigh the specific company's circumstances when voting, providing a less rigid and more sensitive tool.

However, as noted above, so far current proxy advisors have either disregarded tenure altogether (Glass Lewis) or have adopted policies that are too lenient and thus ineffective (ISS).

If proxy advisors maintain their current guidelines, mandatory implementation then becomes a more necessary option for such implementation. Granted, mandatory requirements passed through legislative action are potentially costly, and the outcome of legislative action could be unsatisfactory due to political compromise. However, legislative measures are not necessarily needed in order to cap tenure. Since current independence standards are not only set by federal and state law but also in the listing rules, a simple amendment to such rules by the stock exchanges would result in a similar result. Adding a provision on tenure to the pre-requisite for director independence would be fairly simple, and similar changes to the definition of director independence have already been implemented in the past. Such a process could be fairly quick and cost effective.

Moreover, an actual change to the listing rules might not even be necessary. Current independence requirements, as set by the stock exchanges, already contain general language requiring the board to ascertain that a director is independent. Issuing a rule interpretation advisory alerting companies that the stock exchange considers tenure to be a factor in determining independence could be a sufficient first step in achieving this goal.

VIII. CONCLUSION

Independent directors have become a cornerstone of modern corporate governance in the U.S. Their importance to the corporate governance landscape and to regulators is reflected in the words of

S.E.C. Chairman Arthur Levitt in 1999: "[W]ithout strong independent directors, accountability is nothing more than a word on a page."[133]

Despite the strong public sentiment favoring board independence and the regulatory push toward independent directors, true independence is still an elusive goal. While recent years have seen significant progress in delineating the factors that could help determine director independence, the quest for true director independence is far from over. One important variable that has been missing from current regulatory standards is director tenure.

By providing theoretical arguments as to the importance of tenure as a factor that may impact director independence and by providing empirical evidence documenting a recent rise in board tenure, this Article has stressed the importance of directing regulatory attention to board tenure. The Article has strived to place these trends in the larger context of board structure transformations, viewing the rise in board tenure, along with other recent trends in board structure, as a market attempt to push back against the regulatory emphasis on director independence. This reaction, the Article argues, is manifest in the introduction of a new hybrid board member who complies with the black letter of the independence requirements but at the same time possesses many of the attributes corporate insiders brought to the board table – the new insider.

Coupling this market movement with the impact it might have on board independence, the Article has explored the benefits and risks of the new insider model as well as the potential need for regulatory intervention. Specifically, the Article suggests a more nuanced approach to director term limits – calling for term limits only for members of the audit and compensation committees that are calibrated in their tenure restrictions to allow companies to retain worthy long tenured directors but at the same time safeguard the independence of the audit and compensation committees who serve as the monitoring arm of the board. Such an approach would pave the way for the "strong independent directors" regulators envisioned when mandating their presence in U.S. boardrooms.

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[133] *See* SEC PRESS RELEASE, *Opening Remarks at the SEC Roundtable on the Role of Independent Investment Company Directors* (Feb. 23, 1999), *available at* https://www.sec.gov/news/speech/speecharchive/1999/spch253.htm.