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Rethinking Board Evaluation

In her regular column on corporate governance issues, Holly Gregory considers the role that board evaluation, particularly individual director evaluation, can play in supporting the board's effectiveness.

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Holly counsels clients on a full range of governance issues, including fiduciary duties, risk oversight, conflicts of interest, board and committee structure, board leadership structures, special committee investigations, board audits and self-evaluations, shareholder initiatives, proxy contests, relationships with shareholders and proxy advisors, compliance with legislative, regulatory and listing rule requirements, and governance best practice.

Board composition provides the foundation of experience and competency that supports all board and committee efforts. The modern era of governance reform began with a focus on recasting the public company board to include more independent outsiders and fewer management directors and persons with close connections to management. Board composition is once again in the spotlight. Investors are increasingly concerned about board quality and refreshment mechanisms in light of long director tenures, rising age limits and perfunctory director renomination decisions. In an environment of expanding business complexity, the relatively slow pace of board turnover may result in board composition that is out of sync with the company's needs, potentially creating gaps in relevant expertise and knowledge.

Search Institutional Investor Priorities for more on investor priorities for regulatory and voluntary governance reform.

Most directors are elected annually, which means they are renominated annually. In most boards, however, there is an overwhelming presumption that each director will be renominated. This presumption is so strong that in the vast majority of cases, any change on a board is due to a director reaching the age limit or deciding to no longer serve. Most governance and nominating committees do not assess with any rigor the board's composition in relation to changing business needs, let alone the performance of individual directors as components in renomination decisions.

Board evaluation was intended as a tool to help boards avoid stasis and continuously seek to self-improve. However, according to the *PwC 2014 Annual Corporate Directors Survey*, available at *pwc.com*, 70% of director respondents report that they find it a challenge to be frank in evaluating the board. More disturbingly, 63% find the process akin to a "check the box" exercise.

As boards prepare to undertake their annual board evaluations, these concerns should be addressed. To achieve benefit from the evaluation effort, a rote compliance-focused approach must be avoided. Adjusting scope and methodology from time to time helps keep the evaluation meaningful. Given the concerns outlined above, there is a need for renewed focus on board composition and board refreshment mechanisms. Boards that do not yet assess the individual performance of directors in evaluation efforts should consider doing so.

Whatever the scope of the evaluation efforts and the methods used, the goal should be thoughtful consideration of areas for performance enhancement. Only the board and its members are positioned to take the actions necessary to continuously improve.

BOARD EVALUATION: OVERVIEW

Annual board evaluation is a best practice that has gained considerable traction over the last 15 years. Board evaluation is supported by New York Stock Exchange (NYSE) listing requirements that require boards of listed companies to address board evaluation in corporate governance guidelines and provide for evaluation of certain committees in committee charters (see *Box, Stock Exchange Evaluation Requirements*).

According to the *Spencer Stuart U.S. Board Index 2014*, 98% of S&P 500 boards report that they undertake some form of annual evaluation, most commonly consisting of a formal self-assessment of the effectiveness of the board as a whole and its key committees. Only about 50% of boards surveyed by Spencer Stuart in 2000 (before the enactment of the Sarbanes-Oxley Act of 2002 and the reform of listing standards that occurred around the same time) undertook these evaluations.

Evaluation provides the board and its committees with the opportunity to consider how group culture, cohesiveness, composition, leadership and related meeting and information processes and governance policies influence performance. In addition to helping identify areas for potential adjustment, evaluation provides an opportunity to remind directors of the importance of group dynamics and effective board and committee processes in fulfilling board and committee responsibilities.

Individual director evaluation remains a minority practice among S&P 500 companies, with only 34% of S&P 500 companies reporting that they evaluate individual directors in addition to their full board and committee evaluations. However, the practice of individual director evaluation is on the rise, doubling in the past five years among S&P 500 companies.

Stock Exchange Evaluation Requirements

Under the New York Stock Exchange Listed Company Manual Section 303A.09 and Commentary (NYSE Listing Rules), companies listed on the NYSE must have and disclose a set of corporate governance guidelines and principles addressing, among other things, board evaluation. The NYSE Listing Rules also require that the key committee charters provide for annual evaluations of committee operations and recommend that the "board should conduct a self-evaluation at least annually to determine whether it and its committees are functioning effectively."

Companies listed on NASDAQ do not have similar requirements, but many still engage in self-evaluation as a matter of good governance practice. In addition, independent auditors often inquire into the board's evaluation of the audit committee as part of the auditor's assessment of the internal control environment. This has further encouraged evaluation in companies not listed on the NYSE.

Search Comparative Corporate Governance Standards Chart: NYSE vs. NASDAQ for a comparison of the corporate governance listing standards of the NYSE and NASDAQ.

Emphasis on evaluating board and committee performance is appropriate given the collective nature of board and committee decision-making authority. At the same time, the foundation for effective collective decision-making is the engagement and efforts of individual directors. Therefore, individual director assessment can be a valuable complement to the board and committee evaluation process. Individual evaluation encourages self-reflection and can help directors identify and address individual behaviors that may improve group dynamics and performance. In addition, formal evaluation of individual directors can help support the renomination decision process.

BOARD AND COMMITTEE EVALUATION

Boards should understand the framework under which board and committee evaluations are conducted, as well as take steps to ensure evaluations are carried out effectively.

Search Board Self-evaluation for a questionnaire for the self-evaluation of a company's board.

Search Nominating and Corporate Governance Committee Self-evaluation, Compensation Committee Self-evaluation and Audit Committee Self-evaluation for questionnaires for the self-evaluation of a company's relevant board committees.

EVALUATION FRAMEWORK

Most board and committee evaluations are intended to assist in identifying areas in which performance can be improved so that performance issues may be addressed. Some boards may have other more targeted goals, depending on the situation, and the focus of the evaluation should be adjusted to those goals. Evaluations also provide an opportunity to survey directors about the issues that they believe should receive more attention in board and committee meetings and in board materials.

The areas of consideration for board and committee effectiveness provide the basic framework for evaluation. These areas, and related questions boards should ask, include:

- **Composition and leadership.** Do the board and its committees have the appropriate composition to address the governance needs of the company currently and in the foreseeable future? Is the leadership of the board and its committees effective?
- **Refreshment mechanisms.** Does the board have appropriate refreshment mechanisms in place? Is it overly reliant on age limits? Does it make active decisions regarding renominations or are those decisions fairly rote? Does the board evaluate individual directors with some degree of rigor and provide feedback so that individuals can improve? Are those evaluations considered in renomination decisions?
- **Focus (or agenda) and information.** Do the board and its committees focus appropriately on the most important issues facing the company (and is there agreement on what those issues are)? Do the board and its committees have the information needed to make informed decisions in a timely manner?
- **Culture.** Has the board created an appropriate culture? Does that culture put the company's interests at all times above the interests of directors (including their interest in renomination) and value informed discussion of diverse views, constructive disagreement and debate, timely resolution of issues and appropriate handling of conflicts? What is the quality of the board's relationships with shareholders, management and key advisors, and directors' relationships with each other?
- **Governance structures and practices.** Has the board created governance structures and practices that support its ability to govern effectively and objectively?

Most board and committee evaluations cover these areas. They focus on elements of group behavior, recognizing that boards and their committees are more than the sum of their parts.

CONDUCTING AN EVALUATION

While evaluation processes should be tailored to the specific needs and objectives of a company, there are common elements. To conduct an effective evaluation boards should:

- **Delegate authority.** Typically a board committee (usually the governance and nominating committee) and/or the lead director or independent chair is delegated the task of developing and implementing an evaluation process.
- **Define the objective.** The objective of the evaluation should be defined with some specificity. Boards should ask the following key questions:
  - Is the evaluation being undertaken simply to comply with listing rules and best practice?
  - Are there specific areas that require close attention? For example, is it time to examine the board's risk assessment strategy, or how the board selects its leader?
  - Have there been significant changes on the board that increase interest in working on board culture and alignment with management?
  - Are there any underlying concerns about how the board is functioning?
  - What would be considered a successful outcome, for example, stimulating general ideas about process improvements and confirming that the board generally believes it is effective, reemphasis on governance roles and expectations, enhanced consensus as to governing approach or commitment to compositional change?
  - Are there sensitivities about exploring certain areas and, if so, why?
- **Determine the scope.** The defined objective will help to determine the scope of the board evaluation, both as to who will be the subject of the evaluation effort (such as the board, committees or individual directors) and the topics that will be addressed.
- **Identify the participants.** The defined objective will help identify the persons who will be asked to provide their viewpoints. Presumably this will include directors regarding board evaluation and committee members regarding committee evaluation. In addition, key members of management may be invited to participate. Individual directors may be asked to self-assess or they may be asked to assess their peers. Boards should determine whether a third-party facilitator will be called on to assist or whether the committee chair, lead director, general counsel, corporate secretary or other insider will serve in that role. A third party is often relied on to help tailor areas for inquiry, collect and collate information from surveys and interviews, and facilitate discussion. Using an attorney may preserve the ability to argue at a later date that the attorney-client privilege attaches. However, this argument has not been tested, and boards and committees should not rely on this protection. (This leads some boards and committees to rely solely on paperless facilitated discussions.)
- **Select the tools.** The evaluation process typically involves obtaining viewpoints about board, committee or director performance through the use of surveys or interviews. Viewpoints can also be obtained through a more streamlined process involving a facilitated board or committee discussion (see *Box, Evaluation Toolbox*). These methods can also be combined. For example, a survey or an interview may be used to obtain information in a manner that protects confidences, followed by a facilitated discussion, or a survey may be sent out, followed by brief interviews and culminating in a facilitated discussion. The defined objective will help determine the topics that are covered in the evaluation. To keep the evaluation fresh, both the process for obtaining input and the specific questions should be changed from time to time.

- **Consider the culture.** In designing the evaluation process, consideration should be given to the board's culture and how to assure that the process helps to build trust among participants. Where factions are already apparent, special efforts may be needed to ensure that the process does no harm.
- **Analyze and discuss the results.** The information obtained from surveys and interviews is collected and analyzed in a written or oral report that is designed to stimulate a full board or committee discussion of the results. Whatever format is used, the evaluation should culminate in deliberation and discussion about how the board and its committees can improve their function. This is key to a productive evaluation.
- **Commit to action.** The results of the evaluation should be used to resolve issues, make changes and achieve goals. If discussion leads to consensus about areas in which changes might be beneficial, appropriate follow-up is important. This may involve delegation of further study or other work and implementation to the governance and nominating committee for changes in board processes, or to another committee or management. Minutes should reflect that the evaluation was undertaken, but need not reflect much else (unless there is a clear action item).

INDIVIDUAL DIRECTOR EVALUATION

Evaluation of the board and its committees requires some consideration of the contributions of individual directors to assess whether the decision-making body is performing effectively. While it is relatively common for board and committee evaluations to include general assessments of the participation and preparedness of board members, many boards have been hesitant to evaluate individual directors. This is an area worth reconsidering when contemplating how to refresh an approach to board and committee evaluation. Even short of undertaking detailed individual director self-evaluation and peer evaluation, some evaluation of the contributions of individuals may provide valuable insights into areas for improvement.

Director evaluation can help underscore performance expectations, help directors consider their own contributions and provide directors with feedback that they can use to improve performance. Since individual directors bring very different experiences and competencies to the board, these evaluations tend to be based on fairly general and observable criteria, recognizing that directors contribute in varying ways in board meetings, committee meetings and outside of the boardroom.

As with board and committee evaluations, a range of approaches are available, including:

- **Open-ended questions.** These can be added to a board evaluation, either in interview or survey form, to elicit comments about the contributions of individual directors.
- **Self-assessment.** Each director performs a self-assessment, typically through a written survey. This provides an opportunity for self-reflection. It is also sometimes used as an initial step toward implementing a broader peer evaluation process.

Evaluation Toolbox

Boards can use the following tools to conduct an effective evaluation:

- **Written surveys or reports.** These provide an efficient means of obtaining viewpoints while allowing for confidentiality. However, they may not elicit a full explanation of a particular point of view. Typical surveys include questions that can be answered with standardized responses, as well as open-ended questions and areas for comment. If written surveys or reports are used, these materials may potentially be sought in litigation discovery proceedings. Generally the underlying "raw" evaluation materials, such as surveys and interview notes, are not retained after the results have been compiled.
- **Interviews.** These take more time to conduct but provide the opportunity to explore viewpoints more fully. Questions are typically open-ended and therefore the interviewer can explore issues raised in detail.
- **Facilitated discussion.** This provides the opportunity for directors and committee members to share viewpoints, discuss potential modifications to governance practices in response to concerns and reach consensus. It may also help clear the air regarding underlying tensions. While facilitated discussion can be used alone to streamline the entire process, if it is used without a survey or an interview it does not provide the opportunity for confidential input.

- **Peer review.** In a more expansive approach, each director performs a self-assessment and an anonymous peer review of each fellow director. This can be done through an interview or open-ended survey questions (although given the number of directors that each director must assess, comments on open-ended questions tend to be limited). Some boards use a written survey in which each director provides numerical ratings of all fellow directors. Directors should understand that numerical values can lead to a perceived ranking of "best" and "worst" even though the differences in ratings may be very small.

Typically the governance and nominating committee determines the parameters to be assessed, addressing the essential responsibilities of an effective director. These parameters, as well as the related questions boards should ask, include:

- **Director commitment.** Does the director attend and actively participate in meetings? Is the director appropriately prepared and informed? Is the director generally available as needed for special meetings? Does the director stay up-to-date with information about the company's business, market and regulatory developments, and other bodies of relevant knowledge?

- **Fiduciary duty.** Does the director understand legal obligations to the company and its shareholders? Is the director objective and willing and able to challenge management constructively, as appropriate? Does the director respect the line between oversight and management? Is the director effective in expressing viewpoints? Does the director follow up regarding areas of concern?
- **Contribution.** Does the director provide constructive criticism and thoughtful recommendations and generally exhibit good judgment? Does the director bring special skills, unique knowledge or other special qualities to the board? Does the director's conduct engender mutual trust and respect within the board? Does the director listen to others?

These topics can be expanded as appropriate. Often it can be helpful to ask directors to provide actionable suggestions about ways that each colleague can improve their performance, for example, by completing the following statement: "This director could be even more effective if ____."

As with full board and committee evaluations, in a peer evaluation, a trusted third party often facilitates the evaluation, serving as a neutral and confidential conduit for the receipt, compilation and summary of evaluation results. A composite report of the feedback is then provided to each director orally or in writing for the director to consider.

If significant performance issues are identified, they should be considered by the chairman, lead director or the governance and nominating committee, as appropriate, to determine whether coaching, additional educational opportunities or other support for the director is required, or whether board service should be ended (for example, through a determination not to renominate the director).

In determining how to implement individual director evaluation, the board should adopt the approach that is most likely to encourage candor and constructive feedback. Where a board is hesitant about implementing individual director evaluation, it may be implemented in stages, for example:

- The first stage could be simple self-assessment to encourage self-reflection on the qualities and criteria that the governance and nominating committee has decided to focus on.
- At the next stage, peer evaluation can be added, but with an understanding that results will only be reported to the subject director. This may provide comfort to the directors regarding the process, as they will have the opportunity to consider feedback and take action to change any perceived problems.
- In a later stage, the chairman, lead director or governance and nominating committee would receive a report identifying significant outliers or issues.

BOARD EVALUATION DISCLOSURE

Separate and apart from the benefits of board, committee and individual director evaluation, pressures for improved evaluation processes are likely to come from calls for enhanced disclosure of the processes that companies adopt. The Council of Institutional Investors (CII) issued a report in September 2014 that emphasizes that investors want more information about the board evaluation process. The report, *Best Disclosure: Board Evaluation*, available at *cii.org*, provides examples from 2013 and 2014 proxy statements of what CII considers as examples of "best in class" disclosure relating to board evaluation. Examples fall into two categories:

- Explanation of the mechanics of the evaluation process.
- Discussion of the key takeaways from the most recent evaluation.

The report recognizes that the latter type of disclosure is uncommon among US companies, but is more prevalent in the UK, Europe and Australia.

Shareholders can be expected to press companies for more disclosure about evaluation processes, especially in circumstances where shareholders have concerns about governance failures or the absence of regular director turnover.

The views stated above are solely attributable to Ms. Gregory and do not necessarily reflect the views of Sidley Austin LLP or its clients.