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BOARD SELF-EVALUATIONS

What is a board self-evaluation?

It is an exercise whereby the board of directors (or a board committee) assesses its own performance, typically using pre-determined, tangible objectives, with the goal of enhancing its future effectiveness by identifying strengths and weaknesses in the primary areas of the board's or committee's responsibility.

Are board self-evaluations required?

The boards of directors and the audit, compensation and nominating/corporate governance committees of companies listed on the New York Stock Exchange (the "NYSE") are required to conduct self-assessments at least annually. There currently is no such requirement for NASDAQ- or American Stock Exchange-listed companies or other public companies.

Should the board of my company perform a self-evaluation if it is not required to do so?

You need to decide whether the benefits outweigh the risks.

What are the benefits?

Benefits include:

- Compels directors to identify the board's or committee's strengths and weaknesses and to assess how the board or committee has actually been functioning as compared to how it should be functioning. It may also more rapidly draw the attention of the board and/or committee to potential problem areas that can be dealt with more easily as a result of being identified sooner.
- Fosters better communication among directors.
- May help re-focus directors on long-term goals and strategies.
- May assist with the director nomination process by identifying areas where the board lacks needed expertise or could benefit from additional expertise or from someone who would bring a different perspective. May also demonstrate that existing board or committee size is too large or too small.
- May improve directors' sense of personal accountability.

Risks include:

- Information gathered during the evaluation process may be discoverable in litigation, and could contain revelations of board or committee shortcomings. This risk can be mitigated by limiting retention of written materials pursuant to a board-approved document retention policy that is consistently followed. The board can also reduce its liability risk by following

up on and taking corrective actions in response to negative evaluations. See "How Should the Evaluation be Conducted?" below. Because the evaluation process may enable the board to identify and eliminate weaknesses before they result in actions or omissions that actually do subject the directors to liability, the risk of not performing evaluations may be greater than the risk of doing them.

- Evaluation process could negatively affect board collegiality and discourage board service. However, by using strict controls to ensure confidentiality (if desired) and focusing on the board as a whole, rather than individual directors, these negative effects can be minimized.

Who should oversee the evaluation process?

The NYSE listing standards provide that the nominating/corporate governance committee is responsible for overseeing the board evaluation process. As noted above, the NYSE listing standards also require each of the audit, compensation and nominating/corporate governance committees to conduct their own self-evaluations. While companies not listed on the NYSE have greater flexibility in this regard, it seems logical that the nominating or other committee charged with corporate governance matters would oversee the process. In any event, it should be an independent body of the board.

Some companies use a third party, such as outside counsel or a consultant, to help administer the process. The outside party can assist by collecting self-assessment questionnaires and/or taking notes during director interviews and then preparing a summary of the results, to be presented to the board and/or the committee being evaluated. This role certainly could be performed by one of the independent directors (such as the chair of the nominating/corporate governance committee) or an employee of the company (such as in-house counsel or corporate secretary). Some directors may be more comfortable candidly expressing their views, however, if an outside party performs these tasks.

How should the evaluation be conducted?

There are no rules or requirements regarding the manner in which the evaluation is conducted. Two commonly utilized alternatives are self-assessment questionnaires and one-on-one interviews.

Questionnaires are typically structured in a manner that asks the director to rank on a numerical scale how well the board or committee has met a series of objectives, and allows the director to write-in explanations of his or her responses. Questionnaires can also be structured to ask much fewer, but more open-ended, questions that require a narrative response. While this approach may produce more candid responses from directors, they may not be mindful of the legal ramifications of their candor. Although we suggest that you have a document retention policy in place that provides that completed questionnaires be destroyed after the evaluation process is complete, there is always the possibility that this policy will not be followed or that someone may have kept a duplicate copy.

One-on-one interviews can be done in lieu of, or as a follow-up to, self-assessment questionnaires. Interviews may allow for exploration of issues of concern in greater

depth. If the board prefers that individual director responses be kept confidential, however, then the interview method obviously will not be utilized.

After the questionnaires have been collected and/or interviews completed, a designated person (e.g., outside counsel, in-house counsel, nominating/corporate governance committee chair) should prepare a report for the board (or committee being evaluated) summarizing the results. The report should be prepared in such a way that does not attribute input received to individual directors. The minutes of the meeting at which the results are discussed should be very generic and simply reference the fact that the board discussed its own performance. The report, if written, should not be made part of the minutes.

Regardless of whether questionnaires or interviews are utilized or whether the board instead performs its evaluation simply by discussion of its performance at one or more meetings, the most important thing of all is that the board follow-up and ensure that actions are taken to correct any weaknesses or problem areas identified in the evaluation process.

What should be the objectives against which the directors' performance is assessed?

There is no "one size fits all" here, but the following areas would be relevant to most evaluations:

- **Role of the Board.** Among other things, entails an assessment of: how well the directors appear to understand their role and responsibilities; how well the board communicates with the CEO; whether the board has adequate resources from management and whether management has adequate access to the board; whether the board is sufficiently challenging and supportive of management; whether there is a culture that promotes candid communication and rigorous decision-making; whether the board is effective in evaluating management succession plans; and how effective the board is in monitoring management's implementation of the company's strategic plan.

- **Board Organization and Composition.** Includes consideration of: whether the board is of the right size and has the proper committee structure; whether the proportion of independent directors to inside directors is optimal; whether there is an appropriate mix of skills, experience and other characteristics among the board members; and whether the process of selecting director nominees is appropriate.

- **Board Meetings.** Involves an assessment of whether there is an adequate number of board meetings each year; whether the information provided to directors in advance of meetings is provided in a timely manner, is of high quality and enables the directors to make informed decisions; whether the meeting agendas contain the appropriate items and the amount of time allotted for agenda items is sufficient; and whether the directors' attendance record is acceptable.

- **Compensation.** Considers whether the amount and nature (cash vs. equity) of director compensation is appropriate and is sufficient to attract and maintain quality director candidates.

Evaluations of the audit, compensation and nominating/corporate governance committees would consider many of the items noted above, as well as whether the committees are performing their responsibilities as outlined in their charters.

How often should board and committee evaluations be conducted?

As noted above, NYSE-listed companies must conduct these evaluations at least annually. Unless circumstances dictate otherwise, annually is probably sufficient. Of course, evaluations are meant to be a continual process, particularly regarding follow-up and corrective measures to be taken in response to any negative evaluations.

Should individual directors be evaluated, in addition to the board or committee as a whole?

This is a subject of much debate, with benefits and risks to be considered. Benefits include:

- Provides directors with more direct feedback so that they can improve their individual performance.
- Can serve as an early warning system for under-performing directors, which could inform the nominating committee's decision on whether to re-nominate a director. It can also give under-performing directors the opportunity to turn things around, thereby benefiting the board as a whole.
- Instills even stronger sense of personal accountability in directors.

The risks of individual director evaluations include:

- Could negatively affect board collegiality, as directors receiving a negative evaluation may feel they are being singled-out and may become hostile toward other directors.
- There could be a reluctance of directors to comment negatively on their peers, which would defeat the purpose of the exercise.
- Potential new directors might choose not to join the board and existing members of the board may decide to leave.
- May actually encourage counterproductive participation, as some directors, fearing perceptions of underperformance, may speak out at meetings on topics beyond their expertise or undertake tasks for which they are not fully qualified.
- If a particular director receives a significantly negative evaluation or several negative evaluations on which the same issues reappear, the board could subject itself to legal liability if it fails to take action.

If my company were to decide that individual directors should be evaluated, how should this be done?

As with the evaluations of the board as a whole, there are no requirements here. Possible methods include:

- An individual director (probably the Chairman or lead independent director, if the Chairman is not independent) evaluates each director and then holds one-on-one meetings to provide suggestions for improvements.

- Directors complete self-assessment questionnaires. This may mitigate some of the risks of individual director evaluations identified above. Even if directors are not entirely forthcoming in completing the questionnaires, they may recognize in their own minds what their shortcomings are, which could lead them to confront weaknesses and improve their future performance.

- Peer evaluations. Directors would probably be least accepting of this approach, for many of the reasons described above as risks of individual director evaluations.

What, if anything, should be communicated to the public regarding the board evaluation process?

If public disclosure is to be made at all, it should be limited to the fact that evaluations are performed, without discussion of the results. This can be communicated in the proxy statement or, if the company has adopted corporate governance guidelines (only NYSE-listed companies are required to have these), in the guidelines themselves.

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For over 30 years, Silver, Freedman & Taff, L.L.P. has represented financial institutions and other companies nationwide in connection with initial public offerings and other capital raising transactions, mergers and acquisitions, regulatory and enforcement issues, tax and compensation matters, and corporate governance matters. With attorneys who previously served with the federal banking and thrift regulators as well as the Securities and Exchange Commission, Silver, Freedman & Taff, L.L.P. provides a full array of legal services to financial institutions and other companies.

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