Reprinted with permission of the publisher: the National Association of Corporate Directors (NACD) 1828 L Street, NW, Suite 801, Washington, D.C. 20036 — 202-775-0509, www.nacdonline.org

Evaluating the Board of Directors

By Lois Herzeca

The Case for Board Self-Evaluation

It is almost universally agreed that annual board self-evaluations are a corporate governance "best practice." The Conference Board Commission on Public Trust and Private Enterprise recently stated in its report:

> The Commission believes that each board should develop a three-tier evaluation mechanism which includes evaluation of the performance of the board as a whole, the performance of each committee, and the performance of each individual director, as necessary.

Moreover, the proposed New York Stock Exchange corporate governance rules specifically provide that the board of directors *should* conduct an annual self-evaluation, and that each of the audit, compensation, and governance/nominating committees *must* have a charter that addresses an annual performance evaluation.

Self-evaluations also make good business sense. If a board self-evaluation is performed effectively, there can be significant benefits to the corporation. A board evaluation should focus the board more clearly on the long-term strategic direction of the corporation and enhance the relationship between the board and senior management. It should result in greater cohesiveness among the board members and more effective action in times of crisis. Most importantly, by conducting a self-evaluation, a board dramatically demonstrates that it will hold itself accountable for its performance. It sets the right tone at the top; in this case, process is as important as substance.

Director Summary: Boards should conduct annual self-evaluations, both because new regulations may mandate them and, more importantly, because the process focuses the board on its mission and oversight function. Evaluations do have risks; ensure confidentiality and implement a corrective procedure if problems are discovered.

Preliminary Considerations

The initial matter to consider in commencing a self-evaluation program is whether to hire outside consultants. For some companies, the size or nature of the board, the limited financial resources of the corporation, or the corporate culture, argue against using outside consultants for the evaluation process. In such cases, the general counsel, perhaps in conjunction with outside counsel, could design an appropriate self-evaluation program. For many public companies, however, there may be significant advantages in using outside consultants to facilitate the evaluation process by helping to design procedures, administer evaluations, analyze results or suggest future action. Whether or not outside consultants are engaged, the self-evaluation process should be designed to reflect the unique characteristics and culture of the corporation and its board members.

It is prudent for the entire evaluation process to be overseen by a committee of the board composed entirely of independent directors. Normally, the governance or nominating committee would be assigned this task, but the board may delegate the responsibility to a new committee formed specifically for the purpose of conducting evaluations.

The Objectives of the Evaluation Process

The self-evaluation process should begin with a clear statement of the board's objectives. What is the purpose of the evaluation? The evaluation will be most useful if the process has specific articulated objectives, and the board is committed to taking appropriate action to achieve those goals. The best evaluations focus on a few high-priority areas.

A useful way to determine which aspects of board oversight should be emphasized in the evaluation process is to review the corporation's recent history, particularly the following matters, which may serve as indicators of problems:

- Decline in stock price, compared to peer companies
- Quarterly or annual results significantly below forecasts

- Failure to meet strategic goals
- Earnings restatement
- Government investigation of the company
- Significant shareholder or employee lawsuits
- Unstable management team, with frequent changes
- Frequent board resignations
- Director discontent
- Difficulty recruiting qualified board members.

After considering these indicators, the focus and objectives of the evaluation can become better defined.

The most common areas that a board evaluation might concentrate on fall within the following categories:

The board's size, composition, committee structure, and communication practices. Should the board's size be expanded or reduced? Are the frequency and length of board meetings adequate? Does the committee structure function appropriately? Do directors have the right mix of experience, skills, background, and diversity? Does the board take advantage of e-mail and Internet opportunities for communication? Has the board toured the corporation's facilities and met with operational staff? Are director orientation and education programs useful and sufficient?

The board's relationship with management. Does the board receive adequate and timely information from management? Does it have sufficient input into the agenda? Has the board been "surprised" by events occurring within the corporation? Is the board comfortable raising issues with management? Does it have sufficient access to management? Does the board seek outside advice when appropriate?

The board's performance evaluation of senior management. Are the board's performance measures adequate? Is the compensation scheme the right mix of salary, bonus, and equity? Are there policies in place to encourage senior management to own stock? Has the board used outside consultants or comparative industry data?

The board's view of plans for management succession. Does the board have a succession plan for both normal and emergency scenarios? How often does the board review the succession plan?

The role of the board in reviewing and evaluating the corporation's strategic plans. How complete is the board's understanding of the corporation's strategy, business plan, risks, and opportunities? Is there an effective system in place to identify critical issues and opportunities? Does the board periodically review business plans and budgets? Does the board adequately monitor financial and operational indicators throughout the year? Does the board get comparative industry data?

The board's understanding of the corporation's financial statements and financial reporting system. Does the board have adequate procedures for evaluating the independence and performance of the outside auditors? Does the board understand the corporation's critical accounting policies, principles, judgments, and estimates? Is the board sufficiently familiar with the corporation's system of internal controls?

The board's ability to manage a crisis. Can the board effectively deal with a crisis? Has it identified key players within and outside the corporation (i.e., law firms, investment bankers, and public relations specialists)? Does it have established channels of communication within the corporation?

Conflicts of interest in the boardroom. Have the directors disclosed personal interests that may be actual or apparent conflicts of interest? How are these instances handled? Are there adequate systems in place to avoid unintended conflicts?

Conducting the Process

The evaluation process itself can have multiple components. It can and should include evaluations of the effectiveness of each board committee (particularly the audit and compensation committees) in relation to its charter and articulated goals, as well as applicable legal and regulatory requirements. It can employ several complementary formats. The principal formats for developing data during the evaluation include: open discussions, individual director interviews, written questionnaires, individual director-assessments, and objective fact gathering.

In an open discussion format, the committee chair, a lead director, or an outside facilitator develops an agenda with an identified list of specific topics for discussion. This individual is responsible for guiding the discussion so that each topic is addressed and each director's point of view is heard. The directors should set aside a significant block of time for the discussion, free of distracting influences. Disadvantages of an open discussion are that it does not permit the confidential expression of personal views, it may discourage discussion of sensitive topics, and it generally does not lend itself to an in-depth analysis of particular topics. Therefore, for many companies, open discussions should be followed by additional evaluation techniques, such as questionnaires and individual interviews.

Individual director interviews should be the center of any evaluation process. As long as there are appropriate assurances of confidentiality, individual sessions should allow directors to address their particular concerns on a variety of topics. The interviewer, whether another director or an outside consultant, should be prepared with a list of questions and should carefully

Great care should be taken to keep accurate records; document retention practices should be carefully reviewed with legal counsel.

follow-up on any points raised in the interview. It is also useful to interview senior management to get their assessment of the board's effectiveness.

Written questionnaires are a widely used format for evaluation. Although they can be a useful tool, they should not be used exclusively because they do not allow for a full, focused expression of views.

The evaluation process can be expanded beyond the full board evaluation to focus on individual director performance, in order to enhance personal accountability. Useful techniques include director self-assessments and peer evaluations. The criteria can be objective (attendance, participation, areas of expertise, independence, level of commitment) or more subjective (overall contribution). Currently, most corporations do not perform individual evaluations, although it is generally viewed as a desirable practice by commentators and many institutional investors. Individual evaluations are sometimes perceived as a threat to collegiality in the boardroom. Additionally, until the practice becomes more widespread, individuals may be disinclined to join corporate boards that conduct individual evaluations. Of course, if a particular director is obviously delinquent in his or her duties, or engages in unethical behavior or damaging conflicts of interest, such director's conduct should be addressed immediately.

Finally, questionnaires and interviews can be supplemented by gathering objective data. It is worthwhile to compare the corporation's record of board and committee meetings (duration, frequency, attendance, participation), director education programs, and evaluation processes with those of comparable companies.

After all the discussions, interviews, questionnaires, and data gathering have been concluded, the results must be compiled, evaluated, and communicated appropriately to the board. It is in this area that outside consultants may prove particularly helpful. Care should be taken to preserve confidentiality during the reporting process, and to ensure that concerns are not attributed to particular individuals. Any written summary of the results of the evaluation should be delivered in draft form to each director on the committee well in advance of a full committee meeting to discuss the results. The summary should detail the results in a clear and understandable fashion.

The committee should then develop an action plan to address the concerns raised in the evaluation, and create a specific timeline for implementation. Consideration should be given to having an outside facilitator or the committee chair meet with each director individually to review the results and recommendations, in advance of any discussion at a full board meeting. The final report, including the action plan, should be discussed, modified as necessary, and approved by the full board.

The Risks

Board evaluations are not without risk. If confidentiality is compromised, the board may lose its ability to function effectively. Moreover, the legal environment surrounding internal corporate evaluations, and the applicability of a privilege, is currently uncertain. Any self-evaluation has the potential to produce information that could lead to civil or criminal liability, if it is not covered by applicable legal protection. Great care should be taken to keep accurate records and the document retention practices of the committee should be carefully reviewed with legal counsel.

The corporation may choose to publicly disclose the fact that it conducts a board evaluation process, but it should refrain from disclosing the results of such process, which should be kept confidential. Most importantly, if the evaluation process uncovers any information that could indicate corporate misconduct or negligence, the general counsel or outside counsel must be alerted immediately and the matter must be pursued until it is resolved appropriately.

Finally, it is important to monitor the board after the evaluation has been completed, to ensure that any suggested remedial action or proposed improvements are actually undertaken. If the board has identified problem areas and then fails to act to remedy them, the corporation and the directors may be exposed to potential liability.

Conclusion

Board self-evaluations can be a valuable mechanism for improving corporate governance. The mere commencement of an assessment process can often spur directors to improve their performance. A well-designed and implemented self-evaluation process can improve board functioning, reinvigorate the relationship between the board and management, and refocus the corporation on its fundamental principles. ■

Lois Herzeca is a partner specializing in corporate governance and transactions at Fried, Frank, Harris, Shriver & Jacobson, New York, and a director of The Children for Children Foundation. She may be reached at lois.herzeca@ffhsj.com.