



## Board Self-Evaluations: Practical and Legal Implications

By Mark Kessel and Stephen T. Giove

The NYSE mandates that the boards of listed companies undertake an annual self-evaluation to determine whether they and each of their committees are functioning effectively. While Nasdaq does not impose similar requirements, companies listed on this exchange, as a matter of good governance, often undertake this performance review. The self-evaluation is intended to provide a systematic process by which the board and its committees can review their performance, make sure they are discharging their obligations, and institute steps for further improvement.

In implementing the self-evaluation, boards not only need to have an appreciation of the process, but also should make certain that it is suited to the company's particular situation and needs. That is, does the board have the commitment and

resources to engage in a robust self-evaluation process? Factors that can influence how the board approaches this process can include whether the company has been going through an unstable situation either due to a change in its business, pressure on the board from activists to change its composition, a change in senior management, or the longevity of board members.

In today's litigious environment, the board should also recognize that a self-evaluation could highlight board weaknesses that if subject to discovery by plaintiff's counsel, might enhance counsel's evidence in respect to claims against the company and its board. Therefore, boards are well advised to commence and conduct the self-evaluation process with the advice of counsel in order to build into the process appropriate safeguards to protect the

company and its board members. Practices for self-evaluations vary widely from company to company, and there are no disclosure requirements relating to the self-evaluation process.

### The Self-Evaluation Process

In NYSE-listed companies, the nominating and governance committee is responsible for overseeing the self-evaluation process, with its chair managing it. For a Nasdaq company, others, such as the independent chair of the board or the lead independent director, may take on the managerial role. In all situations, it is important that a member of the board "own" the process even if an external firm will be doing most of the work.

**Designing the process.** While the nominating and governance committee

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is responsible for overseeing the process, the entire board should approve the fundamental aspects of the evaluation and how it will be conducted. At the outset, the board should decide whether an external firm or a member of senior management will perform the evaluation; whether questionnaires will be used; whether individual interviews will be conducted; and whether a group discussion will be part of the process. Other design-oriented questions include determining who will have access to the information collected; whether the evaluation will include assessments of individual directors; what documents created in connection with the process will be retained; what will be included in the records of the company; and whether committee self-evaluations can be conducted simultaneously with the full board self-evaluation.

**The evaluator.** At the outset, the board should decide whether the evaluation will be carried out by counsel, either in-house or outside. If inside or outside counsel is selected, the board should determine that the procedures proposed by such counsel will enable the board to preserve the claim of the attorney-client and work-product privileges in potential litigation. One of the potential benefits of employing outside counsel as opposed to using inside counsel is a greater forum for complete candor and confidentiality. As the cost of using outside counsel should not be a major impediment, and given the likelihood that there is a greater degree of protection, it is recommended that the board consider the use of outside counsel.

While it is often debated whether it is appropriate to use the company's regular outside securities or governance counsel as the evaluator, absent circumstances that dictate the need for the retention of independent counsel, there are often benefits in using counsel that is familiar with the

company and its workings. There are also governance advisory firms that can facilitate the process.

The most critical factor in selecting an outside facilitator is that the person chosen is experienced in conducting self-evaluations, as very often sensitive and nuanced matters are raised during the process. Lastly, the board can turn to people inside the company to carry it out, such as the general counsel or corporate secretary. In such an event, however, a number of the benefits associated with using outside counsel or a firm are likely to be lost. For example, if one-on-one interviews with directors to elaborate on the responses to a questionnaire are to be part of the evaluation, eliciting further candor on sensitive matters by an employee of the company will be less likely.

**Participants.** The board should agree on the participants in the self-evaluation process. There are some fundamental issues to consider. Should the process be limited only to directors, or should input from management also be elicited? If management is to be involved, then members should be restricted to those who have had regular contact with the board, such as the CEO, CFO, or the general counsel, so that their input is more likely to be meaningful. If a member of management will be collecting the evaluations for the committee, the board should consider whether management participation in the self-evaluation process will make directors more constrained in their comments than if their comments were provided to an outside source.

**Questionnaires.** While the process does not have to include a director questionnaire, using one tends to focus the board on the critical issues that need to be evaluated. As the use of a written questionnaire might be detrimental to existing or potential litigation, counsel should be consulted

on its use and the legality of the destruction thereof at the completion of the process.

Like the entire self-evaluation process, the questionnaire should be tailored to the company's particular situation. Consideration should be given to questions that focus on key issues for the company, as well as the use of a variety of question types, including essays, and scales to try to elicit more specific responses. In general, unless the company has engaged in a self-evaluation process for a number of years and is now focusing only on particular issues, questionnaires tend to be designed to elicit views on many of the following matters:

- whether the board has adequately addressed strategic planning and the risks facing the company without "micromanaging" the company's operations;
- the board's relationship with the CEO;
- whether the size of the board is appropriate for the needs of the company;
- whether the board has the requisite experience to be a resource to the company's management;
- whether some of the members should be rotated off the board because of age, longevity, lack of sufficient participation, collegiality, or other reasons such as making room for gender or race diversity;
- whether new board members receive an orientation on the company's business and operations, and if needed, governance matters, in order to be sufficiently knowledgeable about the company and make a meaningful contribution;
- whether the board is provided with the appropriate materials from management in a timely manner so as to be sufficiently prepared for board decisions;
- whether the board is meeting an appropriate number of times given the nature of the company's operations and issues it is facing;
- whether board members regularly at-

tend meetings and are well prepared for the issues to be addressed;

- whether the board has functioned effectively;

- whether the board has the right committees and they are functioning effectively;

- whether the company has an adequate CEO succession plan; and

- whether the board provides sufficient performance feedback to the CEO.

The questionnaires should be distributed in print form and the answers completed on the form, not electronically, to allow appropriate destruction by counsel and to avoid inadvertent material being available in potential future litigation. In addition, in order to facilitate candid responses from directors, completed questionnaires should be seen only by the facilitator.

**Individual director evaluation (peer reviews).** A sensitive issue that comes up is whether the questionnaire or discussions with board members should also seek to assess each director's performance. While there are benefits to be derived from board members commenting on the performance of the other directors, there can be considerable downside to this process. Obviously, giving feedback may enhance that director's future performance. For the most part, however, the chairman or the lead director already should have discussed the subpar performance of a director during the course of the year. Hence, the peer review process may impair collegiality and should be approached with caution. But if it is undertaken, it is strongly recommended that a facilitator such as outside counsel or a governance firm be employed.

**Committees.** As noted above, the audit, compensation, and nominating and governance committees are each required by NYSE rules to perform an annual committee self-evaluation. Companies take different approaches to these requirements. Some have wholly separate processes

conducted by each committee, while others conduct their self-evaluations simultaneously with the board's self-evaluation. While there can be considerable time and cost savings from conducting the board and committee self-evaluations simultaneously, consideration should be given as to whether there are particular issues in particular committees that warrant particular attention.

### Reporting the Results

Whether it is led by counsel or another facilitator, the results of the self-evaluation should be reported to the full board, and individual members should not take notes during the process. While not essential, it

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is useful to give the chair of the governance committee or another director leading the process a brief preview of the findings. This will give the leader an opportunity to consider appropriate steps to take with respect to sensitive matters. For example, if a conclusion has been reached that a particular director be asked to step down or relinquish the chair of a board committee for underperformance, it would be advisable that the groundwork be laid so as not to unduly foster ill will among board members.

The key to the self-evaluation process is for the board to have adequate time to candidly discuss and interpret the findings, and agree on any shortcomings in the board's performance and the steps to address them.

To avoid lawyers using the board self-evaluation in potential litigation against the company, it is recommended

that the minutes or a self-evaluation report be prepared with the advice of counsel detailing the self-evaluation process and such other aspects of the process counsel deems appropriate. As noted, at the conclusion of the self-evaluation process, consideration should be given as to which of the documents created during this process, with the exception of the board minutes, should be destroyed.

### Following Up

The benefits to be derived from a self-evaluation will be lost unless the leader of the process takes steps to follow up on the recommendations and address any shortcomings that the board identified. If the board concluded that it should add race and gender diversity to its mix, for example, the nominating and governance committee should be tasked to implement this finding, which may require the engagement of an executive search firm, the expansion of the board, or the replacement of existing board members with the newly recruited ones. The leader of the process should also assign responsibilities to board committees or members of the board or of management for those steps that the board decided needed to be taken to improve board performance. Target dates should be established for the steps to be completed.

Aside from the regulatory requirements for a self-evaluation, a well-constructed board self-evaluation is one way to discern whether the board is effectively fulfilling its fiduciary responsibilities. In the absence of an effective evaluation, a board may be deluding itself that it has been providing the strategic guidance and oversight for which it has been elected. **D**

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