



JONES DAY COMMENTARY

TALK TO ME: DESIGNING AN EFFECTIVE BOARD EVALUATION PROCESS

For New York Stock Exchange listed companies, board evaluations are a fact of life.¹ Many directors have reached a saturation point with this annual, and sometimes numbingly repetitive, process. And yet, an evaluation process that is conducted in a thoughtful manner can yield insights that are extremely valuable to the board and, by extension, the company. On the other hand, a rote, check-the-box evaluation has little potential to be helpful and is a waste of time to all involved.

Planning a thoughtful, useful evaluation process raises a number of questions—Why go through an evaluation process? What are your goals, beyond mere compliance, in conducting board evaluations? Who should design the evaluation? What type of evaluation process should be used? How should the evaluation process be conducted? What should be done after the evaluations are completed?

WHY GO THROUGH AN EVALUATION PROCESS? WHAT ARE YOUR GOALS, BEYOND MERE COMPLIANCE, IN CONDUCTING BOARD EVALUATIONS?

Among other benefits, board evaluations can lay the foundation for filling gaps in director skill sets, fostering better communication not only among directors but also with management, focusing the attention of the board on strategic considerations rather than minutiae, and generally moving the board and its internal dynamic to a higher level. While this *Commentary* speaks of evaluating the board as a whole, the decisions and processes described here are equally applicable to committee evaluations.

Often, the issues illuminated by board evaluations are neither new nor unknown to the board—but they may

1. Sections 303A.04, 303A.05, 303A.07, and 303A.09 of the NYSE's *Listed Company Manual*.

be unacknowledged. The process of going through evaluations at least makes directors confront those unacknowledged issues, such as board composition concerns. We have also found that evaluations focusing on board processes (what level of information is provided, how the information is presented, what presentations should be presented, appearances of outsiders at board meetings, whether meetings with individual managers before the board meeting is a good idea, etc.) are useful as a means of getting board members to truly engage with one another.

WHO SHOULD DESIGN THE EVALUATION?

Typically, the nominating and governance committee has responsibility for the evaluation process, but this does not mean that this committee must do all of the work. Input from other directors, the assistance of management, and, if appropriate, the assistance of outside advisors is useful in designing a successful evaluation process. At the bottom, however, the topics should come from the board members themselves—after all, no one else really knows what's on their minds.

WHAT TYPE OF EVALUATION PROCESS SHOULD BE USED?

The evaluation format is perhaps the most difficult decision to be made in designing the process and depends upon a number of factors. Board evaluation is not a static process—one size does not fit all, and the methodology used in a previous year may not be appropriate for the current year. For instance, if an in-depth oral interview process is used one year, and the results of the process are actively being implemented, it may be appropriate to streamline the process by using written evaluations for the next couple of years. When thinking about the type of evaluation process to use, three areas should be considered: (1) written v. oral, (2) numbers v. commentary, and (3) board evaluation v. peer evaluation.

Written v. Oral. Many lawyers consider the use of written evaluations to be heresy, as the unedited and sometimes injudicious commentary may be discoverable in litigation. And there is the additional risk that written evaluations become little more than superficial homework. But the reality

is that many boards actually use written evaluations and want to continue doing so. Written evaluations, whether in the form of ratings or commentary, generally should be used when a company's circumstances are stable and there are no issues of obvious note likely to surface during the board evaluation process. Written evaluations, however, run the risk of not being sufficiently thorough, as the quality of responses depends almost entirely on the sophistication of the commentary and the time and work that each individual director is willing to spend in responding in writing. If a director is not invested in the process, the response to a written survey is unlikely to be helpful. And while, as noted above, written surveys create a record detailing a director's negative views of the board's effectiveness, it should also be noted that written surveys demonstrate a deliberative process. We have found that many boards, populated by data-driven individuals, may feel most comfortable having data recorded and compared year-over-year, making a written evaluation process essentially unavoidable. If written evaluations are the chosen route, the board should consider adopting a records retention policy, and complying with it, and in any event we advise sending responses to outside counsel who prepare written anonymous summaries and destroy the originals.

Oral evaluations are a good methodology to use when the board has factions, when there are specific issues to be addressed, when problematic comments are anticipated, or when the company is engaged in or anticipates shareholder litigation. In addition to allowing for creation of a thoughtful written record, this method may also elicit more reflective, in-depth discussions among the directors. Directors generally are asked to set aside at least an hour for the discussion, which gives an established amount of time in which the board focuses solely on the evaluation process.

If the decision is made to conduct evaluations individually, rather than as a group discussion, make note that the interviewer must be chosen carefully. This is a good role for an attorney, as the goal should be to retain as much confidentiality and attach as much privilege as possible to the discussions. If the company deems that this is not an appropriate role for the general counsel, or if the general counsel is uncomfortable conducting the interviews, consider using an outside facilitator, such as a consultant or an attorney, keeping in mind the goals of confidentiality and privilege and

the requirement that the facilitator mesh well with the board as a whole. As troublesome as written evaluations may be, they pale in comparison to the collegiality destroyed by a facilitator who is either presumptuous or seeking to uncover a scandal.

Numbers v. Commentary. Written evaluations can be designed with a rating system (e.g., 1 to 5), open-ended questions with space for commentary, or a combination of the two. A rating system has some risk of becoming a check-the-box process, rather than insightful and useful. For some boards, however, ratings are unavoidable due to board member preference. For instance, if a board is composed of several engineers, many of the board members may prefer to see the numerical values inherent in a ratings system. If the company opts to use a ratings system, be certain to provide opportunity for, and encourage, commentary. Also, be sure to define the ratings in as neutral a manner as possible—lowest scores would be “needs improvement” rather than “failure.”

Commentary-based evaluations, consisting of open-ended questions with space for response, generally are more useful, as they require more thought and action from the directors. However, the responses to these evaluations are entirely dependent upon two factors—how much effort the director puts in and the quality of the questions. When compared to oral evaluations, the downside of these evaluations is that, unlike oral evaluations, there is less, if any, opportunity to ask follow-up questions, and less opportunity for directors to speak at length about issues. With either quantitative or qualitative questionnaires, however, it is important to recast the surveys each year to address current issues of common concern.

Board Evaluation v. Peer Evaluation. Board evaluation refers to the evaluation of the board and its operations as a whole. This method is potentially less divisive than peer evaluations but may not necessarily reveal the most critical area that needs improvement.

Peer evaluation refers to the evaluation of all members of the board on an individual level. While this method has potential to be divisive, it also is more likely to provide thorough analysis of the board and of the contributions of each member and of other players with whom the board interacts. This method

must be facilitated in order to maintain as much privilege and confidentiality as possible. Companies tend to seek out peer evaluations in one of two circumstances: seeking to win the proverbial gold medal for good governance, or seeking an indirect means of addressing an awkward issue in the board room. The facilitator must be extremely careful in designing the questions for a peer evaluation process, as there is a danger that the questions could offend one or more board members or negatively affect the board's culture. However, if a peer evaluation process is done correctly, it can be a constructive evaluation approach. In our experience, the reality of peer evaluations is far more digestible and comfortable than the anticipation of them.

HOW SHOULD THE EVALUATION PROCESS BE CONDUCTED?

As discussed above, facilitated interviews have the potential to produce the most valuable results, but they also require the most preparation. Although the issues discussed below apply to all types of board evaluation processes, we now focus on conducting a facilitated interview process.

To begin, gather background information—talk to management, the chair of the governance committee, the board chair, the lead director, the general counsel. Learn as much as you can about their concerns and the goals for the process. You may discover a “thousand-pound gorilla” in the boardroom, and it's best to know about it first, to frame your subsequent discussions. Also, review old evaluations, focusing on issues that have arisen repeatedly and gaps in the questions that were asked.

Next, design the questions. Thinking of the questions in terms of interval training—low intensity to high intensity, back to low intensity—is helpful. Start with easier questions, then move to the more difficult, sensitive questions, and end on a note that allows the interviewee to expound on his or her overall views of the board. For instance, questions on the adequacy of materials and meetings logistics generally are safe, nonthreatening topics to start with, but about which directors always have opinions. The more sensitive questions, such as whether the board has the right skill sets, effectiveness of the board, what the board's biggest achievements

and challenges have been, and any company-specific issues to be addressed, tend to work well in the middle, once the interviewer has had a chance to establish a rapport with the interviewee. Be attentive to crafting these questions carefully, as they should not only elicit answers to the issues of particular concern but also avoid leading the witness. It can also be interesting to ask each interviewee whether he or she thinks his or her views are outliers—people tend to have a fairly good sense of where their views fit in with those of the rest of the board. End on a note that allows the interviewee to reflect, such as asking “What word of caution would you offer to the board?”

Then, conduct the interviews. If possible, interview upper management in addition to the board members. While not a strict 360-degree process, it can be very helpful to receive and share management’s sense of the board’s functionality. The interviews should be scheduled with sufficient time—an hour to an hour and a half generally works well. At the beginning of the interview, explain the process and assure the interviewee of the confidentiality of all statements. We have found that it is most productive *not* to rigidly adhere to the order of the questions—the goal should be to cover all necessary areas but to allow the conversation to flow. Follow up on comments the interviewee makes, and allow the interviewee to discuss issues significant to him or her.

WHAT SHOULD BE DONE AFTER THE EVALUATIONS ARE COMPLETED?

After the interviews have been concluded, analyze the results. Develop a short list—ideally, no more than four or five items—of the major points that arose from the interviews. Once you have a thorough grasp of the results of the interview process, schedule a debriefing—this can be with

the entire board, one or more people (such as the chair, lead director, and general counsel) who will report the results to the board, or both. Allow plenty of time for the debriefing, as this is not the time to rush. Be certain to maintain the confidentiality of the interviewees. This includes being careful not to attribute statements to particular individuals, and to avoid any phrasing that would make it easy to identify the interviewee who made the statement.

Finally, and most importantly, assist the company in developing an action plan around the results of the evaluation process. The action plan should identify specific initiatives the board will pursue in the coming year. After all, the overall goal of the evaluation process is to improve the effectiveness and usefulness of the board, not to just go through the motions.

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The authors wish to thank Robert A. Profusek and Richard H. Koppes for their assistance in the preparation of this Commentary.