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Structural Options for Board Self-Evaluations

By Laurence J. Stybel and Maryanne Peabody

Like it or not, there is a trend towards board of director self-evaluation. It is required for listed companies on the New York Stock Exchange. ISS and Morningstar use board self-evaluation as one of the components for their board rating systems. The National Association of Independent Schools requires boards of private schools to engage in board self-evaluation. The SEC will require annual board self-evaluation for mutual funds. The government of Finland now requires it for public companies.

Benefits of Board Self-Evaluation

Benefits revolve around (1) enhancing the public perception of the board, (2) defining the board culture, (3) laying the foundation for more favorable directors and officers (D&O) liability insurance premiums, and (4) enhancing board effectiveness.

Enhancing the public perception of the board. No board compensation package can make up for the destruction of reputation when the newspaper headline names you next to the title, “Board Members Asleep at the Switch.” That was the situation faced by the board members of the Amelia Peabody Foundation on December 21, 2003, when the *Boston Globe* highlighted a cozy and lucrative relationship between Peabody Foundation board members and its external law firm. The world of foundation governance is often perceived as low hanging fruit for aggressive state attorneys general. Some public companies and many large nonprofits also have foundations as separate legal entities.

Having a structured program for board self-evaluation in place is one component to assure key constituency groups that the board takes its responsibilities seriously.

Defining the board culture. A structured program for board self-evaluation is one component of a system to attract and retain competent people to serve on boards. Competent professionals are not going to be frightened by a board culture that says, “We have a responsibility to evaluate the effectiveness of the CEO. And we also have a responsibility to evaluate our own effectiveness in the mission of this organization. We are a good company and this is a good board. That does not imply that we are satisfied with ourselves. Continuous process improvement is something we expect of our management and of ourselves.”

The reverse is also true. Merely introducing this system as an ongoing tool can sometimes cause the weakest performing board members to leave, unless they are committed to improving their performance as board members.

Foundation for more favorable D&O premiums. We have spoken with AIG, the largest D&O insurance carrier. We were told that in the future, a systematic, ongoing program of board self-evaluation can be a favorable factor underwriters will take into account when establishing D&O premiums for companies. But this area is a new frontier for insurance companies.

Phase One will be underwriters simply asking, “Do you engage in board of directors self-evaluation?” Phase Two will be underwriters asking boards, “What method do you use in your board of directors self-evaluation program?”

Enhancing board effectiveness. Slightly more than half of public companies engage in a regular, systematic form of board of director self-assessment. At the same time, a UCLA survey of board members indicates that the three top factors associated with board effectiveness are: (1) presence of strong external directors, (2) an effective audit committee, and (3) board self-evaluation.

Director Summary: Board self-evaluation is required by some regulators and is a good idea for all boards. Use an instrument with face validity, and decide beforehand on your procedure: whether your evaluation is formal or informal, whether or not to retain notes, and how you will use the data gathered.

Frameworks for Board of Director Self-Evaluation

Each board of directors self-evaluation program needs to be designed with the goals of the board in mind.

Board self-evaluation structure. Most respondents create their own proprietary evaluation forms. These forms are usually cut-and-paste products based on what is available for no cost. The advantage of a homegrown instrument is that it is inexpensive and tailored to the needs of the organization.

But these advantages come with costs. In the event of a lawsuit or a negative newspaper article, could it be said that the board designed the questionnaire to avoid dealing with the most critical elements? If there are powerful people on the board, might the questionnaire be created to avoid antagonizing those powerful people? This can be a real problem when the designer of the instrument is a corporate employee or the chairman.

Instruments with high face validity. Another option is the use of nationally accepted instruments with high face validity. We will discuss two instruments: The Balanced Score Card and the National Association of Corporate Directors (NACD) standards for board of director self-evaluation.

The makers of the Balanced Score Card have a protocol for board self-evaluation that ties the board to the larger Balanced Score Card framework. As a conceptual model it is elegant in that it creates a single theme from top to bottom within the company. But it is cumbersome to administer. It also assumes that management and governance are alike. Similarly, it might be possible to create a performance evaluation tool that could easily be used by the executive, legislative, and judiciary branches of the federal government. It would be an intellectually elegant exercise. But aren't these branches of government designed to be distinct and to have checks and balances on each other?

A second standard is the NACD questionnaire based on the NACD Blue Ribbon Commission on board self-evaluation. NACD standards are accepted within the for-profit world but can easily apply to the nonprofit world. NACD standards cover just about every evaluation contingency, regardless of industry. The use of NACD standards provides a commonly accepted gold standard and thus is a better risk management tool.

A third option is to take a standard instrument like NACD or Balanced Score Card and keep the general framework, while also customizing it. This gives boards the best of both worlds. Regardless of which method is used, it is important to keep in mind that this exercise is about commitment to continuous process improvement. Board buy-in to the questions and to the instrument itself is critical.

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Instrument administration. Once the questions are approved, the instrument can be taken on the web and scored. Or it can be done by paper and pencil and scored. Someone called an *interventionist* then works with the board on understanding the implications of the data. The interventionist can be an outside consultant, a board member, or even a member of the president's staff. The interventionist can arrange telephone or face-to-face meetings with board members, and ask questions based on the instrument.

Having clear rules for data retention/destruction is critical. Board members are going to be reluctant to be honest if their honesty may be used against them or the board in a class-action shareholder lawsuit.

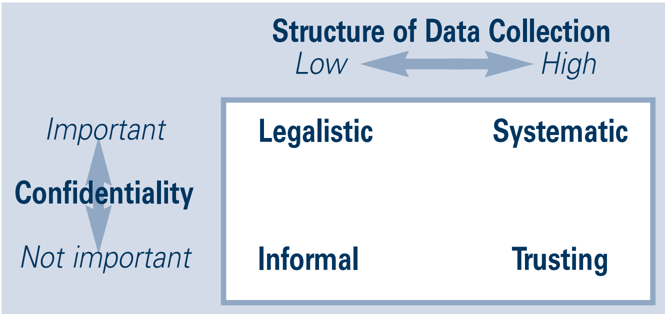
Interventionists who are board members or in-house employees may be required to keep data consistent with whatever the corporate policy is for data retention. External interventionists, however, create their own consistent policies for data destruction.

Approaches to Director Self-Evaluation

Based on preliminary interviews with boards that have engaged in board self-evaluation for three or more years, we suggest that boards consider two variables when selecting a protocol for board of director self-evaluation: structure of data collection methodology (high structure vs. low structure) and confidentiality of data (important vs. not important).

This leads to four procedural approaches to board of director self-evaluation: legalistic, informal, trusting, and systematic. Boards need to be thoughtful and deliberative about how they structure their self-evaluation programs. There are critical D&O underwriting, board rating, and legal implications for each stance that is taken. (See figure on next page.)

Informal. Data gathering is often confined to the chairman saying to the board, "This is the time when we



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evaluate our own functioning. We are not going to write anything down and there will be no minutes kept of this discussion. The minutes will only note that we have had this conversation. Is there anything anyone wishes to discuss?"

This structure ensures that boards can check off that there is compliance with the requirements for a time set aside for board self-evaluation. Confidentiality is not an important issue since nothing will show up in the records and members are encouraged not to write anything down.

This structure is also likely to yield the least valid information for increasing board effectiveness, since the moderator of the discussion may also be part of the problem.

The attitude of the board might best be summarized as, "Let's get this over with!"

Legalistic. This structure is marked by minimal procedure for data collection and tight controls over data collection and destruction. Instruments used might often be limited to homegrown systems or systems adapted from free samples given out by law firms or CPA firms. If the attitude of informal structure is "Let's get this over with," the attitude of the legalistic structure is "Let's do what we have to with a view of minimizing cost, time, and hurt feelings."

Trusting. This structure is marked by an effective procedure for data collection using or adapting well-known instruments with high external validity. The program is viewed as a multi-year effort using the same instrument on a consistent basis so that progress can be objectively monitored over time. At the same time, there is little concern expressed by board members for data confidentiality. For example, data collection may be done on an in-house basis. Data will be secured consistent with the company's policies for data retention. Depending on your point of view, this perspective is an expression of supreme confidence that we are doing the right things or a naïve understanding of the role of litigation in U.S. society. The attitude is, "Doing the right things in the right way."

Systematic. This structure is marked by an effective procedure for data collection using well-known instruments with high external validity. At the same time, there is concern for data confidentiality.

- Data collection, retention, and destruction: Data collection is often done by an external consulting firm with its own policies for data destruction that may differ from the client corporate policy on data destruction (for example, data may be kept for a shorter period). Board members are not allowed to retain their notes and only a general statement is entered into the minutes. All procedures for data collection and data destruction are transparent. Document-discard programs are not necessarily illegal. But prosecutors and regulators review inconsistent data destruction behavior with suspicion.
- Use of well-known instruments: Instead of homegrown instruments, the board uses well-known instruments. This helps constituency groups and D&O underwriters feel confident that critical issues are not being "swept under the carpet" by not being included in the survey. A homegrown instrument administered consistently over time allows for longitudinal comparisons of how the board is functioning over time. A recognized instrument administered consistently over time allows for the *potential* of longitudinal comparisons of how the board is functioning over time, and has the added advantage of allowing comparisons between the client company board and other boards within the same industry who use the same instrument.

Conclusion

In our survey, board members who have spent five-plus hours on a compliance-oriented board of directors self-evaluation usually end up angry and frustrated by the whole process. Continuous process improvement is an alternative and more effective theme for board of directors self-evaluation. That theme constantly stresses that, "We are a great company with a great board." A commitment to a structured system of board self-evaluation is part of the board's ongoing continuous process improvement.

"We are good. And we can always be better. We will constantly strive to do so." Board self-evaluation is an ongoing, positive, and well-thought-through process. It is an organization development intervention with the organization being the board and the beneficiary being the corporation. ■

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