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Looking in the Mirror

For their annual self-examination, boards of directors need sound counsel.

BY STUART G. STEIN
AND EVAN R. FARBER

As most public companies approach the end of their fiscal years, boards of directors and their advisers are beginning to focus on conducting their annual performance evaluation.

Companies listed on the New York Stock Exchange are required to adopt and disclose guidelines for annual performance evaluations of their board and each board committee. NYSE listing standards provide that "[t]he board should conduct a self-evaluation at least annually to determine whether it and its committees are functioning effectively."

In this era of close scrutiny of the performance of directors, companies not listed on the stock exchange may also find that periodic self-evaluations are no longer simply regarded as a best practice, but rather an expected practice.

There are no NYSE or Securities and Exchange Commission rules that describe how boards should conduct self-evaluations. There is no best way, or even a set of best practices, that can be reduced to a single template for all company boards.

Rather, directors must consider in light of their particular board what process will best assess their strengths and weaknesses. And because these evaluations go well beyond customary board minutes in addressing board competence, procedures, and quality, companies must also be aware of potential exposure of this record down the road.

MANY METHODS

Companies can conduct these self-examinations in various ways, some of which are better than others.

One common method is the questionnaire. These often follow the model of employee evaluations, modified, of course, to focus on director performance and related issues. A comprehensive evaluation form will explore in great detail such matters as board composition and director skill sets, knowledge base, effectiveness, standards of conduct, preparation and time commitment, and the flow of information to the board.

Typically, each director completes an individual questionnaire and then returns the completed questionnaire to someone at the company or to outside counsel. The results are tallied and shared with all directors.

Written questionnaires are not the only alternative. Some boards reserve time, either at a special meeting or at the end of a routine meeting, to let directors discuss the board. Without an adequate agenda and willing board members, however, these types of meetings may not achieve open communications or comprehensive evaluation.

Another alternative is to direct a third party—often outside counsel, but sometimes another board consultant—to conduct the evaluation outside the board room. These evaluations usually consist of one-on-one interviews with a specific list of questions.

The best-designed self-evaluations are developed only after a company has taken time to reflect on the personalities of the board and its committees, the personalities of individual members, the issues or pressures that arose in the past year, and the board's goals. The goal is a frank expression of directors' views, concerns, and suggestions.

PRESERVING PRIVILEGE

Inevitably, a good self-evaluation will raise sensitive issues. The board must therefore beware of creating embarrassing, or even harmful, records that could be discoverable in litigation.

In litigation or other contexts, hostile parties may have the chance to review the company's books and records, including board materials. For that reason, many companies go through great pains to cloak a board or committee evaluation in the attorney-client privilege. But such claims are subject to challenge.

Both the form and substance of the evaluation are important for establishing the privilege. Written materials should originate and terminate with legal counsel—internal or external—and should be prepared by counsel in consultation with appropriate board members. Counsel should collect responses to questionnaires or conduct interviews, and they should compile the information and make the presentation to the board. Boards should consider carefully whether directors really need to be given written materials.

Remember that responses can be taken out of context. Companies

should give careful attention to how information is solicited. Nobody wants to create a "smoking gun" with a director's response to a question that is later taken out of context.

Many off-the-shelf assessment forms call for responses of "strongly disagree," "disagree," "agree," and "strongly agree," or rankings on numerical scales. While these may be helpful in assessing the strength of a particular criticism or praise from a particular director, they do not necessarily allow for cross-director comparison. People have different grading scales. While one director may record her view as "strongly agree," another may record the identical view as "agree." Thus, standing alone, the numbers may give a false impression (to later litigants) of the level of director disagreement or disapproval of company practices.

One strategy is to eliminate the degrees or rankings of responses. Questions can elicit a simple "yes or no" or "agree or disagree" response.

Another option is to require detailed responses to written or spoken questions. Contemplative responses and an honest sharing of information obviously will be more beneficial than a simple numerical response. Any questionnaire should encourage this by providing room for extensive additional comments. But if written explanations are sought, directors should be cautioned about intemperate responses.

Examples of potential problems might include apparently horrified responses such as "See what we did!" or problematically detailed responses such as "I strongly disagree with the statement that directors receive materials sufficiently in advance of board meetings because the board was provided with materials on the XYZ transaction at the board meeting at which it was considered and approved, and none of the directors had an opportunity to review any materials or ask an informed question."

Face-to-Face Interviews

That said, companies should not fear directors airing their views. Most directors are accomplished and well-educated, have important practical experience, and can be articulate. A key to a successful evaluation is to get them talking freely.

To do that, boards should consider using oral rather than written evaluations. Many people find it easier to express themselves by talking. A structured but flexible conversation—guided by both conceptual, open-ended and specific, targeted questions—will often yield more comprehensive, thoughtful, and insightful responses than would a written questionnaire. Follow-up questions can be asked to gain additional facts, examples, context, or clarification.

It is also more likely that a director will provide a response to the questions "Do you have anything else to add about how the board is functioning?" and "Do you have any suggestions on how the board can be more efficient?" if the director can respond in open air, rather than on two lines of paper.

This is not to suggest that conducting a board evaluation by interview is easy. The interviewer must be knowledgeable about the company and the board, take copious notes, and think on his or her feet to ask follow-up questions.

If the directors are to speak freely, they must have utmost confidence that the evaluation will be kept confidential and used for only its intended purpose. To help instill this confidence, the interviewer must be someone regarded as sufficiently independent of management and the directors. Therefore, an employee of the company, who directors might fear would gossip or share information with management, probably is not the best choice.

A director may not feel comfortable communicating openly with outside counsel if outside counsel is known to be so chummy with other directors or management that his independence is questionable. It also does not inspire frankness if the lawyer is known to temper his advice to avoid offending management or to shrink from hard decisions from fear of losing business (or friends).

To protect communications as privileged, boards should consider having an attorney conduct the interviews, who would then present the results to the board. Boards may want to have two attorneys present for the interview—one to take copious notes, and the other to focus on interacting with the director. Under most circumstances, outside counsel should be used as long as the board regards them as sufficiently independent and credible.

Interviewers should consider conducting the interview in the director's office, home, or some other place where the director feels comfortable and otherwise removed from the board room. The point is to foster a detached, objective assessment of the board.

The Results

Once all the questionnaires have been collected or the interviews conducted, the results must be presented to the board. There is no magic to this presentation except that it should accurately reflect the information gathered in a way that allows the board to glean lessons from that information.

The data should be clear and easily digestible by the directors. The presentation should facilitate year-to-year comparisons. And specific comments should not be subject to attribution. This will provide directors with the additional comfort that they can be candid in subsequent years.

Presentations can vary depending on the evaluation process. For example, some may report average scores or the frequency of certain responses (such as three "strongly disagrees" or five "strongly agrees"). Some may include charts and graphs of the frequency of certain responses, as well as sanitized quotations from interviews. Some presentations may be elaborate with graphics. Others may be simple memos to the board that summarize trends, consistencies, and inconsistencies in directors' responses. The choice should depend on the needs and wants of the particular board.

Some prudent boards do not want any written work product at all, opting instead for an oral briefing by the attorneys who conducted the evaluation. Obviously, the minutes taken for such a meeting should document the occurrence and purpose of the meeting.

One size does not fit all in fashioning a board evaluation process. Time should be spent upfront in determining how to encourage frank assessments from directors in order to reduce the risk of comments being taken out of context and to protect the company's ability to assert the attorney-client privilege for all the sensitive information gathered.

Stuart G. Stein is a partner in the D.C. office of Hogan & Hartson, where he heads the firm's financial services practice and corporate governance group. Evan R. Farber is an associate in the firm's D.C. office. They may be reached at sgstein@ hhlaw.com and erfarber@hhlaw.com.