Advancing Board Refreshment Through the Director Succession Planning Process

"Board refreshment" is currently a hot corporate governance topic. A board of directors' ability to "refresh" itself on a regular basis can help ensure that the board is comprised of the proper mix of directors to meet both current and long-term needs of the board, the company and shareholders, and provide the necessary oversight of the company's evolving corporate strategy and risks. New and fresh perspectives on the board, it is often argued, contribute to the board successfully addressing those needs and oversight responsibilities. Director succession, director tenure, mandatory retirement, proxy access, board evaluations and board diversity, among other factors, are all integral and interrelated components that either contribute to or result from board refreshment.

This corporate governance update focuses on director succession planning and the critical role it plays in board refreshment. Specifically, this update (1) provides general information concerning director succession planning, (2) summarizes the current director succession-related policies and positions of several large asset managers and pension funds, and certain corporate governance advocates, to provide insight into the expectations of those parties with respect to director succession planning and (3) presents practical considerations for boards to help facilitate successful director succession.

Director Succession Planning and Corporate Governance

Director succession planning is an integral component of board refreshment and focuses on the strategy, policies and procedures that boards have adopted to replace board members. Board refreshment, which is at the forefront of many investors' minds, is a critical tool to enhance board diversity (including, but not limited to, gender, race, ethnicity and age, as well as diversity of experience, skills and perspectives) and to recruit board expertise aligned with the company's evolving corporate strategy. Board refreshment also addresses issues of lengthy director tenure, board entrenchment and the interrelationship of those factors with director independence (as it is argued that a lengthy tenure may compromise a director's independence from management).

Certain studies have revealed that shareholders view a director succession plan and a regular process of board refreshment as increasingly necessary to help ensure that the board has "the necessary skills and expertise"[1] and that there is a positive correlation between some board turnover and company performance.[2] Another study noted that the third most frequently raised issue by shareholders during the 2015 proxy season (following only proxy access and disclosure of political contributions/activities) was board composition and refreshment.[3]

Although there is no Securities and Exchange Commission ("SEC")[4] or national exchange[5] rule or regulation explicitly mandating that board members participate in director succession planning, a director's general fiduciary duty of care arguably requires such planning.[6]

Current Policies and Positions of Certain Institutional Investors and Corporate Governance Advocates as They Relate to Director Succession Planning

There is no one-size-fits-all approach to corporate governance and director succession planning. The unique characteristics of the company, including those relating to corporate strategy, evolving risks and stakeholder needs, and the adoption of corporate governance policies the company and its board feel are essential to generate long-term shareholder value often dictate, in part, director succession strategy. As boards evaluate their director succession strategies, it may be helpful to understand the current director succession policies and positions of several large institutional investors and certain corporate governance advocates, as this understanding provides insight into the general expectations of these parties with respect to director succession planning. A select summary of those policies and positions is provided below.

Institutional Investors – Asset Managers:

- BlackRock, Inc. ("BlackRock"):
  - may withhold votes from the independent chair or lead independent director, members of the corporate governance committee and/or the longest tenured

director(s) when there is a lack of board responsiveness to shareholders regarding board composition concerns, evidence of board entrenchment, insufficient attention to board diversity and/or failure over time to promote adequate board succession planning in line with the company's stated strategic direction

- encourages boards to routinely refresh their membership to ensure the relevance of the skills, experience and attributes of each director to the work of the board
- believes it is beneficial for new directors to be brought onto the board periodically to refresh the group's thinking and to ensure both continuity and adequate succession planning[7]

- State Street Global Advisors ("SSgA"):
  - states that board refreshment and director succession planning are key functions of the board and may vote against the chair of the corporate governance committee for failing to adequately address those functions[8]
  - recently reported that during 2014 and 2015, it engaged with over 500 portfolio companies on board refreshment and orderly director succession topics[9]

Institutional Investors – Pension Funds:

- California Public Employees' Retirement System ("CalPERS"):
  - asserts that boards should proactively lead and be accountable for the development, implementation and continual review of a director succession plan
  - believes that, at a minimum, the director succession planning process should (1) become a routine topic of discussion by the board, (2) encompass how to address in an efficient manner both expected future board retirements or the occurrence of unexpected director turnover as a result of death, disability or untimely departure, as well as director turnover either through transitioning off the board or as a result of rotating committee assignments and leadership, (3) provide for a mechanism to solicit shareholder input and (4) be disclosed to shareholders on an annual basis and in a manner that would not jeopardize the implementation of an effective and timely director succession plan[10]
- New York City Employees' Retirement System, New York City Police Pension Fund, New York City Fire Department Pension Plan and Board of Education Retirement System of the City of New York (collectively, the "New York City Pension Plans"):
  - may oppose incumbent nominees who serve on the corporate governance committee if the board has failed to ensure adequate director succession planning and board refreshment[11]
- State of Wisconsin Investment Board ("SWIB"):
  - generally supports the disclosure of board succession planning and policies, board self-evaluations, board retirement policies, a process for discharging directors and board refreshment[12]

Certain Corporate Governance Advocates:

- National Association of Corporate Directors ("NACD") (advocating on behalf of directors):
  - believes that governance structures and practices should encourage the board to refresh itself and that boards need to ensure they are positioned to change and evolve with the needs of their companies[13]
- Council of Institutional Investors ("CII") (advocating on behalf of shareholders):
  - maintains that boards should implement and disclose a board succession plan that involves preparing for future board retirements, committee assignment rotations, committee chair nominations and overall implementation of the company's long-term business plan
  - notes that boards should respond positively to shareholder requests seeking to discuss incumbent and potential directors[14]
- The Business Roundtable ("BRT") (advocating on behalf of management):
  - encourages boards (through their corporate governance committee) to engage in director succession planning as part of their responsibility to oversee the composition of the board
  - further advises that the corporate governance committee should regularly conduct an assessment of the mix of backgrounds and skills represented on the board to evaluate whether the board, as a whole,

contains the right balance of professional and personal experience and includes individuals who bring industry and other relevant knowledge, financial expertise, diversity and other desired characteristics to the board[15]

Considerations for Boards of Directors

To facilitate director succession planning and help determine what related policies and practices will contribute to more effective corporate governance and are in the best interests of the company and shareholders, directors may consider the following:

- **Examine Corporate Governance Documents**. An initial step in the director succession planning process should involve the board examining the company's current governance documents (e.g., corporate governance guidelines, charter of the corporate governance committee and director nomination policy) to ensure that necessary provisions and policies in connection with such succession are included therein. Such documents should explicitly enumerate and delegate the duties and responsibilities that will permit the board to establish a director succession strategy and the assessment framework to facilitate that strategy.

- **Use an Assessment Framework**. Director succession is generally most effective when reviewed and planned for in an assessment framework on a regular basis. Such framework may involve board, board committee and director self-assessments, including (1) assessing the current strengths and weaknesses of the board and each board committee, (2) identifying the short- and long-term skills needs of the board (in light of the company's corporate strategy, evolving risks and shareholder and other stakeholder concerns), (3) evaluating how the board's assessment changes when retiring directors are factored in the analysis and (4) shifting the board's approach of automatically re-nominating existing directors to one that bases a director's re-nomination on a number of criteria, such as the board's evolving needs and director performance. Once the board reaches a consensus as to its current and anticipated needs, it should develop a candidate profile and initiate the process of identifying qualified potential director candidates.

  As part of the assessment framework for identifying qualified director candidates, the board, typically acting through its corporate governance committee, implements guidelines within which director candidates are assessed and director succession is effectuated. A director nomination policy, for example, generally provides minimum qualifications required of existing directors (to continue serving on the board) and potential new directors (to be initially nominated to the board). Specific desired qualifications, qualities and skills often sought in director candidates include:

  - the highest professional and personal ethics and integrity
  - industry-specific, broad experience or particular expertise in business, accounting, finance, regulatory/government, education, information technology, cybersecurity, risk management or other specialized area
  - experience as a chief executive officer or other C-suite officer
  - a solid record of accomplishment in their chosen fields
  - the ability to develop a good working relationship with other board members
  - sufficient time to effectively carry out board duties
  - the ability to contribute to the board's working relationship with senior management
  - the ability to provide insights, practical wisdom and diverse perspectives based on background, experience and expertise
  - satisfaction of legal and regulatory requirements
  - independence

  A corporate governance committee should assess potential candidates in the context of the then-current composition of the board, the operating requirements of the company and the long-term interests of shareholders. In conducting this assessment, the committee should also consider diversity (including, but not limited to, gender, race, ethnicity, age, experience and skills) and such other factors as it deems appropriate given the then-current and anticipated future needs of the board, the company and stakeholders, and in order to maintain a balance of qualifications, qualities, skills and perspectives on the board. Although a board will often delegate many director succession-related responsibilities to its corporate governance committee, ultimate responsibility remains with the full board. In addition, a board should proactively engage and seek the input of significant shareholders as part of its succession assessment and related processes.

- **Conduct Due Diligence**. Whether a director candidate is recommended through internal recommendations (by way of board members or management), formal third-party recruiters, other sources (e.g., the NACD) or a combination, the board should conduct due diligence on the candidate for purposes of evaluating, among other characteristics, his or her credentials (and confirming that stated credentials are true and accurate), independence and potential related party transactions and conflicts of interest. At a minimum, the following items should be researched and analyzed as part of the due diligence review: professional employment, directorships (at both public and private entities), other business, civic and charitable involvement, awards, education, professional certifications and personal attributes (utilizing public and private databases). Some boards engage third parties to conduct due diligence and vet potential candidates, including candidates recommended by director search firms.

- **Maintain a Pipeline**. After conducting the director qualifications assessment and due diligence (as described above), the board should maintain a pipeline of qualified director candidates. Significant changes in director employment, health concerns or other unexpected personal or professional events may necessitate quick director succession. Having potential qualified candidates already identified will greatly assist with the effectiveness and efficiency of the succession process.

- **Assess Board Policies**. As part of its director succession planning, a board should incorporate periodic (at least annual) assessments of its board leadership, committee membership, rotation and mandatory retirement policies. A board's corporate governance committee is typically delegated the task of recommending to the board the chairmanship and membership of each board committee after considering certain factors (including, but not limited to, board members' experience, knowledge, skills, tenure on committees, time commitments on and off the board, and board and committee member self-assessments). Identifying current and future leadership and committee needs, and director candidates with specific expertise to fill those needs (e.g., in the fields of accounting, finance, risk or cybersecurity), will enhance effective director succession.

- **Disclose Strategy**. As previously discussed, certain institutional investors and corporate governance advocates encourage companies to disclose their director succession strategies. Further, one recent analysis of 2015 proxy statements revealed that S&P 500 companies are becoming increasingly transparent about board composition and director succession by voluntarily disclosing director skill matrices (which should be updated annually) and board succession strategies.[16] That study also revealed a number of emerging best practices with respect to board composition and shareholder engagement, including that boards should view director recruitment in terms of ongoing board succession planning, not one-off replacements, and should proactively communicate to shareholders the current skill sets and expertise in the boardroom and the strategic plan for future board succession.[17] Although not currently mandated by rule or regulation, boards should consider disclosing their director succession strategy to provide greater transparency to shareholders and other stakeholders.

- **Benchmark Strategy**. Boards should regularly benchmark their director succession and board refreshment strategy with those of their peers and the industry in which they operate, as an outlier may become the target of activist shareholder campaigns or be identified by institutional investors as an entity with potentially problematic succession and governance practices. Such benchmarking may include the extent to which companies are disclosing formal director succession policies and strategies, director skills matrices and average board tenure. Similarly, boards should stay abreast of the evolving policies and positions of large institutional shareholders and corporate governance advocates with respect to director succession, specifically, and board refreshment, more broadly.

How Chapman Can Help

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1 *2015 Annual Corporate Governance Review*, Georgeson (November 17, 2015).

2 *Succession Planning for the Board–Taking a More Strategic Approach*, Spencer Stuart (January 28, 2015).

3 *2015 Spencer Stuart Board Index*, Spencer Stuart (November 2015).

4 See, however, SEC Final Rule: Proxy Disclosure Enhancements, Release Nos. 33-9089; 34-61175; File No. S7-13-09 (December 16, 2009) (requiring, among other disclosures, information relating to the board leadership structure, the background and qualifications of directors and director nominees, and the consideration of diversity in the process by which director candidates are considered for nomination).

5 See, for example, New York Stock Exchange Listed Company Manual Section 303A.09, Corporate Governance Guidelines (noting that although companies must address director qualification standards in their corporate governance guidelines, companies *may* also address other substantive qualification requirements in those guidelines, including director succession).

6 For example, neither Delaware case law nor Delaware's General Corporation Law explicitly requires board members to engage in director succession planning. Directors are, however, required to manage the business and affairs of the company (Delaware General Corporation Law, Section 141). Addressing known major risks, such as those related to director succession, is one of a board's duties.

7 *Proxy Voting Guidelines for U.S. Securities*, BlackRock (February 2015).

8 *Addressing the Need for Board Refreshment and Director Succession in Investee Companies*, IQ Insights, SSgA, Rakhi Kumar (March 31, 2014).

9 *Annual Stewardship Report 2015 Year End*, SSgA (April 15, 2016).

10 *Global Governance Principles*, CalPERS (March 16, 2015).

11 *Corporate Governance Principles and Proxy Voting Guidelines*, New York City Pension Plans, The Office of the New York City Comptroller (April 2016).

12 *2016 Corporate Governance Guidelines*, SWIB (2016).

13 *Key Agreed Principles to Strengthen Corporate Governance for U.S. Publicly Traded Companies*, NACD (September 1, 2011).

14 *Corporate Governance Policies*, CII (April 1, 2015).

15 *Principles of Corporate Governance 2012*, BRT (March 27, 2012).

16 *2015 Spencer Stuart Board Index*, *supra* note 3.

17 *Id*.

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