

*What to Ask and Know Before
Becoming a Director*



WHAT TO ASK AND KNOW BEFORE BECOMING A DIRECTOR

Introduction

In this post-Enron era of heightened corporate scrutiny, serving as a director of a public, private or non-profit company requires a vastly greater investment of time, effort and energy than ever before. The duties and responsibilities of a director have expanded, and increasingly punitive corporate governance standards focusing on individual accountability have increased the risk of personal liability. Because the stakes of serving on a board of directors are now much higher, savvy businesspeople are more closely scrutinizing their board opportunities, conducting more due diligence and asking more serious and pointed questions of the organizations whose boards they have been invited to join.

At the fifth annual Foley & Lardner LLP National Directors Institute held on March 9, 2006 in Chicago, a panel including Christie A. Hefner, chairman and chief executive officer of Playboy Enterprises, Inc.; Michelle J. Hooper, co-founder and managing partner of The Directors' Council; and Pamela A. McElvane, chief executive officer of P&L Group, Ltd., addressed the question of "What to Ask and Know Before Becoming a Director." Eric A. Newsom, Senior Counsel at Foley & Lardner LLP, moderated the discussion.

The Role of a Director

Before deciding whether and which boards to join, a potential director must understand the breadth of the director's role generally, as well as the specific role an organization will expect the individual to play on its board. In general, a director must represent stockholders diligently by understanding the company's industry, business, operations and strategic plans and by providing frank, honest, independent management oversight. Specific duties include reviewing and monitoring the progress of a company's business plan and corporate strategy; oversight and approval of a company's budget, financials and operational plans; monitoring of internal control procedures, understanding the qualifications and skills required of the executive team; the hiring and firing of a company's chief executive officer and the review and approval of material transactions.

According to Ms. Hooper, the three most important roles of a director are: (i) selecting and supervising the senior management of the company, which includes the hiring and firing of the chief executive officer, (ii) approving the company's overall strategic vision and strategic business plan and (iii) asking questions of other directors and of senior management. Although Ms. Hooper believes it is the company's senior management which is responsible for developing any particular strategy, it is a board's duty to evaluate, shape, and ultimately, approve that strategy.



Knowing the Industry

In order to effectively serve as a director, in particular to fulfill the director's duty to evaluate, shape and approve company strategy, a director must become familiar with the industry in which the company operates. This may require conducting significant due diligence in an industry about which one may have little knowledge or prior experience. The panelists expressed the necessity of reviewing not just the company's Web sites and quarterly and annual reports, but of reading industry reports, interviewing senior management and other directors, and of visiting facilities to get an understanding of the business issues faced by the company and the industry. While asking questions is one of the primary roles of a director, that director must be able to ask *educated* questions.

Ms. Hefner cautioned, however, that a successful board is one in which diverse perspectives are encouraged and in which the whole is greater than the sum of its parts. Therefore, and while industry knowledge is essential, often times a board will consist of individuals with different levels of knowledge of a specific industry or business. Given this fact, and while most successful boards have several industry experts, it is not necessary that each individual director be an industry expert. As Ms. Hefner noted, sometimes the best boardroom questions are asked by people who are least expert in the field. In this sense, it is important that each individual member of a board know his or her intended role as well as the intended role of his or her fellow directors.

While being familiar with the industry is important, Ms. Hooper also stressed that certain issues cut across industries, that capital requests are capital requests, and cash flow issues are cash flow issues. Even if a director is not intimately familiar with a certain industry, that director can still add value to a board. Further, certain general skills - such as knowing how to ask questions, developing metrics, and shaping processes - can be applied across all industries. Ms. Hefner agreed, commenting that skills developed in one industry often times apply across industries and across areas of expertise. Ms. McElvane added that industry knowledge can also help one transition from non-profit to for-profit boards.

Understanding the Time Commitment Required

In determining whether and on which boards to serve, a potential director must take into account the time commitments required by the board to which he or she is nominated. While this is obviously a personal decision, a businessperson must ensure that he or she has sufficient time and energy to devote to each board. Given the scope of a director's duties and the increased emphasis on personal accountability in today's corporate environment, knowing how many boards one can effectively serve is crucial. Obvious factors to consider include geography and travel requirements, the number of board meetings held each year, the board committees on which a potential director might be expected to serve, and the nature and



amount of preparatory materials a company generally sends its directors prior to a meeting. Of course, one's role on a particular board may impact the number of other boards on which one may feel comfortable serving. For example, Ms. Hefner, who currently serves as the chairman and chief executive officer of Playboy Enterprises, Inc., believes that, while being a chief executive of one company and serving on boards of other companies is a valuable experience, the time intensive role of a chief executive officer limits drastically the number of outside boards on which such an individual can effectively serve. To this end, Ms. Hefner also noted that, presumably due to time commitment constraints, many companies are actively limiting the ability of their chief executive officers and other senior executives to serve on outside boards, if at all. A director's relationship with a company may potentially be more beneficial to the director as well as to the company if the director limits the number of boards on which he or she serves.

Ms. Hooper noted that statistics state that serving on a board of directors requires a time commitment of anywhere from 150 to 200 hours a year. However, in most cases, an individual will be required to allocate additional time to their board responsibilities, and the following activities will add to the amount of time an individual must devote to a board: (i) becoming familiar with the specific industry in which a company operates, and with the business of the company in general, (ii) serving on committees of the board, especially serving on an audit committee in today's corporate environment, and (iii) traveling to and from board meetings. These activities make serving on a board a greater time commitment than ever before.

The Search for Board Candidates Broadens

Given the increased demand for qualified directors and the fact that many companies are limiting the ability of their senior executive officers to serve on outside boards, in recent years companies seeking qualified directors have had to look beyond this historically important group to other pools of director candidates. When asked where companies should be looking, the panelists discussed certain virtually untapped pools of highly qualified candidates, such as women and people of diverse ethnic and cultural backgrounds. Ms. Hefner noted that executives of smaller public companies and privately-held companies represent another overlooked pool of candidates that public companies are mining. In this sense, one should realize that one needn't be a senior executive at a Fortune 100 company in order to qualify for, and add value to, a corporation's board of directors.

The panelists also discussed a change in the process by which companies are nominating and selecting board members. There has been a trend in recent years towards a more formalized, professional process. Whereas candidates were historically nominated based upon recommendations by board members who had personal relationships with the potential candidates, nominating committees are now conducting more formal searches than ever before and relying less on personal



relationships. Nominating committees are also spending more time evaluating their candidates and, in some cases, even dis-inviting members of their board.

Serving on Non-Profit Boards

As the panelists discussed during the breakout session, the role of a director on a non-profit board is increasingly similar to that of a director on a for-profit board. Non-profit boards are, in Ms. Hooper's words, "transforming from boards focused on 'galas' to boards focused on governance." The panelists acknowledged that serving on non-profit boards has historically been viewed and treated as a more social activity than as a business governance activity. And, as Ms. Hefner noted, good intentions are not the same as good governance. However, in recent years, non-profit boards have begun to be more governance-based. Ms. McElvane discussed the recent impact of Sarbanes-Oxley on the non-profit circuit, and the resulting increased need to approach the director's role on a non-profit board in the same manner as an individual would approach his or her role as director on a for-profit board.

Given the fact that non-profit companies need to establish relationships with potential donors, non-profit boards have historically been composed of people willing and able to donate to the organization and, as a result, have been extremely large. As an example of a transformed non-profit board, Ms. Hooper offered her experiences. Ms. Hooper currently serves on a non-profit board that, as of four years ago, was comprised of 45 members. Today, that non-profit organization has a 13-member board, which has adopted a number of Sarbanes-Oxley rules and runs like a for-profit corporate board, but also has a separate 60-member advisory board composed of potential donors.

Because non-profit boards are becoming more like public company boards, they have become, as Ms. McElvane noted, a great place for directors to develop their skills and obtain experience in corporate governance practices and procedures, which are transferable from non-profit to for-profit organizations, and to gain access into the world of for-profit boards. However, while non-profit boards may prepare an individual for a for-profit board, the panelists noted that not all non-profit boards are created equal and, therefore, an individual must be strategic in choosing which non-profit boards to serve on.

Knowing Whether a Board is the Right Board

In determining whether to serve on a particular board, a businessperson must consider whether a specific board will be the right "fit," both from the company's perspective and from that of the potential director. Ms. Hooper noted that this is never an easy determination, as cultural fit involves so many different factors. Ultimately, the culture and dynamic of the board and the company are extremely important factors; they are, however, hard to identify without exerting a great deal of



effort. A potential director, before deciding to serve on a particular board, should meet and get to know and understand senior executives and other directors, and spend as much time as possible within the organization in order to understand how decisions are made within the organization. A potential director should also understand a board's risk appetite and determine whether that person's personality fits within that risk-taking environment. As Ms. Hooper stated, determining whether a specific board is the right board is an art rather than a science. In Ms. Hefner's view, the process of deciding whether an individual is right for a specific board is about "questions and answers and contact and impressions," and determining whether the balance is struck between what a company can give to the director and what the director can give to the company.

In the end, and regardless of whether an individual is considering a non-profit or for-profit board, the importance of conducting due diligence on an organization cannot be emphasized enough. The company and the board will surely conduct their due diligence on the board candidate and will closely scrutinize whether that individual possesses the requisite skill set and qualities to serve on their board. It is no less important for that board candidate to do whatever is necessary to determine whether this particular board is the right board for him or her.

Conclusion

In summary, in an era of increased scrutiny and liability of corporations and their directors, businesspeople must carefully consider their board opportunities before choosing the board to which they will devote substantial time and energy. A board candidate must appreciate all aspects of his or her role as a director, as well as the particular role that an organization intends that candidate to play on the board. A board candidate must understand the industry in which the company operates, and fully understand the time commitment involved. Additionally, with non-profit boards increasingly becoming more governance-focused, it should not be forgotten that such boards present great opportunities to gain knowledge and experience which may facilitate a transfer to the for-profit board world. Ultimately, a potential candidate must do his or her due diligence to determine whether a particular board, whether non-profit or for-profit, is the right board.



For More Information

For more information on the session entitled, “What to Ask and Know Before Becoming a Director,” feel free to contact the session speakers:

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