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Director and CEO Performance Evaluations

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Board and Committee Evaluations

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Prevalence

- New York Stock Exchange corporate governance rules state that the board "should" conduct an annual "self-evaluation" to determine if the board and its committees are functioning effectively and require that the charters of the audit, nominating/corporate governance and compensation committees each address an annual performance evaluation of such committees.
- Board evaluations are not required by the rules of the American Stock Exchange and NASDAQ.
- Despite not being required, annual board of director and CEO evaluations have become increasingly common for public companies.
- According to a 2010 National Association of Corporate Directors ("NACD") survey, 90% of respondents conduct full board evaluations and 81% of respondents conduct committee evaluations.
- Board and committee evaluations are a recommended "best practice" and shareholders often demand that companies conduct such evaluations.
- Firms that rate companies' corporate governance policies, such as ISS, incorporate board of director evaluations into their scoring system.

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Benefits

- Not simply a process of grading the board or committee. Rather, in the words of the NACD, evaluations are "about how directors – both collectively and individually – can become and remain effective enhancers of corporate performance, using a self-assessment process to help them do so."
- The NACD views the ultimate objective of evaluations as providing "guidance that creates superior long-term shareholder value."

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Benefits (con't)

- This process of self-reflection and assessment may have several positive consequences, including:
  - Improved performance by identifying directors' strengths and weaknesses.
  - Broadened focus on long-term company goals.
  - Improved execution of plans by continuously measuring performance.
  - Improved composition of the Board.
  - Improved personal accountability by setting measurable standards and then assessing progress on meeting those standards.
  - Enhanced director credibility by signaling to shareholders that the board and committees take their role of overseeing management seriously.

Potential Risks

- Discovery in litigation.
- Loss of Board collegiality.
- May encourage counterproductive participation.

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Process

- No single correct process.
  - Alternative evaluation procedures include self-assessment questionnaires, one-on-one interviews, questioning key stakeholders, questioning members of management, or some combination.
  - According to the 2010 NACD Survey, 19% of respondents used an outside consultant.
- Frequency.
- Adopt a Board Mission Statement: A sample mission statement provided by the NACD is “To be a strategic asset of the company measured by the contribution we make – collectively and individually – to the long-term success of the enterprise.”

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Process (con’t)

- Develop a strategic plan.
- Evaluate effectiveness of Committee Charters.
- Determine who will identify Board performance measures and objectives. Board committee or full Board? Independent directors only?
- Determine who will conduct evaluations. Chairperson? Lead director? Governance committee?

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Evaluation Areas

- Understanding and developing strategy.
- Size and composition.
- Director development.
- Leadership and culture.
- Meetings.
- Evaluation and compensation.
- Succession plan.
- Constituencies.

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Evaluation of Results

- Analysis and presentation of results.
- Recommendations for change.
- Evaluating the evaluation process.
- Disclosure to shareholders.

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Individual Director Evaluations

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Prevalence

- According to the 2010 NACD Survey, individual director evaluations are less common than board evaluations, with slightly more than one-half (51%) of respondents reporting no evaluation at all.
- A 2008 Korn/Ferry study found that 45% of respondents evaluate individual directors.
  - Of the directors that were evaluated, 50% were evaluated by their peers, 57% relied on self-evaluation, 29% were evaluated by the governance committee, and 8% used an outside consultant for evaluations.
- However, a 2005 NACD report showed that 77% of directors surveyed opined that individual directors' performance should be evaluated regularly.

Benefits

- Provide feedback regarding individual improvement.
- Early warning system.
- Positive message to shareholders.
- Indicative of Board performance.
- Sets expectations.

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Potential Risks

- Legal exposure for failure to act on information.
- Loss of Board collegiality.
- Loss of good candidates.
- May encourage counterproductive participation.

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Process

- Assessment by Board Chair or Lead Director.
- Self-assessment questionnaires.
- Peer evaluations.
- Deciding whether to share results with the Nominating/Corporate Governance Committee.
- Disclosure to shareholders.

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Evaluation Areas

- Attendance and participation.
- Preparedness and availability.
- Knowledge of the company's business.
- Initiative.
- Judgment and candor.

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CEO Evaluations

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Prevalence

– According to the 2010 NACD survey, 89% of public company CEOs are formally evaluated annually, which is up from less than two-thirds in 1999.

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Benefits

- Clearer strategic objectives.
- Improved communications.
- Enhanced CEO development.
- Increased Board independence.
- Allows for greater objectivity about CEO compensation and improved pay-for-performance decisions.
- Greater focus on the long-term objectives of the company.
- Promoting better Board-CEO relations.
- Better early warning system.
- Improved Board function if the CEO is also Chairperson.
- Greater accountability for CEO performance.

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Risks

- Discovery in Litigation.
  - Implications in “Say on Pay” litigation.
    - If evaluations are discoverable, bad or mediocre marks for the CEO combined with a pay raise could bolster the plaintiffs' arguments that the CEO was paid without performing.
- Loss of Board-CEO collegiality and dialogue.

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Evaluation Areas

- Achievement of corporate goals and objectives.
  - Go beyond financial operating performance.
- Management (including CEO) succession planning.
- Stock performance, if a public company.
- Key leadership qualities.

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Process

- Assessment by Board Chair or Lead Director or Committee Chair.
- Self-assessment questionnaires vs. Board questionnaires.
- Participation by senior management of the company/the CEO's direct reports.
- Agreeing on measures.
- Presentation of findings – form and recipients of information.
- Disclosure to shareholders – of results or of process.
- Impact on CEO compensation.
- Develop a corrective action plan that addresses concerns.

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Succession Planning Tool

- Shareholders have increased pressure on Boards regarding succession planning, requesting more disclosure about talent development and succession plans.
- CEO evaluations can operate as an early warning sign as well as serve as an opportunity for Boards to further develop successors that display the characteristics that the current CEO may lack.

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Questions & Answers

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