# Optimizing Board Evaluations

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# Introduction

The effectiveness of a company's board of directors is critical for ensuring that the company has a sound and long-term business strategy that is executed within an environment of prudent risk management. Board effectiveness contributes to the sustainability of the corporation over the long term and is therefore of vital importance to stockholders and other stakeholders. A periodic board evaluation has become part of the accepted governance landscape and, if conducted properly, can be a valuable tool to increase board effectiveness. In addition, board evaluations are now required by certain stock exchange rules and governance documents of many public companies.

The costs associated with a failure to properly assess a company's governance arrangements can be considerable. These costs are greater than any potential non-compliance with stock exchange listing requirements, the company's governance documents and/or applicable regulations in certain non-U.S. jurisdictions. Importantly, a failure to assess and subsequently improve the company's governing body may, over time, lead to a board of directors that is unable to fulfill its fiduciary responsibilities effectively. As the pace of change around us accelerates, it is imperative that corporations evolve as well. Consequently, over time, the balance of skills and experience on the board will inevitably need to change to make certain that the board continues to oversee the management of the company effectively and that the challenges of the day can be handled appropriately. A dispassionate and objective assessment of the board and its committees (and, in certain cases, individual directors) is a necessary step to help ensure that the board continues to function optimally in a changing business environment.

Board evaluations go to the heart of the directors' competence and might therefore be a challenging process to conduct. To help companies and their advisors plan their first board assessment – or to build on their previous ones – this article provides insight into the common types and formats of board evaluations and outlines various considerations for those designing the assessment. Additionally, recognizing that the list of competencies and capabilities required for an effective board is long and that prioritizing the most significant ones is essential to a successful evaluation, this article seeks to focus companies and their advisors on several key topics that each evaluation should address. Finally, this article concludes with some tips regarding the post-evaluation discussion with the board to ensure that the necessary improvements identified through the board evaluation process are implemented.

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# A. Designing the Evaluation Process

It should come as no surprise that there is no single evaluation format that suits every board. In order to enhance the effectiveness of the evaluation, those designing the evaluation process must tailor their approach to the particulars of the company and its board.

There are several factors that should be considered in determining the optimal method to be employed for a specific board. The culture and internal dynamics of the board should be significant drivers of the evaluation process selected; an understanding of these factors will enable the process to be designed to engender the directors' trust and, by extension, their forthcoming participation. Thoughtful consideration should also be given to the needs and situation of the company at that specific point in time. For instance, periods of transition, such as where there has been a change in management or the introduction of a significant number of new directors to the board, may require a different evaluation process than times marked by little change.

It is also critical to consider, at the outset, the company's underlying objective in conducting the evaluation. For example, is the evaluation process simply meant to comply with the company's governance guidelines and any applicable stock exchange listing requirements and/or to gauge the directors' general satisfaction with the functioning of the board? Alternatively, are there perceived deficiencies or specific issues that the evaluation is meant to address? Understanding the goal(s) of the board evaluation should guide the approach the company decides to take and will enable those designing the process to select the tools that are best suited to achieve the company's objectives.

Keeping these factors in mind, those planning the board assessment will need to choose among several approaches on the board evaluation spectrum. There are several procedural aspects of the evaluation that will require careful consideration and should be revisited from time to time, since the approach a company decides to take may change as priorities shift based on the issues facing the board.

1. **Should the evaluation be conducted orally or via written surveys?** The board evaluation process typically involves soliciting the views of directors via individual director interviews, written questionnaires, or some combination of the two (e.g., written questionnaires followed up by one-on-one interviews). If conducted properly, and by an individual that inspires the participants' trust, oral discussions may allow directors a greater opportunity to express concerns and raise issues in a thoughtful and complete manner, while written surveys have the potential downside of being more of a "check the box" exercise and eliciting less qualitative information. Additionally, questionnaires create a written record of the directors' opinions of the board's performance, which may be discoverable in a potential subsequent litigation. On the other hand, written questionnaires can be drafted in a way that focuses directors on the critical issues to be assessed and, assuming the questionnaires provide ample opportunity for directors to express their opinions and depending on the board and its dynamics, they may be more effective in provoking the directors' candid responses. Moreover, a written process may allow for greater reflection than a process that requires immediate responses to verbal questions.

2. **Should the evaluation be facilitated by a third-party service provider or by an insider?** While the vast majority of companies handle their board evaluations internally, others hire a third-party facilitator, such as outside counsel or a governance advisory firm, to spearhead the process. In determining which approach to take, boards should consider who would be most effective in facilitating the evaluation and the ensuing discussion with the board. Boards should ask themselves whether, given the circumstances of the company and the issues facing the board, the directors would be comfortable and forthcoming with an internal facilitator. Additionally, boards should bear in mind that hiring a third-party has the benefit of enhancing the objectivity of the process, may make directors feel more assured that confidentiality will be honored, and may empower directors to voice concerns that may not have otherwise surfaced. Hiring a third party, however,

can often be costly. Additionally, in some cases, the third-party consultant may want access to board and/or committee meetings in order to form its own view of the board's performance, which may cause discomfort among directors and make them more hesitant to provide a fulsome assessment. In our experience, when the board is functioning well overall, boards typically opt to conduct their evaluations internally, while they are more likely to hire a consultant when there are more significant issues to address and the board does not feel qualified to lead the evaluation.

In cases where the board elects to hire a third-party facilitator, the facilitator should be one that is respected and trusted, experienced in conducting board evaluations, and well-versed in evolving governance practices. The board should ensure that the outside firm it engages does not apply a generic approach; the board should work with the firm to ensure that it has all the information necessary to implement an evaluation process that is tailored to the specific issues facing the board.

3. **Where the evaluation is conducted internally, who should be tasked with leading the evaluation?** Evaluations conducted internally are often carried out by the chairman of the Nominating and Governance Committee, the independent chairman of the board or the lead independent director, the in-house legal department, or some combination of these. Particularly where the evaluation involves written questionnaires, the Corporate Secretary's office may have significant involvement in crafting the relevant questions and determining what, if anything, should be modified from the previous year's evaluation – sometimes with the input of outside counsel. Typically, the Corporate Secretary then discusses the proposed questions with the Nominating and Governance Committee and collects feedback from the directors. Where the board's evaluation process involves one-on-one director interviews, the board should give serious consideration to who would be best suited to conduct the interviews. While it is often the chairman of the Nominating and Governance Committee or the independent chairman of the board or lead independent director (depending on the board's structure) who conducts the interviews, the board should strive to ensure that the individual selected for the role is a good listener, knows how to formulate questions to inspire candid and fulsome responses and, most of all, has the directors' trust.

4. **Should the evaluation include peer reviews of individual directors?** In delineating the scope of the evaluation, boards will need to determine whether the evaluation will include performance assessments of individual directors. Peer reviews of individual directors may lead to greater director accountability and help to identify underperforming directors. Peer review is not without risks, however. One concern often expressed is that peer reviews may undermine a collegial board culture. Given this significant drawback, boards deciding to assess individual directors should do so with sensitivity.

Finally, those tasked with devising the evaluation process should consider the attendant litigation risk and how that risk might be able to be mitigated. Information derived from board evaluations may be discoverable in litigation and thus, in addition to considering this fact in determining whether to conduct the evaluation orally or via written questionnaires, boards should be sensitive to how board evaluation material is processed and retained. It may be advisable, for example, to implement a document retention policy applicable to board evaluations (subject to any hold notices that may be issued for pending or threatened litigation) pursuant to which the actual survey results are not retained once the summary report or slide deck, which does not reference individual directors, is prepared and delivered to the board. In addition, for companies employing written questionnaires, the person leading the process should consider reminding the participants that individual survey results may be discoverable in litigation and that, because their words might be used in ways that were not intended, they should be thoughtful in phrasing their responses. Finally, boards may consider retaining an attorney or law firm to be involved in the evaluation process, including the preparation of any summary report, and placing "Privileged and Confidential" legends on all board evaluation material. While these measures alone do not necessarily guarantee the protection of board evaluation material from discovery in a subsequent litigation, they do preserve the ability to advance the argument that the materials are covered by the attorney-client privilege.

# B. Key Topics to be Addressed in the Evaluation

Once the evaluation process has been designed, those leading the evaluation will need to decide what to assess, keeping in mind the objective(s) of the evaluation. An effective evaluation requires thoughtful consideration of the topics to be explored and the questions that will likely elicit robust responses regarding each topic. While there is no one-size-fits-all approach, there are several key areas that should be addressed in nearly every evaluation.

## 1.

**Efficient Use of Board Time.** Because a primary purpose of evaluations is to assess the effectiveness of the board, evaluations should address whether the board allocates its time appropriately. Some specific questions that may be asked in this regard are:

- Should the board be spending more time on matters that it currently does not spend enough time on? Should the board be spending less time on matters that it currently spends too much time on?
- Are there topics that are addressed that are not necessary? Are there topics that are not addressed that should be? In other words, is the board focused on the right issues?

## 2.

**Quality and Quantity of Information.** Ensuring that the right information – and the right amount of information – is appropriately presented to directors and that directors are given sufficient time to evaluate it are critical to enabling the board to function effectively. There are several categories of questions that may be asked in order to explore these issues:

- **Adequacy of Information.** Does the information provided to directors allow them to exercise their oversight responsibility on an informed basis and make properly considered decisions? Are there any changes you think should be made to the information provided?
- **Amount of Information.** Is there a sensory overload from board packets that are simply too long, or are lengthy materials a necessary side effect of increasing regulatory oversight and expectations? Would an executive summary be helpful? If briefing materials are too long, what risks are posed with respect to directors being unable or unlikely to spend the necessary time to review them prior to the meeting?
- **Preparation Time.** Are directors given sufficient time before each board meeting to read relevant papers and thus arrive to the meeting properly briefed?
- **Frequency and Length of Meetings.** Are the number and length of board meetings adequate, in light of the company's situation and the issues it is facing? Are there too many or too few meetings? Are meetings too long or too short?
- **Time Allocation.** Is ample time allocated at the board meetings to ensure full discussion of important matters?

## 3.

**Board Culture and Dynamics.** The quality of the directors' relationships with one another can be an indicator of the board's ability to work productively as a unit, as can be the dynamic in the boardroom. Evaluations should therefore address such questions as:

- How effective are the key board relationships?
- Are individual directors given sufficient opportunity to contribute to discussions at board meetings?
- Does the board encourage robust discussion and value the expression of diverse views and respectful disagreement?
- Do you feel that conflicts are addressed in an appropriate manner?
- Do directors come to board meetings prepared?

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## 4. Board Composition, Leadership Structure and Role of Independent Directors.

**Board Composition, Leadership Structure and Role of Independent Directors.** Each board must ensure that there is an appropriate balance of skills, experience, independence and knowledge of the company on the board to enable it to adequately oversee the company's management and address issues as they arise. Similarly, it is imperative that the board periodically assess whether its leadership structure continues to be effective, given the company's situation at the time, and whether there are any impediments to the ability of independent directors to perform their intended roles. Board evaluations should include questions focused on these issues, such as:

- Does the board have the right mix of skills and experience to enable it to perform its functions completely and effectively?
- Is there sufficient diversity among the directors?
- Is the leadership structure (i.e., the separation/combination of the chairman and CEO positions) working as intended?
- Is there a proper balance on the board between independent directors and management?
- Does the company's governance structure allow independent directors to perform their roles effectively?
- Do the independent directors conduct enough executive sessions throughout the year? Are they effective?

## 5.

**Controls and Compliance.** A key role of the board is to create and foster an appropriate culture of controls and compliance at the company. In assessing the board's effectiveness in this regard, director interviews and questionnaires should include such questions as:

- Do you feel that the company has an appropriate control environment?
- Do you believe you have appropriate access to management and that management has appropriate access to you?
- What is the board (and committee) process for identifying and reviewing risk?
- Are you comfortable that the company's internal controls are effective?

## 6.

**Board Oversight.** Board evaluations should determine whether the board is effective in its oversight of management. In this regard, an evaluation might ask:

- In its oversight role, do you believe the board appropriately advises, supports, and counsels management?

## 7.

**Committee Effectiveness.** In addition to assessing the effectiveness of the board as a whole, evaluations should include questions addressing the effectiveness of the board's committees. Some questions that may be asked include:

- Are the three core committees operating effectively and communicating the results of their work and analyses with the full board?
- Is the committee structure effective? What is working and what could be improved? Should the company have a risk committee separate from the audit committee?

## 8.

**Other Potentially Relevant Topics to Address.** While evaluations will invariably differ with regard to the additional topics they address, some questions that may be worth incorporating in the evaluation include:

- Does the board have an appropriate CEO succession plan in place that addresses CEO succession in the ordinary course, as well as in the event of an unforeseen crisis, such as a sudden death or resignation? As a related matter, do management and the board engage in and encourage the continuous development and promotion of the company's strong internal talent?
- In your experience, what are the characteristics of a high-performing board?
- What is the one improvement you would make to the board?
- Are there any potential areas of risk on which management should be spending more time?
- What is management's process and practice with regard to shareholder engagement, and is it effective? Given the company's facts and circumstances, is the board's engagement with shareholders appropriate?

# C. Post-Evaluation Discussion and Follow-Up

Even the most thoughtful of board evaluations will not be effective unless it is followed by a guided discussion with the board regarding the results of the evaluation and the delegation of appropriate follow-up tasks to address any issues that surfaced during the evaluation.

Once responses are collected – whether via interviews or questionnaires – the director, Corporate Secretary, or outside facilitator who is spearheading the evaluation process should anonymize, aggregate, and organize the data and present it to the board at the next board meeting. This presentation is typically conducted orally, perhaps with the assistance of a slide deck, and should allow for an open dialogue with and among the board members regarding the findings and what should be done to address any identified weaknesses. The presentation of the evaluation's results and the related discussion should be reflected generally in the minutes of the meeting.

Where specific shortcomings have been identified, it is critical that the discussion result in a plan of action for the board to follow up on the recommendations that come out of the process. The person leading the evaluation process should make sure to assign specific responsibilities to the relevant group or individual – e.g., a committee of the board, a specific director or a certain member of the management team. For example, where concerns are raised regarding the quality or quantity of financial information provided to the board, it would be most logical for the Chief Financial Officer (or the person he or she has designated) to take responsibility for the appropriate fix. Necessary improvements regarding the items on the board's agenda or the opportunity for individual directors to contribute to board discussions would be more appropriately delegated to the chairman of the board or lead director. And resolving concerns related to the mix of skills on the board should be tasked to the Nominating and Governance Committee. The leader of the evaluation process should also provide target dates for completing each of the follow-up items assigned.

# Conclusion

Regular evaluations of the board and its committees can be important to ensuring that the board can and does oversee the management of the corporation effectively. Because board evaluations can help foster long-term value creation and enhance the sustainability of the company over the long term, it is in the best interest of each company and its shareholders to devise thoughtful and comprehensive assessments designed to optimize the board's performance and to implement any necessary changes arising from these assessments.

**If conducted properly, a periodic board evaluation can be a valuable tool to increase board effectiveness.**

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