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Corporate Board Composition and Evaluation Under Heightened Investor Scrutiny: Legal Considerations

Best Practices Regarding Diversity, Quality, Director Tenure and More

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Corporate Board Composition and Evaluation under Heightened Investor Scrutiny: Legal Considerations

Impact of Current Trends and Building an Effective Board

October 27, 2015

Mark Mihanovic

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- Privately-held companies
 - Regulatory demands not primary driver
 - Evolving needs of growing companies
 - Board provides guidance to, and mentorship of, CEO and other members of management
 - More limited budgets enhance importance (in terms of both utility and efficiency) of relevant skills being provided by individual Board members
 - Strong Board important for credibility of company with venture capital investors, lenders and other financing sources

- Privately-held companies (continued)
 - Special situations
 - Family business
 - 50-50 stockholder ownership
 - Close corporations
 - Frequent issues
 - Stockholder voting agreements
 - Cumulative voting
 - Redemptions
- Publicly-traded companies

- Board responsibilities to company and its stockholders
 - Direct management of business and affairs of company
 - Delegate authority to management or to Committees of Board
 - Selection of chief executive officer and appointment of other executive officers

Basic Board Responsibilities and Director Fiduciary Duties

- Board responsibilities to company and its stockholders (continued)
 - Oversight of strategic growth through financing transactions, acquisitions and other significant transactions
 - Approve sale of company
 - Special Committee of Directors
 - Advise and counsel CEO and executive management team
 - Monitor performance of CEO and executive management team

- Basic fiduciary duties to company and its stockholders
 - Duty of loyalty
 - Duty to act without self-interest
 - Duty of care
 - Duty to act in informed and considered manner

- Business judgment rule provides basic standard of review for duty of care
 - Presumption that directors are acting in good faith and that Board action taken is in the best interests of the company and its stockholders
 - Court will not substitute its own business judgment for that of Board of Directors if there is rational business purpose
 - No liability for action taken in good faith and with appropriate care
 - Presumption is rebuttable if third party can establish that the Board did not act in informed, careful manner (or breached duty of loyalty)

- Enhanced scrutiny standard of review
 - Select situations in which courts will take closer look at Board's actions irrespective of compliance with fiduciary duties
 - Employment of defensive techniques to block take-over proposal by outside party
 - Change-in-control transactions

- Entire fairness standard of review, if business judgment rule presumption is rebutted
 - Burden of proof on Board to show transaction is entirely fair to company
 - Entire fairness encompasses procedural fairness/“fair dealing” (as well as substantive fairness/“fair price”)
 - Strictest standard of review of Board actions, granting no deference to Board’s judgement

■ Interested transactions

- Business judgment rule does not apply where the transaction in question involves the self-interest of individual directors
- Delaware law provides that contracts between the corporation and an interested director shall not be void or voidable, provided:
 - All material facts are known to the entire Board and the transaction is approved by a majority of the disinterested directors or
 - The transaction is fair to the corporation at the time it is approved by the directors

- Heightened scrutiny
 - Stockholders
 - Regulators
- Activist stockholders
 - Proxy contests
 - “No vote” campaigns against directors
 - Short sellers
- Institutional Shareholder Services and other proxy advisory firms
 - Governance ratings
- Increased attention to “over-boarding”
- Desire for greater financial and other transparency

- Direct communications by Board with stockholders
 - Close coordination with investor relations officer
 - Regulation FD
- Information technology
 - IT strategy
 - Social media
 - Cybersecurity and risk mitigation
- Evolution of financial reporting and related internal controls
- Diversity issues
 - Gender
 - Racial

- Executive compensation
 - CEO pay
 - Compensation consultants
 - “Say-on-pay” advisory voting
- Separation of Chairman and CEO roles
- Staggered Boards
- Proxy access
 - Easier for stockholders to nominate their own candidates to Board
- Increased importance of crisis management
- Globalization of economy and business and growth of multinational corporate relationships
- Increasing lawsuits over Director stock awards

Trends Impacting Board Composition and Effectiveness

- Focus on CEO and Board succession planning
- Societal attention to climate change, diminishing resources, human rights

- Selection of Board members
 - Personal qualities
 - Character/integrity
 - Communications skills
 - Intellectual firepower
 - Biography/accomplishments
 - Expertise and experience
 - Industry/company knowledge
 - Financial
 - Operations
 - Information technology
 - Risk management
 - International
 - Availability/time commitment

- Selection of Board members (continued)
 - Intensive due diligence
 - Executive search firm or other third-party service provider
 - Board Committees
 - Leadership
 - Board Chair/“Lead independent director”
 - Board Committee Chairs
 - Diversity
 - Gender
 - Racial
 - Board dynamics

- Selection of Board members (continued)
 - Legal/stock exchange requirements for public companies
 - Listed companies (other than controlled companies) are required to have majority of independent directors
 - Listed company's Audit Committee and (other than for controlled companies) Compensation Committee and Nominating Committee are required to consist entirely of independent directors
 - Audit Committee qualifications and strict definition of "independence"
 - Post-IPO transition period
 - Weighting of selection factors

- Board executive committees/other committees
- Board size
 - Number from five to 12 for most newly-public companies
- Board and CEO succession
 - Moving long-standing directors off the Board
 - Finding new directors
 - Company internal CEO pipeline
- Bylaw term limits for directors

- Board processes and Board member job descriptions
 - Understanding by all Board members of Corporate Governance Guidelines (including clear processes and position descriptions for Board Chairman and other Board members), Code of Conduct and Committee Charters (including clear processes and position descriptions for Committee Chairs and members)
 - Pre-Meeting management information-sharing with Board
 - Board Meeting Minutes

- Board member training and education
 - Third-party training sessions for Board and Audit Committee members
 - Attorneys
 - Auditors
 - Other service providers
- Board Off-Site Retreats
 - Discussion of long-term strategic objectives
 - Improve dynamics and strengthen relationships among Board members and among Board members with management

- Conflict of Interest policies and procedures
- Proxy Statement disclosure
- Director compensation
 - Equity Incentive Plan limits on total director compensation (including cash)
- D&O insurance and other director indemnification protections
- Board evaluations

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CORPORATE BOARD COMPOSITION AND EVALUATION UNDER HEIGHTENED INVESTOR SCRUTINY

BOARD, COMMITTEE AND DIRECTOR EVALUATION

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DISCUSSION TOPICS

- CORPORATE GOVERNANCE ASSESSMENTS
- BOARD, COMMITTEE AND DIRECTOR EVALUATIONS – GENERAL PRINCIPLES
- SAMPLE EVALUATION QUESTIONS
- BEST PRACTICES IN THE EVALUATION PROCESS
- INSIGHTS ON RESISTENCE TO EVALUATION PROCESS
- PAPER OR ELECTRONIC PROCESS
- USE OF THIRD PARTY BOARD EVALUATION SERVICES
- BOARD RETREATS

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CORPORATE GOVERNANCE ASSESSMENTS

- A growing trend is for corporations to commission corporate governance assessments to benchmark their historical corporate governance practices against current best practices
- A corporate governance assessment will typically include reviews of:
 - Foundational documents to determine which governance practices are mandated by those documents and to identify potential deficiencies that should be addressed
 - Governance process and procedure documents and historical records

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CORPORATE GOVERNANCE ASSESSMENTS

- Use of third party corporate governance service vendors
- Director and officer training programs
- Director and officer indemnification practices and procedures
- Subsidiary and joint venture governance management practices
- Delegation of authority processes
- Board and Committee resolution approval processes
- Current corporate governance principles, practices, procedures and objectives

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CORPORATE GOVERNANCE ASSESSMENTS

- Board of Directors and Committee structure and composition
- Board practices and procedures relative to potential director conflicts of interest
- Legal entity structure
- Operation of Board Committees
- Working relationship between Office of the Corporate Secretary, executive management and Board of Directors

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CORPORATE GOVERNANCE ASSESSMENTS

KEY QUESTIONS

- Do the Board's governance documents provide the best structure and processes to facilitate desired results?
- Do the Board's meeting agenda allocate sufficient time for discussions of strategy?
- Are Board and Committee roles and responsibilities understood by the entire Board?
- Do the criteria for Board member selection and Committee membership facilitate an effective Board of Directors?

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CORPORATE GOVERNANCE ASSESSMENTS

KEY QUESTIONS

- Are Board and Committee roles in identifying and managing cyber-security and other risk defined and understood?
- Is management of material risks assigned to appropriate members of the executive management team?
- Are Board, Committee and Director evaluation results being employed to improve Board performance?

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BOARD, COMMITTEE AND DIRECTOR ASSESSMENTS

- Corporate Boards are increasing their focus on Board and individual Director evaluations
 - Assessments allow each director to weigh in on what is working best, what may require strengthening, what challenges may be ahead and which issues they feel are important but may not yet have been addressed
 - Assessments are done either via questionnaires or interviews

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BOARD, COMMITTEE AND DIRECTOR ASSESSMENTS

- Based on assessment results, existing Board skill sets and competencies and succession priorities are evaluated and plans to improve Board and individual Director effectiveness and Board cohesiveness are developed
- There are several corporate governance service providers who can assist with Board and Director assessments, including a number of on-line director questionnaire vendors

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BOARD, COMMITTEE AND DIRECTOR ASSESSMENTS

DESIRED OBJECTIVES

- Strengthen performance of the Board, Committee or Director
- Facilitate the removal of a Director if performance improvement is not achieved within a reasonable period of time
 - Lack of independence
 - Lack of desired competencies
 - Failure to exhibit appropriate/desired director attributes or behaviors

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BOARD, COMMITTEE AND DIRECTOR ASSESSMENTS

GENERAL PRINCIPLES

- Regular, third party-administered assessments of Board performance are considered a critical best good governance practice
- For public companies, institutional shareholders seek the disclosure of the evaluation process, the evaluation results and how the Board will address those results
- Annual Board, Committee and Director evaluation demonstrates the Board's commitment to accountability and improvement

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BOARD, COMMITTEE AND DIRECTOR ASSESSMENTS

GENERAL PRINCIPLES

- Chief Governance Officers who directly or indirectly administers evaluations should have clear direction regarding the goals and objectives of the evaluation
- These goals and objectives will vary by the level of organizational maturity of different Boards

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GENERAL PRINCIPLES

- Early Stage Boards – Focus on core governance issues
- Private Company Boards – Focus on Board dynamics related to emergence from family owned/controlled status to widely held private company status
- Pre-IPO Boards – Focus on enhancing corporate governance structure and transitional issues (e.g. compliance with securities laws)

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GENERAL PRINCIPLES

- Mature Boards – Focus on performance of critical Board duties (succession planning, financial monitoring, risk management)
- Large, Publicly-traded Company Boards – Focus on risk management, strategy development and leadership transition
- Non-Profit Organization Boards – Focus on implementation of corporate Board best governance practices

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GENERAL PRINCIPLES

- Prior to designing the evaluation questions, the Board should specify its goals for the evaluation
- Assessment of Director skills and competencies
 - Business and Financial acumen
 - Industry knowledge
 - Fundamental legal knowledge and understanding
- Self and Peer Evaluations of Directors – similar to “360” evaluation process

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SAMPLE EVALUATION QUESTIONS

- The organization has an effective system to manage its material risks
 - Enterprise- wide
 - Robust and Dynamic
 - Integrated into operations
 - Aligned with risk appetite
 - Culturally embedded

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SAMPLE EVALUATION QUESTIONS

- The Board appoints its Board Chair based on appropriate criteria
 - The responsibilities of the position
 - The independence, character, ability, experience and expected performance of the candidate
 - The ability to devote the time required
 - Includes input from other Directors

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SAMPLE EVALUATION QUESTIONS

- The Board has appropriate documentation and position descriptions for each individual Board role and key performance criteria for the Chair of the Board, the Chair of each Board Committee and individual Directors
 - Complete, accurate, detailed and clear
 - Reviewed annually
 - Benchmarked against regulatory requirements and best practices

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SAMPLE EVALUATION QUESTIONS

- Evaluate individual Director attributes
 - Integrity, organizational loyalty and independent judgment
 - Monitoring and oversight orientation (ability to challenge and take action)
 - Interpersonal and social style (communication, teamwork and influencing skills)
 - Analytical and thinking skills (ability to evaluate situations and make decisions)
 - Strategic and advisory orientation

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SAMPLE EVALUATION QUESTIONS

- Evaluate individual Director Core Competencies
 - Leadership, Corporate Governance and Ethics (Code of Conduct)
 - Financial and Economics Literacy (Audit Committee)
 - Legal and Regulatory Compliance
 - Strategic Planning and Risk Management
 - Information Technology
 - Entrepreneurship and Marketing

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SAMPLE EVALUATION QUESTIONS

- Evaluate individual Directors regarding the following:
 - Engagement -- Board and Committee participation
 - What percentage of Board and Committee Meetings did the Director attend during the evaluation period?
 - Did the Director actively participate in Board and Committee discussions during the evaluation period?
 - Did the Director actively share insights and provide advice during Board and Committee discussions during the evaluation period?

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SAMPLE EVALUATION QUESTIONS

- Overall Director Experience
 - Does the Director think the Board and its actions are effective?
 - How does the Director rate the quality of Board meetings?
 - Does the Director find efforts to facilitate Board member orientation and development to be beneficial?

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SAMPLE EVALUATION QUESTIONS

- Committee Chairs should be evaluated based on whether he or she has taken reasonable steps to:
 - Provide that responsibilities and duties of the Committee as specified in the Committee Charter are well understood and carried out as effectively as possible
 - Provide that relationships between the Committee and reporting Company management are conducted in a professional and constructive manner

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SAMPLE EVALUATION QUESTIONS

- Committee Chairs should be evaluated based on whether he or she has taken reasonable steps to:
 - Provide for the effective separation of Committee oversight and Company management responsibilities and hold Company management, advisors and other Committee members accountable to high standards of contribution toward stewarding the Corporation
 - Encourage Committee members to ask questions and express viewpoints during meetings

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BEST PRACTICES IN THE EVALUATION PROCESS

- A Board evaluation tool should be tailored to address specific objectives of the Company's Board – terms should be defined and questions should be clear and precise
- The evaluation should be independent and anonymous to eliminate Board and executive management biases – independent Board evaluation services are available
- The Board Chair (or Lead Director), each Committee Chair and each Director should be evaluated by the Board, each Committee and all the Directors, respectively

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BEST PRACTICES IN THE EVALUATION PROCESS

- The competencies and attributes of all Directors should be assessed
 - Director competencies include compensation, financial, governance, industry, information technology, risk management, strategic and sustainability knowledge
 - Director attributes include communication, engagement, integrity, leadership and teamwork skills
- Failure to assess and remediate competencies and behaviors can perpetuate complacent or problematic directors and board dysfunction

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BEST PRACTICES IN THE EVALUATION PROCESS

- A deliberate effort should be made to prevent one or more (entrenched or dysfunctional) directors who are threatened by the evaluation process from trying to block or unduly influence the evaluation
 - These directors may argue that the governance expert conducting the evaluation does not understand the Board or the Company
 - Any director who attempts to block an evaluation commissioned by the entire Board may be a candidate for resignation

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BEST PRACTICES IN THE EVALUATION PROCESS

- The Board evaluation process should be holistic in nature
- Evaluations should include assessments of the entire Board, each Committee and their Committee Chairs and each Director
 - Directors should peer-evaluate one another
 - Non-Committee members should evaluate Committees on which they do not serve
 - Committees should assess themselves as well as the units in the Company for which they provide oversight
- A holistic evaluation yields more comprehensive results

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BEST PRACTICES IN THE EVALUATION PROCESS

- A thoughtful and appropriately resourced evaluation process (survey and interview design), including the use of technology, will result in a significant evaluation report that will identify governance issues to be addressed by the Board
- The result of a robust evaluation process should provide meaningful recommendations to improve Board effectiveness

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BEST PRACTICES IN THE EVALUATION PROCESS

- The results of a Board evaluation must be taken seriously and related recommendation should result in Board action
 - The Board, Committee Chairs and each Director should prioritize and own their respective evaluation results, report collectively and transparently and hold each other accountable for acting on the results
 - Implementation of action steps should be assessed in the next round of evaluations

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BEST PRACTICES IN THE EVALUATION PROCESS

- The results of a Board evaluation must be taken seriously and related recommendation should result in Board action
 - There should be executive sessions at the Board and Committee levels to discuss improvement actions
 - Each Director should debrief with the Chair or the Board and the Chair of the Nominating and Governance Committee regarding individual Director results and develop improvement measures
 - Evaluations that do not yield improvement should have consequences

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BEST PRACTICES IN THE EVALUATION PROCESS

- A robust and meaningful Board, Committee and Director evaluation process may avoid the need to implement Director term limits in the Company's by-laws
- The Board will need to determine whether and to what extent evaluation results should be disclosed to shareholders
- Companies regarded as well run have implemented robust Board, Committee and Director evaluation processes
- Public company shareholder groups have increasingly been encouraging Boards to regularly evaluate themselves

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INSIGHTS ON RESISTENCE TO EVALUATION PROCESS

- Some Boards still resist the Board, Committee and Director evaluation process
- Some Boards conduct their evaluations without external support by using internal resources or generally available questionnaires that address Board administration rather than more difficult Board governance issues such as risk management and succession planning
- Some Boards have the non-best practice attitude of “if it isn’t broken, why fix it?”

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INSIGHTS ON RESISTENCE TO EVALUATION PROCESS

- The counter to this attitude is that a thoughtfully composed and effectively administered Board assessment tool will surface governance issues that may not otherwise be apparent and generate recommendations designed to improve Board dynamics and effectiveness
- An anonymous process surfaces issues that might not otherwise be presented when some Board members may be discouraged from raising issues by more dominant members of the Boards on which they serve

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PAPER OR ELECTRONIC PROCESS

- Board evaluations are increasingly being conducted via digital services rather than paper questionnaires.
- Issues with paper process:
 - Risk of loss and illegibility
 - Time requirement and potential for Director frustration
 - Inconsistency between questionnaires of different companies
 - Effort and cost related distribution and collection
 - Tendency to “back-burner” completion

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PAPER OR ELECTRONIC PROCESS

- The evaluation process can be streamlined by use of a secure, internet accessible, electronic database questionnaire and provides several advantages over paper questionnaires:
 - Time efficiency and simplified reporting
 - Ease of customization for each Company and Director
 - Management of multiple year Director information
 - Automation of evaluation completion tracking
 - Significant increase in integrity/accuracy of collected data and reported results

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PAPER OR ELECTRONIC PROCESS

- Overall advantages of selecting a digital process:
 - Preserves internal resources and reduces external costs
 - Streamlines data management process
 - Increases efficiency of evaluation response management
 - Reduces administrative burden

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USE OF THIRD PARTY BOARD EVALUATION SERVICES

- There are several third party Board evaluation service providers
- It is important to assess each provider's specific capabilities
- An appropriate provider has substantial experience assessing Boards across many industries
- An third party evaluation provider should be used because:
 - Internally sourced evaluations are subject to Board and management biases and may not provide anonymity
 - Other Company service providers may be conflicted

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USE OF THIRD PARTY BOARD EVALUATION SERVICES

- Recent best practices favor the use of third party providers as a way to ensure greater robustness, honesty and anonymity
- Other advantages include:
 - Experience garnered from other evaluation engagements
 - Preservation of internal resources to attend to other corporate governance related tasks
 - Provision of anonymity and confidentiality for Directors being surveyed

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USE OF THIRD PARTY BOARD EVALUATION SERVICES

- There are three approaches to Board evaluation services:
 - Telephone or in person interviews – may be subject to variability and interviewer bias but may surface otherwise hard to uncover issues
 - On-line surveys – preserve respondent anonymity and increases data integrity
 - Combination of interviews and written surveys – results provide Boards with deeper input and ideas on special Board challenges

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USE OF THIRD PARTY BOARD EVALUATION SERVICES

- Selection Criteria:
 - What is the service provider's reputation or specialty?
 - What are the service provider's specific related competencies?
 - How will the acquired information be used?
 - Is the service provider able to customize the process?

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USE OF THIRD PARTY BOARD EVALUATION SERVICES

Selection criteria:

How will the service provider make choices on the evaluation's content and method of delivery?

Is an electronic evaluation offered by a service provider easy to access and complete?

How much support does the service provider offer to develop the evaluation and oversee its process?

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USE OF THIRD PARTY BOARD EVALUATION SERVICES

- The service provider selected should:
 - Provide a comprehensive report, including a detailed description of the process used and results obtained and a summary of findings
 - A deliverable that will enable the Board to understand the results of the evaluation and develop a related action plan for improvement
 - Produce a report with recommendations that are easy to understand and benchmarks against which future performance can be measured

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USE OF THIRD PARTY BOARD EVALUATION SERVICES

- The evaluation should include thoughtful questions regarding important governance topics such as board dynamics, priorities and performance measures
- The evaluation tool should be designed to capture open ended comments and crucial thoughts and ideas on board performance that result in a robust improvement plan for the Board
- Evaluations typically consist of a combination of yes/no and scalable agree/disagree questions with an opportunity for Directors to provide more expansive written responses

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USE OF THIRD PARTY BOARD EVALUATION SERVICES

- Evaluation questionnaires (including questions about the Board as well as Committee(s) on which the Director serves) should take the respondent no more than an hour to complete
- It may take longer if there are special circumstances being addressed such as:
 - Cyber-security and other risk management issues
 - Strategy, performance and compensation issues
 - Board refreshment and shareholder engagement issues

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USE OF THIRD PARTY BOARD EVALUATION SERVICES

- The third party service provider's report should contain a narrative portion coupled with scoring data and a visual representation of the quantitative results for ease of use by the Board to develop improvement action plans
- The third party service provider can provide objective and independent observations and insights that might not otherwise be apparent to the Company's Board and executive management team, including the Chief Governance Officer

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BOARD OF DIRECTORS RETREATS

- Boards are increasingly using retreats to build cohesiveness among Directors and between the Board and executive management
 - Retreat objectives are developed and a relaxed retreat environment is used to focus discussion, reach conclusions and build productive working dynamics
 - Retreats provide opportunities for discussion, debate and reflection relative to developing long term strategies and a wide range of other issues that do not fit neatly into regular Board or Committee meeting agendas

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BOARD OF DIRECTORS RETREATS

- Board retreats can develop and strengthen healthy Board dynamics and provide an opportunity for directors to get to know one another and develop a stronger working relationship with the CEO and other senior executives of the company
- The combination of Board and Director evaluations/assessments and Board retreats can strengthen Board effectiveness and efficiency with respect to decision making in the best interests of the Company and its shareholders

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SOME CONCLUDING THOUGHTS

Strong Boards regularly evaluate their performance

Evaluation helps a Board to fine tune its effectiveness and that of its Committees and enhances the contributions of each Director

Evaluations provide a significant benefit as a result of a small investment of time and money with respect to improvements in:

- Board composition, policy, process, leadership and dynamics

- Director contribution and development

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SOME CONCLUDING THOUGHTS

- Board evaluations result in the development of tools and processes designed to improve the Board's performance
- The Board should use its evaluation results to:
 - Identify issues and behaviors to address in order to improve the Board's effectiveness
 - Develop an action plan to address and resolve the identified issues
 - Monitor progress toward the achievement of desired results

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