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The Relationship Between Director Tenure and Director Quality

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ABSTRACT

In this paper, we empirically examine the relationship between the length of service of corporate board members (i.e., director tenure) and "director quality." There are conflicting points of view on whether increased director tenure is beneficial or detrimental to a company. On the one hand, a number of organizations have expressed serious concerns about the possible negative consequences of corporate directors serving for too long in their role as board members. In fact, certain groups have argued for placing term limits on corporate directors. Those who advocate term limits for directors contend that directors become "entrenched" and overly friendly toward management as their years of board service grows. As a result, long tenured directors may tend to overly rely on the assertions of management and may become lax in their duties to monitor management activities. However, not everyone agrees that increased tenure is detrimental to governance effectiveness. Some argue that directors gain valuable firm-specific information as their board tenure increases, with a resulting increase in the expertise needed to effectively govern the firm.

Although research is limited, the evidence that does exist is conflicting about whether long periods of director tenure increase or decrease a director's contribution to the company. One strand of prior research tests what we label the "Expertise Hypothesis," which proposes that board members gain valuable knowledge about a company and its operating environment over time and that their expertise in firm-specific governance matters grows over time. Under this hypothesis, director quality would increase as tenure increases.

Another line of research examines what we refer to as the "Entrenchment Hypothesis," which asserts that board members become less independent over time as they become entrenched in their position on the board and start to put management concerns over shareholder concerns. They become, in effect, insiders rather than true outside directors. Under this hypothesis, director quality would decrease as tenure increases. Prior results are conflicting since results consistent with both hypotheses have previously been documented. Interestingly, Huang (2013) demonstrates that increased board tenure is beneficial up to a point (around nine years), and then becomes detrimental after that point.

In this paper, we attempt to reconcile the conflicting results of past research. Using a large sample of over 30,000 firm-year observations collected from the *Audit Analytics* database over the years 2004-2014, we compute a variable that serves as a proxy for "director quality." This measure of director quality is calculated using an algorithm similar to the page rank algorithm used by Google. Using regression analysis, we find a significant positive correlation between director tenure and director quality. Increased tenure on the board increases beneficial experience, which in turn leads to improved director quality scores; i.e. improved corporate governance.

We also extend prior research by separately examining the effect of "inside" tenure versus "outside" tenure. We define "inside tenure" as the length of tenure on a particular company's board of directors. For board members with multiple directorships, "outside tenure" is defined as the length of tenure a board member has from serving on the directorships of other companies. Overall, after controlling for the length of inside tenure, there is also a positive relationship between average outside tenure and director quality. Increased tenure on outside boards increases beneficial experience, which leads to improved governance.

We further examine whether the relationship between director tenure and director quality varies depending on the size of the company on which the "inside" or "outside" tenure is acquired. Our results are relevant to the discussion of whether term limits should be set for corporate directors. We find that director tenure increases director quality up to a point and then tends to level off, rather than decreasing after that point. We demonstrate that companies are benefited by increased board tenure up to a certain point, and for levels of overall tenure above a certain point, incremental increases in tenure no longer have a significant effect on corporate governance. Thus, our results provide support for the Expertise Hypothesis and fail to support the Entrenchment Hypothesis.