*CLO 21 Advisory Group*

# Self-Help: Board Evaluations Become De Rigueur

**Once a seldom-used tool, board evaluations are becoming not only enthusiastically accepted, but also required. The benefits can be enormous. But so can the risks.**

BY STEPHEN E. NOWLAN AND ANGELA CARLUCCI

In its recent proposal to modify its rules for listed companies, the New York Stock Exchange included a requirement that companies address how they will conduct periodic self-assessments of their boards as well as their audit, nominating/governance, and compensation committees. The Securities and Exchange Commission is expected to approve the proposal.

At a time when governance standards for boards of directors are evolving rapidly, the processes put in place to evaluate boards, committees, and directors will focus directors' attention on a Pandora's box of issues related to the appropriate roles, evolving responsibilities, and performance of board members. As the board wrestles with these issues, the general counsel's role in helping the board understand expanding legal requirements and refine standards of performance will be increasingly important.

> **[ IN BRIEF ]**
>
> As board evaluations become either required or expected, general counsel will face a number of new challenges, responsibilities, and opportunities—any one of which could make or break their careers. These include:
>
> - Managing relationships with the board, officers, and other advisors
> - Dealing with new disclosure issues
> - Advising on new discoverability concerns

## The Move Toward Evaluations

According to a 2002 Korn/Ferry study, only 37 percent of the boards of the Fortune 1000 formally evaluated the entire board's performance on a regular basis. As a result of the new NYSE requirement and the increased scrutiny of governance practices resulting from Sarbanes-Oxley, regular board and committee evaluations will likely be conducted not only by NYSE-listed companies, but also by a high number of other companies that do not want to appear deficient in their governance practices.

For a majority of boards and directors, then, self-assessments are a new experience.

According to two recent surveys, a majority of directors of public companies are looking forward to these evaluations. The National Association of Corporate Directors surveyed directors of 2,000 public companies and found that 91 percent were in favor of regular board evaluations. A 2002 survey by Korn/Ferry of directors of companies with $200 million or less in sales found that 77 percent felt that the performance of individual directors should be evaluated regularly, although only 12 percent of their boards do so. Directors' enthusiasm will certainly lead to self-assessments by many boards that are not required to implement them.

Investors are clearly interested in governance practices as well. McKinsey & Company's 2002 "Global Investors Opinion

DONNA TEREK

**Nowlan: GCs must help boards understand expanding legal requirements.**

Survey" of 200 investors who manage $2 trillion in assets found that more than 75 percent would pay a premium for companies that are visibly well governed.

## How Evaluations Have Changed

To understand the perspectives of general counsel on board evaluations and related issues, we recently conducted phone interviews with more than 20 general counsel, including members of the CLO 21 Advisory Group, and corporate secretaries from leading companies. General counsel, especially those who also serve as corporate secretaries, are very involved in the evaluation processes, often working with the board chairman, governance committee chair, or other board members to develop or refine the evaluation questionnaire, summarize the results, and provide legal advice on various issues.

It is not surprising that the evaluations conducted by many early-adopting boards generally focused primarily on housekeeping and communication issues, including the number and length of meetings and the preparation of board materials. However, as several general counsel pointed out, directors are now confronted by several sobering factors which were not true when some boards first started conducting evaluations: the obvious failure of boards at Enron, WorldCom, and others to fulfill their responsibilities despite supposedly competent directors and tough internal controls; the haunting possibility of personal liability should aggressive carriers of directors and officers policies refuse claims or attempt to rescind director coverage; and the fact that no director wants to be the poster child for post-Enron ineptitude and wind up testifying before Congress or being grilled by the SEC.

Today, board and committee evaluations are taking place in the context of these expanded concerns, and directors themselves are more assertive in their roles. As boards become more independent and populated by more qualified directors, board members who customarily participate in probing discussions about corporate and executive performance are not likely to be satisfied with perfunctory "check the box" evaluations.

In fact, many general counsel and corporate secretaries we spoke with reported that the evaluation process and discussion about results have provided their directors with a new opportunity to put the board's role and responsibilities on the meeting agenda, and explicitly and candidly discuss the board's performance and its role in overseeing the company's management, direction, and progress.

**General counsel must ensure that evaluation documents are being managed prudently—and destroyed routinely after the appropriate interval.**

While traditionally the role of boards focused on the quality of management, company strategy, and the oversight of internal controls, the evaluation process is raising some challenging questions about just how deeply the board should delve into these areas to ensure that the company is appropriately and effectively managed and pursuing the right business strategy. Most general counsel reported that there is now a greater interest in formulating the evaluation topics and process to go beyond housekeeping issues and focus on core performance questions as well.

Discussions initiated by these evaluations will undoubtedly provide directors with a forum in which to address these key questions. Many board members look to the general counsel for advice because each of these questions is fraught with legal considerations when it comes to balancing the role and function of the board against those of management.

In addition to conducting evaluations of the board and key committees, a minority of companies conduct annual evaluations of individual directors by having all directors complete questionnaires about each director. In some cases, only those who are standing for reelection are evaluated by those directors whose terms will not be renewed or by the governance committee.

## Challenges for General Counsel

There are several new or expanding challenges facing general counsel as a result of board and committee evaluations.

### 1. Managing Relationships With the Board and Executive Officers

More rigorous evaluation processes will result in far-reaching discussions about the role and focus of the board in helping the company achieve its long-range objectives, and may be the lightning rod that brings contentious issues to the table. As boards become more independent and increase their reliance on the general counsel to provide advice and guidance about the role of the board, the general counsel will need to build relationships with board members while maintaining effective working relations with the CEO and other executive officers, who may have differing opinions about the board and its role.

The general counsel will need to be effective in building bridges between sparring factions, even while providing sound and objective legal advice. To survive, the general counsel must be viewed as a trusted, competent, and effective partner for both the board and executive officers.

### 2. Managing Relationships With Other Advisors

Directors are looking for more effective ways to gain assurances that their companies are being properly managed and demonstrating greater interest in retaining their own legal counsel and outside advisors. Some directors, we were told, will be quicker to require the use of consultants with no ties to management to perform compensation studies and assessments of business practices. Offering one extreme example, a former general counsel who is now in private practice told us that a director of one of his clients was seeking to engage outside counsel to advise him directly, even though the board had already engaged another law firm to advise the board, inde-

## Self-Assessments in Practice

### More Interaction

"Our board initiated its first self-evaluation in 1997 and repeated the process in 2000. Directors responded with substantive comments that provided a basis for very positive discussions about how to improve the board's effectiveness. As a result of the evaluation feedback, the board has fewer but longer meetings, an annual off-site retreat focused on company strategy, and more interaction with company executives through one-on-one meetings. The governance committee also evaluates individual directors who come up for reelection at the end of their terms."

**—Amy C. Corn, Vice President, Secretary, and Chief Governance Officer, Pitney Bowes**

### New Ideas

"Since 1996 we have seen a great deal of value in the evaluation process. It focuses every board member on the specific facets of their responsibility. It generates an opportunity for improvement and fosters communication about issues you might not hear about until later. And it puts new ideas on the table."

**—Bridget M. Healy, Vice President, General Counsel, and Secretary, Becton, Dickinson and Company**

### Management Input

"While we are not required by NASDAQ to conduct board or committee self-assessments, we determined this was a step our board should take consistent with our understanding of corporate governance best practices. And our board has gone one step further: as part of this process, it solicited the input of several members of management. While this is a departure from the evaluation process conducted at most companies, 'partner [employee] view' surveys are an important part of our culture."

**—Paula Boggs, General Counsel and Secretary, Starbucks Coffee Company**

### Evaluating Relationships

"We have been doing director evaluations since 2001 and are now rolling out this practice to our committees. The purpose of the evaluation process is to assess the effectiveness of the board and its committees in carrying out their duties and to evaluate their relationships with management. Historically, good governance has been a high priority for our chairman and our board, and we pride ourselves on being on the leading edge."

**—Solomon B. Watson IV, Senior Vice President and General Counsel, The New York Times Company**

pendent of the general counsel.

It is likely that more general counsel will be faced with having other independent—and sometimes adversarial—voices working directly with board members on complex issues. Managing these relationships will require great skill, patience, and a constant focus on achieving the right results in order to avoid unnecessary political entanglements.

### 3. Disclosure Related to Board Evaluations

While a lawyer's natural instinct is to maintain the confidentiality of board evaluations and resulting changes in governance, investors and government agencies want to understand what a corporation is doing to govern itself effectively. A company may see a boost in its reputation by disclosing some information about its evaluation process and results. The general counsel will need to discern how changes in public expectations for transparency increase over time and advise the board on the risks and potential benefits of disclosing details of the evaluations.

### 4. Discoverability of Evaluation Documents

At some point, it's likely that the plaintiffs' bar will try to use a board's evaluation documents to support allegations of mismanagement or fraud in investor litigation. While conceding that this may happen, most general counsel we talked with indicated that they believe the value of conducting a candid evaluation process outweighs these risks. General counsel must ensure that evaluation documents are being managed prudently in keeping with the company's records-management program—and destroyed routinely after the appropriate interval. They may want to provide some guidance to board members as to what types of comments should be saved for discussions rather than included in written questionnaires.

### Evaluation Process Creates Opportunities

Nearly all the general counsel we talked with are optimistic that the benefits of periodic and increasingly more substantive board and committee evaluations will be worth the time and effort invested in them. Boards will no doubt gain a stronger understanding of what they want to accomplish to improve their performance. General counsel will have the opportunity to work more closely with directors and serve as counselors, helping directors refine their vision of the board's role and what they need to do to implement this vision. They will also need to pay close attention to how they manage the complex relationships and expectations that will arise from the board's introspection and discussion. Misreading relationships or expectations could be a career-limiting problem. •

*Stephen E. Nowlan and Angela Carlucci are partners with Emerging Trends Consulting Group. E-mail them at snowlan@lawexec.com and acarlucci@lawexec.com. Nowlan serves as a consultant to the Chief Legal Officer of the 21st Century Advisory Group (CLO 21), which meets four times a year to study and forecast the role of the law department in the 21st century.*