TEN KEY QUESTIONS TO ASK BEFORE JOINING A BOARD

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Congratulations. You have been invited to serve on a company's board of directors. The invitation no doubt acknowledges the value of your skills and experience, and you are excited about the idea of helping the company find success.

There are some important issues to consider, however, before taking up the offer. Simply put, serving on a board of directors has never been more risky. Your reputation and even your personal assets could ultimately be at stake if you find yourself on the board of the 'wrong' company.

BEWARE THE LIABILITY 'TRIP WIRES'

The risks are numerous and varied. Companies, whether public or private, face an ever-expanding regulatory and litigation landscape where there are more liability 'trip wires' for even the best-run organisations. Regulators have stepped up their level of scrutiny, and investigations that once were considered routine are now costing significantly more to defend and taking longer to resolve. In this era of the 'Occupy Wall Street' movement, public opinion has also turned, with less benefit of the doubt being given to corporations and their leaders in front of a jury. Meanwhile, market volatility, with its attendant risks, may be the new normal.

Many believe that businesses today must be more agile and competitive, and allow less margin for error. At the same time, many businesses face increasing pressure to globalise, exposing them to foreign laws and regulations with unclear but potentially large risks, including personal liability for directors.

Given this environment, it is critical to do thorough diligence on a company and its board and to address any 'red flags' before you make the decision to join. To assist you with this process, we have listed 10 key questions to ask. These questions are divided into four main areas: the stability and future course of the company; the stability and cohesiveness of the board; the company's compliance and oversight process; and the protection from the risk of personal liability afforded to you as a director. Some of these questions focus more on the obligations of public companies and their boards, such as assessing compliance with the Sarbanes-Oxley Act 2002. Many, however, are equally applicable to publicly traded and privately held companies. In either case, they are intended to help determine whether the opportunity is right for you.

Of course, there is no 'one size fits all' set of questions to ask. Ultimately, different companies face different risks and may employ differing (but hopefully effective) corporate governance mechanisms. The key point is to ensure that you have asked questions and received meaningful answers, so that you can make an informed decision about whether or not to join the board.

ASSESSING THE COMPANY'S STABILITY AND FUTURE COURSE

1) Is the company financially troubled?

Troubled companies pose numerous legal, accounting and financial challenges. Some directors operate as so-called 'turnaround' experts, focused on helping to carry out corporate rescues or assisting in strategic transactions or bankruptcy filings. If this is not your area of expertise, however, consider carefully whether this is the right job for you. First and foremost, you have to recognise that managing the turnaround of a company is ultimately the fiduciary responsibility of the board — which would include you.

As a practical matter, troubled companies require significant involvement from their boards. For example, directors may be called upon to meet with affected stakeholders, including employees, lenders and other creditors — not something that is often expected of directors of healthy companies. In addition to the time commitment of this expanded role, directors face potentially heightened risk. Under the laws of some states in the US, for example, directors of a company that is insolvent, or in the 'zone of insolvency', may owe duties to this larger group of stakeholders, in addition to the company's shareholders. Failing to perform these duties effectively and conscientiously may leave directors more vulnerable to claims against them personally.

Compounding the problem, a company in a weak financial position may ultimately not have the financial resources to defend and protect directors (in other words, to pay defence costs and indemnify them) in the event that the directors are sued.

Given these potential pitfalls, you should carefully consider whether the risks of serving on the board of a troubled company are outweighed by the benefits of board service.

2) Do I understand how the company operates?

You should gather a lot of information about a company before deciding whether to join its board. If the company is public, a good starting point is its publicly filed documents. These include quarterly and annual reports, proxy statements and press releases. If the company is followed by analysts, you should also read their reports. If the company is private, ask for and review its financial statements. This material will inform you about the company's financial performance over time and allow you to formulate better questions for the management. For example, have there been any significant fluctuations in the company's stock price? If so, what caused those fluctuations? Determining whether a drop in stock price has been caused by an internal business factor, such as the loss of a key customer, will give you an insight into the strength of the company's business strategy. On the other hand, if that share drop was caused by a failure in internal controls or financial oversight, that fact will provide a useful insight into the company's compliance culture, or lack of it.

You also should consider the role of the company's auditor. Has there been any change in the auditor in the last few years? If so, what were the circumstances? If you have any concerns, ask for permission to speak with the auditor. In addition to its knowledge of the company's financial health, it should have a view on the strength of the internal reporting controls.

Another area to investigate is the external factors affecting the company. How is it performing compared with its competitors? Is the industry in which it operates poised for growth, or does it face significant challenges that cast a cloud over future prospects?
And consider the profile of the company's shareholder base. Who are they? Is a large portion of equity held by family interests, venture capital or private equity funds, or large institutional investors? The make-up of the shareholders can have a big impact on how the board operates. In private companies,

for example, significant investors often have designated directors on the board to protect their investments. In public companies, large institutional investors may be outspoken about the board's role or actions. You may be able to find out more on this subject through Institutional Shareholder Services (ISS) or similar organisations.

Regardless of whether the company is public or private, it is important to understand the influence of the shareholder constituencies on the company's future course. Is there one particular investor or group of investors that is attempting to control the company? Are there minority shareholders that oppose those efforts? Understanding those dynamics will give you an insight into whether the board can manage the company effectively, or whether it runs the risk of becoming deadlocked among warring factions.

3) Has the board or the company attracted litigation, investigations or other claims?

An important area to consider is the history of claims against the company or its directors, officers and employees. Is there any litigation against, or regulatory investigations involving, the company and/or its personnel? If so, you will want to know the nature of those matters and the effect on the company's bottom line and public image. Have individual directors ever been sued as a result of their board service? If so, has the company fully indemnified those individuals? Was there insurance available to defend the claim? These questions will give you a good sense of how well prepared and motivated the company is to protect its directors in the event of claims.

Beyond past and pending litigation, however, is a broader universe of threatened or potential claims. What litigation risks are on the horizon? Are there financial or regulatory matters simmering that could lead to claims? Has the company received demand letters or other similar communications? Another way to determine the existence of future litigation is to ask whether there have been any notices given to the company's insurer for directors' and officers' (D&O) liability in the last few years. In some cases, insurance may cover matters, such as demand letters, that have not yet ripened into litigation.
Finally, ask whether there are any threatened or pending investigations by a governmental or regulatory authority concerning the company or its personnel. Investigations can be 'formal', involving document subpoenas and depositions, or they can be more 'informal', involving 'voluntary' requests for information and witness testimony. In either case, you need to understand the scope of any investigation and its potential implications for the company and the board.

4) What are the company's prospects?

Now that you have a handle on the company's current operations and litigation history, the next question is how the company will fare in the future. Forecasting growth prospects, of course, is a difficult and uncertain exercise, but there are some tangible factors that are likely to have an impact. First, consider the company's sources of revenue. Is revenue tied disproportionately to one customer or a small group of customers, or to a particular industry segment? Does the company have a strategy in the event of the loss of a key customer or weakness in its target industry?

Evaluate the company's sources of funding. Does it carry a significant amount of debt? If so, in what form? Does it need additional funding to continue or to expand its operations? If the company is a start-up, what is its 'burn rate'? What are the prospects for further funding and on what terms? If the company is facing a 'down round' financing, for example, with new investors picking up stock cheaply, directors are often under scrutiny for the decisions made that negatively affect or dilute existing shareholders.

You also will need to know whether the company's success is contingent upon any particular milestones being achieved, such as regulatory approval of a drug or device. What are the implications if approval is not granted? Are there licences or permits that the company needs to expand its business? What are the hurdles facing the company to secure such approvals? What is the likelihood of a positive outcome?

From a broader perspective, it is also important to understand the prospects for the industry at large. Is it poised for growth or facing challenges that may have a negative impact on companies in this sector in the future?

ASSESSING THE BOARD'S STABILITY AND COHESIVENESS

5) What is the 'tone at the top' of the company?

One of the most important subjects to consider before joining a board is the judgement, experience and temperament of the board and senior management. This is often described as the 'tone at the top' of an organisation. This is a 'soft' factor that may seem difficult to gauge, and getting candid answers from leaders of the company may be difficult. Consider whether speaking with directors or management on a one-on-one basis will yield helpful responses. Starting at a basic level, you will need an insight into the experience and background of the directors and senior management. Do they appear qualified for their roles? For example, in the case of audit committee members, do they have specific financial expertise, or more generalised experience?

More subjectively, what is the board's culture? Are there directors who dominate board deliberations or who discourage meaningful discussion or dissent? How does the board interact with management? Are there directors who serve as an effective counterbalance to management?

Of course, you will want to understand the management style of the chief executive officer. Does the CEO encourage an open and collaborative environment between the board and management? Is the CEO committed to listening to the board's input, and can directors interact with senior management without the presence of the chief executive? A CEO with an autocratic style, or one who considers the board to be simply a 'rubber stamp' for management, is likely to pose problems for you as a director and interfere with your ability to discharge your duties to the company and its shareholders. One way to approach this topic is to ask if any directors or senior management have recently left the company. If so, what were the circumstances of those departures? Do they reveal anything about the dynamic between the board and management?

6) Is the board provided with adequate information and resources?

The ability of directors to perform their duties is tied directly to the quality of information that the board receives from management and how that information is evaluated. One question to ask, for example, is what is contained in the 'board books' received by directors in advance of the board meetings? Do directors only get summary financial reports, or are they also given full financial details, including drafts of public filings? On the other hand, you don't want to see a board drowning in data. The availability of meaningful information — in an understandable and concise format — is essential for board members in identifying and managing risk. Management's willingness and ability to provide the right balance of information will help you understand how effectively management works with the board and supports it in its oversight role.

Does the board meet as frequently as it should? The answer to this question will, of course, depend on the size and complexity of the company. Nevertheless, because the board is charged with the overall oversight of the company, it needs to meet regularly enough to ask appropriate questions of management. You will also need to make sure that board committees, including the audit committee, are meeting often enough to carry out their functions effectively.

Another important resource to consider is the company's general counsel. It is the job of counsel to provide the sort of competent legal advice that helps directors to discharge their fiduciary obligations and protects them from legal risk. Does the general counsel perform well in this role? Does counsel regularly attend board meetings and provide insight into key issues? Or does counsel act in more of an administrative role, focused on documenting the board's actions rather than providing substantive input? You should find out whether the board is adequately supported by counsel, to ensure you will get the legal advice you need to do your job effectively.

ASSESSING COMPANY COMPLIANCE AND OVERSIGHT

7) Is the company committed to compliance?

Another important 'tone at the top' issue is compliance. Remember, the failure to implement an effective compliance and ethics programme may breach the board's duty of care, giving rise to at least the potential for personal liability against directors. Consistent with Sarbanes-Oxley and New York Stock Exchange and Nasdaq rules, the board needs to ensure that the company has a well-designed and well-implemented set of corporate governance principles. In that vein, you should explore whether the board adequately monitors the company's policies and procedures on legal compliance, ethical conduct and maintenance of adequate internal controls.

Additionally, have the company's policies been updated in light of the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (Dodd-Frank) and the new 'whistleblower' regulations of the US Securities and Exchange Commission (SEC)? For example, has the company's existing whistleblower policy been reviewed to confirm that it sufficiently emphasises the value placed by the company on employees coming forward with concerns and complaints? Have the company's policies against retaliation been reviewed in light of both Dodd-Frank's new 'private cause of action' for employee whistleblowers and the SEC's ability to enforce Dodd-Frank's anti-retaliation provisions?
Likewise, are foreign-based compliance exposures, as provided for by the Foreign Corrupt Practices Act (FCPA), taken seriously by management and the board? If so, the company should have an FCPA policy in place that clearly describes the FCPA's legal standards (including applicable local laws) and provides guidance on permitted corporate behaviour.

Applicable foreign-based compliance policies should also set out guidelines for FCPA-related areas, including political and charitable contributions, travel and entertainment, and gift giving.
The strength of the company's policies on these issues — and its willingness to re-examine them — can tell you a lot about the ongoing commitment of the board and senior management to compliance and the maintenance of internal controls, and you will need to be comfortable with this stance. Has senior management created an appropriate corporate culture that values ethics and internal compliance? Aside from the written policies and procedures, is the actual corporate culture one that punishes bad behaviour while stressing the importance of compliance?

Another emerging compliance area — and one that is increasingly significant for all types of company in terms of regulatory exposure and potential civil liability — is data privacy and cyber risk. As with other areas of compliance, the strength of internal controls, and risk assessment and monitoring is vital here. For example, what is the company's strategy for addressing the privacy of personal information within its control? Does the company have sufficient resources available to implement and maintain a privacy protection system, including the appointment of a ‘chief privacy officer’ — one who is responsible for compliance and is familiar with state, federal and any relevant foreign privacy regulations?

In the event of a cyber or privacy breach, does the company have programmes and policies in place that will allow it to manage the crisis by minimising damage, recovering lost data and restoring confidence in the affected constituencies? Likewise, you should know at least in general terms what steps the company has taken to secure its own confidential electronic data against unauthorised access or use.

ASSESSING PROTECTION AGAINST PERSONAL LIABILITY

8) What level of indemnification is available from the company?

Even the best-run companies and boards may experience claims from shareholders or other parties. While the company should attempt to minimise this litigation exposure to the extent possible, the risk cannot be eliminated. Therefore, before you decide to join a board, you must ensure that you will be adequately protected against personal exposure in the event a claim is filed against you. Two important safeguards that should be afforded to you by the company are your rights to indemnification and protection under the company’s programme for D&O liability insurance.

Corporate indemnification will be your first line of defence as a director. The company’s indemnification obligations are typically found in its charter or by-laws. Pursuant to state law, companies are allowed to indemnify directors with respect to legal costs (including attorneys’ fees), settlements, judgments and, in some cases, fines and penalties.

Not all indemnification provisions are created equal, however. For example, some provide for mandatory advancement of defence costs during litigation; others may permit, but not require, the company to advance those costs. You will want to review (or have your own counsel review) the company’s programme to ensure it provides the fullest indemnification permitted by law.

You should also enquire whether the company provides for standalone indemnification agreements for the benefit of its directors. These may offer enhanced protection, through certain contractual protections, that will not necessarily be found in the indemnification provisions of the company’s charter or by-laws or pursuant to applicable law.

9) What directors’ and officers’ insurance coverage is available to me?

Of course, even when the indemnification obligations appear adequate on the face of it, such protection is contingent upon the company’s ability to fund those obligations. A company without sufficient assets may not be able to provide the safety net necessary to protect directors in the event of a significant claim against them. Accordingly, you should ensure that the company has sufficient D&O insurance as a backstop for its indemnification obligations.

You should consider this a business necessity. Indeed, service on the board of a company without D&O insurance would not be advisable unless that company unquestionably has sufficient assets to self-insure and will continue to maintain those assets in the future.

D&O insurance generally provides coverage for judgments, settlements and defence costs incurred in connection with the defence of a claim against a director or officer. As with indemnification provisions, all D&O insurance is not of the same quality. There is no standard form used, and the scope of coverage can vary among insurance carriers. With that in mind, you should plan on ‘kicking the tyres’ on the company’s D&O insurance programme, by, for example, having your own counsel confirm that the policy's terms and conditions offer competitive coverage and have been negotiated by an experienced D&O insurance broker (preferably with the assistance of the company's outside counsel). You should also seek to confirm that the policy limit — the amount of coverage provided by the D&O policy — is sufficient.

10) Is this board opportunity a good match for me?

Now that you've performed your due diligence on the company, you should perform some 'self-diligence' to determine whether this is the right opportunity for you at this time. Start by asking yourself whether this company needs your expertise. If so, in what ways? Specifically, how do you see yourself adding value?

Additionally, ask yourself whether you are confident that you have enough time and energy to serve as a director. It may be difficult to quantify that commitment, but you must be prepared to devote sufficient time to stay adequately informed about the company's operations and governance. For many directors, this commitment is substantial, and being a member of a board committee will be even more demanding.

Finally, you must be prepared to handle board emergencies, which come at short notice and require intense periods of full-time work and focus. Will you be up to, and available for, those challenges should they arise?

CONCLUSION

No company is without its share of risks, and the points raised in this article are not intended to discourage qualified individuals from serving on a board. Companies of all types need good directors and the role is important and often rewarding. The key is to know the risks, issues and required commitments before you join. By doing so, you will be better positioned to handle future challenges to the company, to the board and to yourself as a director.

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