Redefining The Lead Independent Director

by Holly J. Gregory

While the number of U.S. corporations with an independent board chair continues to increase, the *lead independent director* position has become the boardroom norm at many companies. The motivators for creating this lead director boardroom leadership structure, its status and powers continue to vary greatly from board to board.

The leadership structure of large U.S. publicly traded companies has evolved significantly since the turn of the century away from the tradition of combined leadership in one individual who holds both the CEO and board chair positions. The most prevalent public company leadership structure is now one in which the board has leadership independent from the CEO, through an independent chair or lead or presiding director.

Public companies are not required to have an independent board leader. Nevertheless, boards have altered their leadership structures as attention has focused on the role that independent directors are expected to play in providing objective oversight while holding management accountable.

Many shareholders now accept that a well-designed lead director role can provide an effective alternative to a separate chairman.

Independent leadership is viewed as particularly important with respect to board oversight and decisions regarding corporate strategy, management succession, performance and compensation, audit and internal controls, board composition and functions, and accountability to shareholders. Leadership in most S&P 500 companies is now shared between the CEO and a lead director selected by the independent directors (hereinafter, a lead director).

Large institutional investors and proxy advisors generally prefer that boards select an independent chair and avoid giving the CEO the chair title. Shareholder proposals seeking the adoption of an independent chair structure remain common, and pressures to move toward an independent chair may never fully abate.

While many shareholders favor an independent chair, many also accept that a well-designed lead director role can provide an effective alternative. As companies continue to develop the lead director role, it is becoming similar to the role of an independent chair.

The primary differences are in the title of "chair" versus "lead director," and in the power to wield the gavel in full board meetings versus in executive sessions of the independent directors. The lead director role is becoming synonymous with leading the efforts of the board, as distinguished from the CEO's role in both leading management and the company for most external matters.

Boards and their advisors should follow developments in this area and ensure that the leadership structure they have adopted is:

- Appropriate for the company's particular circumstances.
- Effective in supporting board objectivity in business judgments and oversight.
- Well articulated in company disclosures and policies.

Boards should review their leadership structure on a periodic basis to ensure that it is appropriate for the company. Boards with a lead director should review the functions of that role on a periodic basis against emerging practices. Additionally, boards should consider the independent board leadership

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structure as a component of both CEO and board succession planning.

□ ***Pressures for independent leadership.*** The move away from combining the chair and CEO roles has been driven by a number of forces. Changes in listing rules and SEC disclosure requirements have focused attention on board leadership. Listing rules imposed in 2003 (generally associated with the Sarbanes-Oxley Act) raised expectation that independent directors provide objectivity in overseeing management.

Mandates of the Dodd-Frank Act, adopted by the SEC in 2009, require disclosure of the board's rationale for combining or splitting the chair and CEO roles. At companies where the chair and CEO roles are combined, disclosure of whether the company has a lead director and the specific role the lead director plays is required.

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Shareholders and proxy advisors have fueled this change. Shareholder proposals and proxy voting policies generally support proposals for an independent chair unless the company maintains a strong lead director role. Many institutional investors also favor independent board leadership through their proxy voting and governance policies, including BlackRock, State Street, CalPERS, CalSTRS, the New York City Pension Funds, and TIAA.

Independent board leadership is also supported by governance effectiveness guidance that expresses a "best practice" consensus that boards should have some form of independent leadership. Examples include:

▫ "Every board needs a strong leader who is independent of management. The board's independent directors usually are in the best position to evaluate whether the roles of chairman and CEO should be separate or combined; and if the board decides on a combined role, it is essential that the board have a strong lead independent director with clearly defined authorities and responsibilities." *(The Commonsense Principles of Corporate Governance, Preamble (2017), available at governanceprinciples.org.)*

▫ "The board should be chaired by an independent director. The CEO and chair roles should only be combined in very limited circumstances; in these situations, the board … should name a lead independent director who should have approval over information flow to the board, meeting agendas and meeting schedules to ensure a structure that provides an appropriate balance between the powers of the CEO and those of the independent directors." *(Council of Institutional Investors, Corporate Governance Policies (Sep. 15, 2017), available at cii.org.)*

□ ***Shareholder proposals.*** Shareholder proposals seeking an independent chair continue to be prevalent. Proponents appear to target companies that they perceive to have board oversight or performance issues, with little regard to whether the company has adopted independent board leadership.

According to Proxy Monitor, at Fortune 250 companies in 2017, proposals regarding an independent chair were the most frequent governance-related shareholder proposal, and the third most frequent shareholder proposal overall.

Although none of these proposals received majority support in 2017 or 2016, it is likely that they will continue to be submitted and the issue of independent board leadership will continue to be debated.

In 2017, 43 independent chair proposals went to a vote. These proposals are commonly supported by the two primary proxy advisors, Institutional Shareholder Services Inc. and Glass, Lewis & Co., and they tend to receive significant shareholder support, albeit short of passing rates.

On average, independent chair proposals received support of approximately 30 percent of the votes cast in 2017, with nine proposals receiving support of 40 percent or more. Generally, average support for these proposals has *decreased* since 2012, when the 50 proposals that went to a vote received support on average of more than 35 percent of the votes cast. Twenty-one proposals received support of 40 percent or more, and four received majority support.

☐ ***Proxy advisor policies.*** ISS has historically favored shareholder proposals calling for independent chairs. In 2017, ISS recommended in favor of 30 of the 43 (70 percent) proposals that went to a vote, compared to 34 of the 46 (74 percent) proposals in 2016 and 36 of the 50 (72 percent) in 2012.

ISS bases its vote recommendation on a "holistic review" of the company's board leadership structure, governance practices, and performance. Factors it will consider negatively include:

- The presence of an executive or non-independent chair in addition to the CEO.
- A recent recombination of the role of chair and CEO.
- A departure from a structure with an independent chair.

ISS will also consider "any recent transitions in board leadership and the effect such transitions may have on independent board leadership as well as the designation of a lead director role." For companies that have a lead director, ISS will assess whether the role is robust. Generally this requires that the lead director:

- Is elected by and from the independent members of the board.
- Serves for a term of at least one year (rotating the role, for example, among committee chairs on a quarterly basis, is not considered sufficient).
- Has "clearly delineated and comprehensive" duties. These include: serving as liaison between the chair and the independent directors; approving information sent to the board; approving meeting agendas for the board; approving meeting schedules; authority to call meetings of the independent directors; and availability for consultation and direct communication with major shareholders.

Glass Lewis generally supports shareholder proposals seeking an independent chair unless, among other things, the company has indicated it intends to separate the roles and has a clearly defined lead director role.

☐ ***Current data.*** According to Heidrick & Struggles, in 2016 only 6.4 percent of newly named CEOs were immediately named chair (down from 9.5 percent in 2013). Additionally, the 2017 Spencer Stuart U.S. Board Index indicates that, for the first time, the majority of S&P 500 CEOs do not also serve as the chair. According to Spencer Stuart:

- 51 percent of S&P 500 companies have separated the chair and CEO roles, up from 46 percent a decade ago.
- Approximately 28 percent of S&P 500 companies have boards with an independent chair (compared to 13 percent in 2007), an increase of approximately 1.4 percent per year over the past ten years.
- 84 percent of S&P 500 companies have either a lead or presiding director, although two percent of these boards rotate the role among independent directors or committee chairs.
- Of the companies that designate a lead or presiding director, 74 percent use the title lead director, while 26 percent use the title presiding director or specify they have a director who presides over executive sessions.

☐ ***Terms and tenure.*** Most boards do not set an express term limit for the lead director. According to the Spencer Stuart Study, of the companies that do set a term limit, a one-year renewable term was the most common. This study indicates that the average tenure of lead directors is approximately four years. For independent chairs, average tenure is just over four years.

☐ ***Board leader compensation.*** According to the Spencer Stuart Study, independent chairs of S&P 500 companies are more likely to be paid additional fees for their service than are lead or presiding directors. Specifically, 96 percent of independent chairs earn additional compensation, versus 66 percent of lead directors.

The additional fees paid to independent chairs are on average significantly higher than those paid to lead directors, and lead directors are paid more than presiding directors. The average additional fee for an independent chair of an S&P 500 company in 2017 was $162,751. In contrast, the average additional fee for a lead director in 2017 was $36,868 (up 10 percent since 2016) and for a presiding director was $26,840 (down 16 percent since 2016).

The Lead Director's Job

Common Tasks At Top Company Boards

A review by Sidley Austin LLP of the companies that comprise the Dow Jones Industrial Average (Dow 30) identified 23 companies with a lead director, and two companies with a presiding director. The most common responsibilities of these independent board leaders include:

- ☐ Serving as a liaison between the chair and the independent directors (25 companies).
- ☐ Approving information sent to the board (19 companies).
- ☐ Approving meeting agendas for the board (22 companies).
- ☐ Approving board meeting schedules (20 companies).
- ☐ Calling executive sessions or meetings of the independent directors (25 companies).
- ☐ Being available for consultation and direct communication with major shareholders (22 companies).
- ☐ Chairing executive sessions of independent or nonmanagement directors (25 companies).
- ☐ Having authority to call board meetings (nine companies).
- ☐ Advising on, recommending, or approving the retention of outside advisors and consultants who report to the board (seven companies).
- ☐ Presiding at board meetings in the chair's absence (22 companies).
- ☐ Guiding, leading, or assisting with:
  - The board and director self-assessment process (13 companies).
  - The board's annual performance evaluation of the CEO (12 companies).
  - The CEO succession planning process (five companies).
  - The board's consideration of CEO compensation (three companies).

☐ ***Board leadership roles and responsibilities.*** Whether the independent board leader is an independent chair or lead director, there are certain roles and responsibilities that are common. However, presiding directors often have more circumscribed roles, typically focused on presiding at executive sessions. In contrast, it is typical for an independent chair or a lead director to be involved in identifying issues for the board's agenda and information to be provided to the board in preparation for board meetings.

Independent board leaders, regardless of title, are likely to take a leadership role in chairing meetings of independent directors. They serve as a communication point for delivering sensitive messages from the independent directors to the CEO.

Many view the role of a lead director as a viable alternative to an independent chair if the position is defined with real power and authority. A 2011 report by the NACD compared the roles of a typical independent chair to a lead director and found that the primary differences relate to:

□ The power to call a board meeting. Unlike the independent chair, the lead director generally does not have convening power for full meetings of the board, but does have the power to convene sessions of the independent and nonmanagement directors.

□ Control of the board agenda and board information. Unlike the independent chair, the lead director collaborates with the chair/CEO and other directors on these issues.

□ The authority to represent the board in shareholder and stakeholder communications. Typically the chair/CEO represents the board in communicating with shareholders and external stakeholders. The lead director plays a role only if specifically asked by the chair/CEO or the board directly.

These are key distinctions and they build on other subtle differences in the roles and authority of the independent chair and the lead director. These include the board's role in management oversight, CEO succession, strategic development, board and director assessment, board relations with the CEO and C-suite executives, board diversity and succession, and board risk oversight.

A CEO, whether or not the CEO has the title of chair, is usually the public spokesperson for the company and communicates with investors and the public. The CEO also must play a critical role in developing the board agenda, ensuring the quality and timeliness of the information provided, and keeping the board informed between meetings.

Decisions about board leadership should be governed by *practical realities,* rather than by best-practice theory.

☐ ***Making board leadership decisions.*** The board is responsible for its own structure and processes, and should apply its business judgment to decisions on the appropriate board leadership structure. Given the importance of board culture and group dynamics to board effectiveness, decisions about board leadership should be governed by practical realities, rather than by best-practice theory. It is becoming more common for board leadership decisions to be made by the independent directors, in consultation with the CEO.

The optimal board leadership structure is context dependent, and may change with the circumstances of the company and the board. Factors to consider include:

- ☐ Board culture and practice.
- ☐ Business circumstances.
- ☐ Characteristics, capabilities, and leadership styles of potential board leaders.
- ☐ Expectations of key talent.

Even those who prefer the independent chair structure concede that the time to consider a change is during a CEO succession event. Stripping a chair title from a sitting CEO is likely to be viewed as an indication of a lack of board confidence in the CEO.

The concern most often expressed about the combined chair/CEO role is that it may hamper the ability of the board to provide effective oversight. The chair/CEO has control of the agenda and information, and has inherent conflicts. An independent leadership structure is viewed as a counterweight, but should be designed with an understanding of the challenges that shared leadership may present. These can include: competing centers of power; confusion about leadership roles; and misperceptions about a lack of board confidence in the CEO.

As a practical matter, having one person serve as both chair and CEO may benefit the company and the board. These benefits include:

☐ A unity of command that avoids confusion about leadership roles by designating clear lines of authority and supporting clear and consistent messages.

☐ Leadership by the person most knowledgeable about the day-to-day operations of the company.

☐ Ability to develop business relationships in certain foreign jurisdictions where the chair title provides a higher level of stature than the CEO title. An independent chair is unlikely to be involved in these relationships.

The challenges of shared leadership require attention, but are manageable through a combination of: effective communication; thoughtful, well-articulated apportionment of roles and responsibilities among board leaders and management, and prudent selection of the people in leadership roles.

The relationship between the independent board leader and the CEO requires ongoing care to ensure that the chemistry is appropriate. The relationship of

Independent Board Leadership
What Is Desired?

An independent board leader should typically be:

- ☐ Independent from management (no personal or business relationships) and independent minded.
- ☐ Free from any economic or egotistical need for the role.
- ☐ Able to commit the necessary time and energy to the role.
- ☐ Capable of facilitating consensus and bringing out the best in the board.
- ☐ Respected by the directors and CEO for leadership capacity and business judgment.
- ☐ Respectful of the skills, contributions, and diverse viewpoints of individual directors.
- ☐ Respectful of the distinction between the board and management role, and of the CEO and management team.
- ☐ Supportive of the CEO as the leader of the company internally and externally.
- ☐ Capable of building and maintaining strong cooperative relationships.
- ☐ Excellent at communicating, including sensitive messages from the board to the CEO and to fellow directors.
- ☐ Able to lead in a crisis.

the independent board leader to the board members also requires attention to ensure that the board's role is supported by the leader. Many directors describe the ideal style of an independent board leader as one focused on facilitation of the group's endeavor, rather than a more directorial or autocratic style of leadership.

□ ***Selecting an independent board leader.*** Considerations in identifying a potential independent board leader include whether the candidate understands the nuances of leading the board without usurping board authority, and ability to establish an effective relationship with the CEO. While boards vary in the methods they use to select an independent board leader, the process often includes:

□ *Defining the independent board leadership role* and determining the criteria desired in the board leader.

□ *Identifying potential candidates.* In most circumstances, boards choose an independent board leader from among the current directors. Incumbent directors are already familiar with the board's culture and the company's business, and their ability to work toward consensus and communicate with other directors, as well as other strengths and weaknesses, are already known. However, there are times when it may be beneficial or necessary to look outside for an independent board leader (such as when a board has had significant turnover).

□ *Involving the CEO to an appropriate degree,* given the importance of the relationship that must develop between the independent leader and the CEO. While the board should not delegate this decision to the CEO, the CEO and the board leader must be able to work closely together, and therefore the CEO's views should be considered.

□ *Evaluating the strengths of potential candidates,* but avoiding a contest.

□ *Carefully considering whether it is appropriate for the independent board leader to also chair the governance committee.*

□ *Calling for a formal discussion* and vote of the independent directors.

□ *Carefully considering term and tenure.* The annual selection of the independent board leader is in line with the annual election of most directors, and provides an opportunity for assessment of the independent board leader's performance. However, this is not a position that should rotate or change on an annual basis given the skills and relationships needed. The board should also consider whether there should be limits on tenure to support board leadership succession. ■

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