FOLEY
FOLEY & LARDNER LLP

Effective Board Evaluations

2007 NATIONAL DIRECTORS INSTITUTE

EFFECTIVE BOARD EVALUATIONS

Board evaluations are a formal method designed to facilitate board development and foster communications among directors and between the board and management on issues such as corporate strategy, board composition, board processes and the appropriate role of the board of directors in a company's overall management scheme. Board evaluations, when completed properly, should identify areas of strength and weakness, leading companies to make marked changes that positively impact shareholder value.

At Foley's sixth annual National Directors Institute on March 8, 2007 in Chicago, "Effective Board Evaluations" was a featured breakout session. Moderated by Jessica Allen, Foley & Lardner LLP, and Madeleine Condit, senior client partner, Korn/Ferry International, the panelists included Warren Batts, former CEO of Tupperware and Premark International Inc., chairman of the board, Methode Electronics, Inc., and adjunct professor at The University of Chicago; Jon Chait, chairman and CEO, Hudson Highland Group, Inc.; Mary Hill Leahy, senior vice president, general counsel and chief compliance officer, Journal Communications, Inc.; and John Zecca, vice president, MarketWatch, and head of market regulation, Nasdaq Stock Market.

The passage of the Sarbanes-Oxley Act of 2002 (SOX) led the New York Stock Exchange (NYSE) to adopt listing standards stating that the boards of companies listed on the NYSE should conduct regular evaluations of their boards of directors to determine if their boards and committees are functioning properly. The NYSE also requires that the charters of the audit, nominating/corporate governance and compensation committees of listed companies include provisions for an annual performance evaluation for such committees. Although the rules of the American Stock Exchange and the NASDAQ do not require such evaluations, board evaluations are becoming increasingly common and are considered to be a best practice. In fact, a survey conducted by The National Association of Corporate Directors (NACD), in collaboration with Institutional Shareholder Services and Mercer Delta Consulting, LLC, entitled "2006 NACD Public Company Governance Survey", polled more than 798 public company directors and found that 88.5% of companies perform full-board evaluations annually and 90.4% of companies perform committee evaluations annually.

Methods of Evaluation

A major area of concern for companies performing board evaluations is the absence of a universal process that companies can follow or use as a guide. There is no governing body that has published a standard form or guidelines for companies to use as a resource when crafting their board evaluations. The lack of standards leaves companies asking whether their respective methods of evaluation are the best methods, and wondering what changes they could implement to maximize the effectiveness of such evaluations.

Two basic methods exist for conducting board and committee evaluations: quantitative surveys and facilitated interviews. The majority of session participants indicated that their companies performed board evaluations using quantitative surveys that contained a combination of both open-ended questions and simple box-checking exercises. Less than a quarter of participants indicated that their companies had used both quantitative surveys and interviews when conducting their board evaluations.

Utilizing Third-Party Evaluators

While board evaluations are generally conducted by individuals within the company, it is becoming more common for companies to hire individuals outside their company to execute their evaluations. Companies vary in their approaches, sometimes bringing in outside evaluators annually, and other times using their services every two to three years. Requirements depend on individual company needs, and should be reassessed as the company grows or it encounters changes that require increased (or decreased) evaluation. Most outside agencies, however, will extract quantitative survey results and report them back anonymously, to ensure that issues can be addressed without comments being attributed to a specific person or persons.

Peer Evaluations

Some companies choose to evaluate individual directors as well as the entire board of directors. During the peer evaluation process, directors are asked to evaluate one another by completing questionnaires relating to their colleague's performance and skill set as a director. The concept of peer evaluations is usually more difficult for directors to accept than the traditional self-evaluation process. Directors, as individuals who have generally been highly successful in their careers, are not always prepared for this type of evaluation, which can raise sensitive issues and at times produce discord among those involved. This breakdown in collegiality can be harmful to the board in general and can hinder the board's ability to successfully conduct board evaluations. It is important to promote a collegial relationship among board members so that they know each other as individuals beyond the position that they each fill on the board. Audience participants agreed, stating that collegiality among board members allows directors to criticize activities rather than point fingers at individuals. Although peer evaluations can be useful, ideally a company will have conducted individual self-assessments for approximately two to three years before moving solely to peer evaluations or including peer evaluations in the process.

Legal Implications

A major concern of companies conducting board evaluations is the legal risk associated with the recordation of the answers. Information that is gathered during the evaluation process is potentially discoverable in litigation. Thus, companies must be careful in the preparation of any report summarizing the results of the evaluation process. Companies must also exercise care relative to the application of document retention policies to the raw data generated by the evaluation process. To help eliminate these risks, a board may consider involving inside or outside counsel in the evaluation process in order to maintain the attorney-client privilege.

Legal risks definitely exist, but they can be minimized. Questioning directors during the evaluations, and recording their responses for presentation for the entire board can be helpful. Also, evaluations can be listed as a meeting topic, but only reported in the minutes as having "been addressed," without specific details being revealed.

Despite these very real legal risks, evaluations do not have to be so focused on the legal implications, wherein useful results are impacted. How the questions are worded may dictate or "guide" the answers that directors will provide. If companies are overly concerned with legal implications and risk, board evaluations may become so limited that their overall purpose is thwarted.

Criticisms of Board Evaluations

An additional concern that board evaluations today spawn is more paper shuffling. The evaluation process can be tricky, as difficulties can arise with the lack of a one-size-fits-all approach. For companies with large boards, it becomes quite difficult to use quantitative surveys to evaluate directors based solely on their contributions at meetings. Given the discrepancies that may result, the best method for conducting board evaluations might be a combination of written and oral questions.

Value of Board Evaluations

Most companies agree that the purpose of conducting board evaluations is to tailor the board's composition and processes so that the company has a "best in class" board to maximize shareholder value. For this to be the case, however, companies must take the board evaluation process seriously and must implement the results gathered through the evaluation process.

If the process becomes a mere box-checking exercise, little benefit can be gained from evaluations. Additionally, if board members give each other high ratings just to move through the evaluation process quickly, the board is not improved by the process. To ensure that the process is taken seriously, companies should have one solid, well-respected "worker-bee," for example, an excellent lead director, that understands the seriousness of board evaluations and pushes directors to engage in the process in an honest manner. A good chairman or lead director can make the difference in ensuring that board evaluations are carried out effectively and efficiently.

Implementing the Result

In some instances, evaluation results are conveyed to the CEO and the chair of the corporate governance committee who are then charged with the resulting implementation. A company should be wary if the received evaluations state that no action is needed, since there is always room for improvement.

One part of the board evaluation process that companies do not always fulfill is the follow-through on the back-end to implement the changes highlighted as necessary or desirable. It is key that either the chair of the corporate governance committee or someone playing a similar role on the board introduce the follow-through items on the board's and committees' agendas so that they are acknowledged and, hopefully, completed. Some companies use the results to initiate conversations with each individual director, underscoring the strengths and weaknesses that exist so that each director is able to see opportunities for improvement.

For More Information

For more information on this session or the sixth annual National Directors Institute, visit Foley.com/ndi2007 or contact the co-moderators directly.

Jessica Lochmann Allen
Foley & Lardner LLP
jlochmann@foley.com

Warren Batts
Methode Electronics, Inc.

Jon Chait
Hudson Highland Group, Inc.

Madeleine Condit
Korn/Ferry International
Madeleine.Condit@kornferry.com

Mary Hill Leahy
Journal Communications, Inc.

John Zecca
Nasdaq Stock Market

2007 National Directors Institute Sponsors

Foley proudly recognizes the 2007 National Directors Institute sponsors: UBS, Aon, Korn/Ferry International, Deloitte, RR Donnelley, D. F. King, Ashton Partners, Boardroom Bound, Chicagoland Chamber of Commerce, NASDAQ, NYSE and Springboard Enterprises. The support we receive from our sponsors is crucial to the development of the program and we thank them for their efforts in once again making NDI a huge success.

Save the date! The 7th Annual National Directors Institute will be held on March 6, 2008 in Chicago. Learn more at Foley.com/ndi.

FOLEY & LARDNER LLP