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Top 10 Topics for Directors in 2016: Board Composition and Succession Planning

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Board composition. To better align board composition with company needs, a board's nominating and governance committee should first determine the specific talents and experiences that they believe will help the company achieve its strategic plan and manage its risk profile. Once the right mix is determined, the committee should identify any gaps in the current board composition. Based on PwC's annual survey, directors continue to view financial, industry and operational expertise as the most important director attributes, with risk management, international, cybersecurity and IT expertise following closely behind.[ii]

The ability to think holistically and work with people are personal attributes that are wholly underrated. These personal characteristics, together with other intangible qualities, such as leadership, trustworthiness, good judgment and diversity of thought, whether age, race, religion or gender, must be considered when building an effective board. Many companies say they are committed to achieving a diversified board; however, the percentage of female and minority directors serving on U.S. boards is disproportionately quite low, with women accounting for approximately 20 percent of independent directors on S&P 500 company boards, and minority directors accounting for just 15 percent of all directors at S&P 200 companies.[iii] Many companies claim that a shortage of qualified candidates limits their ability to diversify. It is interesting to note, however, that, at the 22 S&P 500 companies led by a woman, women directors comprise 28 percent of all board members, while women comprise just 19 percent of directors of companies with male CEOs.[iv]

Director tenure is another board consideration that has made its way into the spotlight. Seventy-five percent of S&P 500 companies have established a mandatory retirement age for directors, with half setting the retirement age at 72.[v] Only three percent of S&P 500 companies have actual term limits for directors.[vi] In the past few years, shareholder groups have argued that long-tenured directors are more likely to align with management, thereby compromising the directors' independence and making it difficult for companies to refresh their board members. ISS' Governance Quickscore now considers the percentage of nonmanagement directors who have served on the board for more than nine years, indicating that such tenure potentially compromises a director's independence. Some investors also view long tenure as problematic. The Council of Institutional Investors (CII) and the California Public Employees' Retirement System (CalPERS) include director tenure as a factor that boards should consider when determining whether a director is independent.[vii] And State Street Global Advisors adopted a policy to vote against long-tenured directors and nominating committee members in companies it identifies as needing "board refreshment."[viii] These types of policies may facilitate board refreshment, but they do so at the risk of losing some of the most savvy and skilled directors with highly valued firm knowledge, expertise or perspectives.

Rather than using a director's age and tenure as the means to board refreshment, boards should renew their focus on the board evaluation process. Board evaluations are intended to provide insight and help boards improve their functions. Yet, too often, these evaluations are completed so that boards can check-the-box for compliance purposes, rather than attain thoughtful consideration on ways to improve board and director effectiveness. Utilizing an outside third party to interview the board, and conducting individual or peer evaluations, are both powerful tools that boards can use to attain valuable feedback and improve board effectiveness.

Board succession. In light of the importance placed on board composition, it is critical that boards have a long-term board succession plan in place. Boards need to be prepared not only for scheduled retirements, but for unexpected departures, shareholder pressures, gaps in skills and expertise, and underperforming board members. Addressing an underperforming director is a delicate issue, but nearly 40 percent of directors in PwC's annual survey opined that someone on their board should be replaced, citing diminished performance due to aging, lack of preparation and/or lack of expertise as primary reasons for dissatisfaction.[ix]

To properly plan for board succession, directors should regularly identify and evaluate potential candidates against the board's needs. Existing board members, senior management and search firms are often the best resources for identifying individuals who may be a good fit for the board. Many boards search for candidates with similar skills or experiences as the director exiting the board, but replacing "like with like" does not necessarily make for an effective succession plan. Boards need to ensure that a director candidate has the experience and expertise that the board needs, along with a personality that would likely fit with the culture and dynamics of the board. The larger the pool of candidates a board has to consider, the more likely the board will find the right person for the job. Boards that take this proactive approach are able to find better candidates and respond faster and more effectively when an activist approaches or an unforeseen vacancy occurs.

This post was excerpted from our annual Top 10 Topic for Directors in 2016 alert. To read the full alert, please click here.

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[i] 2015 Spencer Stuart Board Index, at p. 22.

[ii] PwC's 2015 Annual Corporate Directors Survey, at p. 7.

[iii] 2015 Spencer Stuart Board Index, at p. 16-17.

[iv] *Id*., at p. 16.

[v] *Id*., at p. 15.

[vi] *Id*., at p. 4.

[vii] Council of Institutional Investors, "Corporate Governance Policies," p. 24 (April 1, 2015). *See also*, CalPERS, "Global Governance Principles" (March 16, 2015).

[viii] State Street Global Advisors, "Addressing the Need for Board Refreshment and Director Succession in Investee Companies" (February 2015).

[ix] PwC's 2015 Annual Corporate Directors Survey, at p. 8.

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Board Governance