

Family Business Corporate Governance Series

Building or renewing your board

September 2014

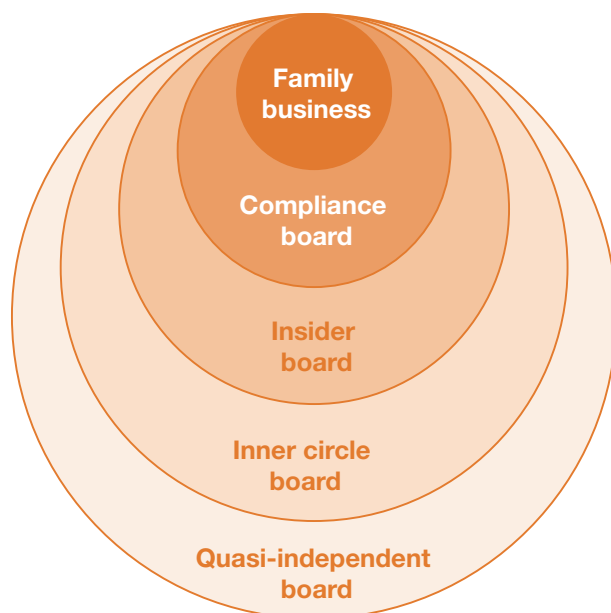


PwC's perspective on family business corporate governance

Individual- and family-owned businesses are a vital part of our economy. If you or your family owns such a company you understand how important the company's success is to your personal wealth and to that of future generations. If you're a nonfamily executive at a family company, you also recognize that its profitability and resilience are vital to your job security and financial well-being.

We see more family companies interested in corporate governance today than we did a decade ago, as shown in changes they've made to their boards. While some family companies have a board only to satisfy legal compliance requirements, more are moving toward the outer rings on the family business corporate governance model, below. Ultimately, owners will choose which level best suits the company's needs and when changing circumstances mean the company's governance should transition to another ring.

Family business corporate governance model*



* Some companies also have an advisory board to advise management (and directors). Advisory board members don't vote or have fiduciary responsibilities.

Compliance board. While most states require companies incorporated in the state to have a board, the requirement may be as simple as a board of at least one person that meets at least once per year. A company may have only the founder on its board. In the early stages of a founder-led company, this type of board may well be the best fit for the company, since the founder is usually more focused on building the business than on governance.

Insider board. Such a board often includes family members and members of senior management. This membership can better involve the family in the business, help with succession planning, and introduce additional perspectives to board discussions. The insider board may be created by the founder—who may no longer be the CEO—or by the next generation owner(s) of the company. That said, the founder/owner(s) retains decision-making authority.

Inner circle board. In this type of board, the founder/owner adds directors he or she knows well. These may include an accountant, lawyer, or other business professional who guided or influenced the company, or the founder's close friends. These directors may bring skills or experience to the board that are otherwise missing and they may be in a position to challenge the founder/owner(s) in a positive way. Such boards might create an audit committee or other committees. That said, the founder/owner(s)—who may or may not be the CEO—retains decision-making authority.

Quasi-independent board. This level introduces outside/independent directors who have no employment or other tie to the company apart from their role as directors. These directors introduce objectivity and accountability to the board and they expect their input to be respected. Board processes and policies will likely become more formalized with outside/independent directors on the board. The number of committees may increase. This outermost ring on the family business corporate governance model is most similar to governance at a public company.

59% of CEOs and CFOs of **147** family-owned/owner-operated companies report having a “formal board of directors that acts on behalf of company owners to oversee the business and management,” per a PwC 2013 survey.

We recognize that governance at any family company will be determined almost exclusively by what the founder (or family members who control the company) wants. You may have a compliance board or an inner circle board—and those may be entirely appropriate for where your company is at present. We’ve seen numerous family companies that benefited greatly from moving toward the outer rings in the governance model—especially when anticipating a generational transition.

In this Family Business Corporate Governance Series, we’ll help you understand how evolving your governance model might help your company, and how boards can assist with some of the particularly challenging issues family companies face. This module discusses the different factors you might consider as you build or renew your board.

Each family company’s situation is unique and we can’t address every scenario. Our goal is to provide a framework of how corporate governance practices apply to family companies so you can decide what’s best for you.

Interview insight

You need to plan early for generational transitions—voting rights, estate plans, and tax issues are all intertwined with the company. And I mean early. Even 5 years before the event is way too late.

— *A family member who is an executive and director of the company*

***This module on building or
renewing your family business
board covers:***

Getting started building or renewing your board	2
Involving family on the board and in the business	8
Recruiting nonfamily directors	11
What about nonfamily owners?	14
Questions to consider	15
Appendix—Director fiduciary duties	16

Getting started building or renewing your board

When you decide it's time to rethink who is on your board, there are many factors you may want to take into account. As well as giving careful consideration to director skills and experience, you'll want to consider whether to add "outsiders" or whether there are other ways you can tap into the knowledge of outsiders.

1. Which knowledge, skills, and attributes would it be helpful to have?

The role you want your board to play will drive what knowledge and experience you'll want on your board. (See the *What is a board's role in a family business?* module in this Series for a description of typical board responsibilities.) Looking at the company's strategy and its challenges, and discussing them with the founder/owner(s), executives, current directors, and key shareholders can assist in identifying the knowledge, skills, and attributes you want in your directors. Once you have this list, you can compare it to the skills and experience on your current board to identify any gaps. Some companies use a grid to do this.

Interview insight

In building the board, it's best to start with what skills you need. Unfortunately, too many companies start with who they know.

— A PwC Private Company Services partner

Looking at the company's strategy and its challenges, and discussing them with the founder/owner(s), executives, current directors, and key shareholders can assist in identifying the knowledge, skills, and attributes you want in your directors.

Interview insight

I saw a company be very strategic in how it filled a board slot—finding in one director many of the experiences and attributes they were looking for.

— A PwC Private Company Services partner

Board composition grid

Needed skills, experience, and attributes	Director names										
	A	B	C	D	E	F	G	H	I	J	K
Financial literacy		X									
Financial expertise			X		X		X				
Industry expertise	X								X		
Operational experience		X		X	X	X	X	X	X		
Technology expertise											
Governmental/regulatory experience						X			X		
Marketing expertise			X					X			
Board experience				X					X		
Family business experience	X				X			X			
Family shareholder	X							X		X	X
Gender diversity		X								X	
Ethnic diversity				X		X					

Adapted for family businesses from the grid developed for *Board Effectiveness—What Works Best*, 2nd edition, written by PwC and published by the Institute of Internal Auditors Research Foundation.

You'll notice a couple of elements in the grid that are unique for family companies:

- An understanding of family business dynamics to help the company and the family navigate some of the typical challenges
- The presence of family members

It's important to recruit directors who will help preserve the principles, values, and ethics that play an essential role in the success of your family business. In some cases, director candidates who have a connection to the family—or even the founder—can be especially helpful. You might also wish to consider directors whose other board experience involves family companies.

A 2013 PwC survey asked CEOs and CFOs of 147 family businesses about the skills needed on their board.

If you could add a skill or area of expertise to your board, what would it be?

	Percent who identified this as the skill they would add
Industry expertise	23%
Strategy expertise	21
Financial expertise	13

As a comparison, in PwC's *2013 Annual Corporate Directors Survey*, public company directors were asked to rate the importance of adding specific skills to their boards.

How would you currently describe the importance of adding directors with the following to your board?

	Percent who rated this "Very important"
Industry expertise	48%
Financial expertise	41
Operational expertise	37
Risk management expertise	36

In addition to knowledge and skills, some shareholders and executives consider gender and ethnic diversity as important attributes in board composition. To what degree does your board resemble your customers, employees, shareholders, or other key stakeholders? Many governance observers believe having diverse board membership can provide better insight into how important constituencies think. However you choose to define diversity, it's helpful to consider whether your directors bring true diversity of thought to the table. In terms of the traditional definitions of diversity, the National Association of Corporate Directors (NACD) *2013-2014 Private Company Governance Survey* reports private company boards have, on average, 1.2 female directors and 0.6 minority directors.

2. Do we need outside/independent directors?

Public companies have certain requirements for independent directors—including that a majority of directors on their boards be independent and that only independent directors serve on audit and compensation committees.

Interview insight

Outside directors provide backbone.

— An executive at a family company

Family business boards have no such requirements. A 2013 PwC survey of family business CEOs and CFOs found that over half (58%) report having no independent directors. The same survey found just under one in five boards (17%) have a majority of outside/independent directors, while another 25% have some independent directors but not a majority.

While public companies have clear definitions of what constitutes an “independent director,” private companies are free to define what the term means for them. The box that follows suggests one way to think about independence.

Possible definition of an “outside/independent” director

A director who has no employment or other significant tie to the company or the family, apart from his or her role as a director. This means the director isn't a significant customer or vendor, isn't involved in other business ventures with a family member, and doesn't have other relationships that would interfere with his or her ability to exercise independent judgment.

What value can outside/independent directors bring? Since they can speak without fear of repercussion (other than being removed from the board), they may feel freer to raise sensitive issues. The advantages of involving nonfamily/nonmanagement directors are discussed in the *What is a board's role in a family business?* module in this Series.

While one outside/independent director can bring value, having more than one may be helpful. For one thing, it's often useful to hear more than one outside point of view on an issue the board is discussing. You may want to consider this as you reshape your board.

Outside/independent directors could be executives or directors of public companies—which have more prescriptive governance practices. If you add such directors, don't be surprised if they press for different governance practices than you're used to. That said, these practices could be valuable and help you attract other talented directors.

3. Would a board of advisors work better at our company?

Some family businesses are reluctant to put outside/independent directors on their boards because of concerns about confidentiality and trust. You may conclude that an insider or inner circle board (see descriptions on pages *i* and *ii*) works best for your company and family situation. But if you also want to bring in outside thinking, you have options:

- Invite individuals who bring specific expertise to serve as advisors to the board. These advisors might join only certain portions of board meetings when those topics are discussed. While these advisors won't have voting rights, you can still tap into their knowledge and experience. This keeps the power in the hands of the insiders or inner circle, yet supplements their experience with the perspectives of accomplished executives.

Interview insight

I originally joined the company's advisory board. But when the company was facing a crisis a few years later, I suggested to the founder that we become a "real" board. We helped shake up the company and had a new CEO in place within a year.

— An outside director at a family company

Interview insight

If we ever create an advisory board, it should include someone who has an innovation or technology bent, to help the family recognize the need to address emerging issues. I'd also value a seasoned CEO to help us understand how businesses can endure.

— An executive at a family company

Interview insight

The [company's] board of advisors doesn't take formal action, but it does pretty much everything else that a corporate board would do.

— A former executive at a family company

- Create an advisory board that is separate from the board of directors. An advisory board's role is to provide the management team with insight and views on specific subjects. It might include technology experts, former regulators, or others with significant credentials in a particular area that impacts the company. In our experience, advisory boards are more common when the company has a compliance or insider board. Creating an advisory board tends to be a comfortable first step to evolving governance.

Whether you put outsiders on your board as directors or use them as advisors, there are ways to protect yourself from a relationship that doesn't work out. You can set term limits. For example, a director or advisor may be appointed for a 1-year term. The board can then decide to renew that term depending on whether the person is adding value.

Whether you put outsiders on your board as directors or use them as advisors, there are ways to protect yourself from a relationship that doesn't work out.

Involving family on the board and in the business

Family businesses often have family members on their boards. That makes a lot of sense because family members may have grown up around the business, often worked in the business, and may have a great deal of their inherited net worth represented by the company.

Having family members on the board can be wonderful, since they tend to have a long-term and deeply personal commitment to the business. But there can be issues, especially with succeeding generations. What are they?

1. Which family members get a seat on the board?

This may be relatively easy if you're dealing with the founder's children—"Generation 2" or G2. (That said, this gets more complicated if the founder has children or stepchildren from multiple relationships.) Unless the founder has numerous children, all members of G2 may get board seats if they wish. But as G2's children mature, how do you determine which members of G3 (and subsequent generations) have the right to a board seat? Another complicating factor is that for tax planning and company control purposes, at some point company ownership may pass into one or more family trusts.

Some families address such issues in later generations by setting aside a specific number of seats for each major branch of the family. For example, if G2 has three siblings, each branch might have the right to two seats on the board. The family (or trust) would then have to determine how to select family members (from G3 or beyond) for those board seats. In some cases, every few years they may choose to rotate which family members hold board seats.

Interview insight

One company includes three generations of the family on the board at any given time. This allows an emeritus generation (to provide guidance), a generation that controls the company, and a successor generation to serve together.

— A PwC Private Company Services partner

Interview insight

Family members who are not part of the business should be educated about their investment in the company.

— An executive at a family company

2. Should you treat family members who are active in the business differently from those who don't work there?

Not all family members will have the interest or aptitude to work at the company. Especially as you get beyond G2, big differences can emerge between what various family members know about the business. That dynamic could lead to tension and a lack of trust in certain family members. Are some receiving more benefits (for example, compensation or perks) from the company than is “fair?” Issues like this could crop up in a family business at any time. Each company will manage through them in the context of its culture, but it's important to make sure the issues don't fester.

Some companies are careful to separate family investment returns (like dividends) from employment rewards (such as salaries and bonuses). They may also have guidelines for how family members can “earn” a position at the company.

3. What if some family members have a different investment horizon or desire for liquidity?

Particularly when you get beyond G2, there may be some family members who aren't interested in an ongoing stake in the company. They may want their money from the business to spend or invest in other ventures as they see fit. That's understandable, but if they push for excessive dividends or even to sell the company, the board needs to carefully balance those requests with what is best for the entire company in the long term. Some family businesses address this by having a policy that sets out how family members can “cash in” their shares.

4. What happens if a family member has no desire to serve on the board, but wants a spouse/partner to serve instead?

Some family businesses are looking at whether family members who would otherwise get a seat on the board could nominate another person in their place. If a family business board decides to allow such substitutions, it may wish to set criteria for these directors.

5. How do you connect other family members to the business?

Family members who own or work at the company may have spouses/partners or children who don't have any direct connection to the family business. Given how significant these companies can be to the families that own them, many choose to create a “family council” or “senate” separate from the board.

What's a family council or senate? Typically a collection of family members representing various branches of the family tree, formed to oversee collective family interests. The family council might serve a number of purposes:

- Acting as a buffer between the family and the governance of the business
- Overseeing all investments the family may have in its portfolio
- Discussing the company's purpose and vision
- Choosing family members to serve on the company's board
- Nurturing the culture and educating the next generation about the company
- Discussing financial needs of family members in relation to their investment in the company
- Developing newer generations of family members to lead and govern the company

Members may rotate with some number of seats on the council designated for each family branch. Many family councils hold an annual meeting so adult family members can discuss the company strategy and other important issues with company executives. These meetings also serve to strengthen family ties and may help identify areas of potential conflict and ways to resolve those conflicts.

Interview insight

The family senate governs how the family interacts with the company and elects family members to the company board.

— A PwC Private Company Services partner

Recruiting nonfamily directors

Earlier we outlined a process for identifying the skills you want to have on your board. If your current directors don't bring all those skills, the next step is to identify and recruit possible candidates.

Interview insight

There's only family on our board and they are resistant to adding outsiders. If they ever become open to this idea, they would be most receptive if a trusted advisor said: "This person would be perfect for your board."

—An executive at a family company

Where can you find director candidates?

- Individuals your current directors know
- Director search firms
- Referrals from company executives and other business associates, including key service providers (e.g., lawyers, accountants, bankers)
- Other business leaders in your community
- Trade associations
- Former officials at regulators that impact your business
- NACD Directors Registry, or similar sources

Identifying a suitable candidate for your family business board is just the beginning of the process. It's important that your process be well planned and organized.

What are the key steps in the process? You'll want to conduct a background check to see if there are any issues that would affect your decision. It's also important to understand the nature of any relationships a candidate may have with the company, the family, or management. Candidates will likely be interviewed by members of the Nominating and Governance Committee (if there is one), the board chair, and certain executives. Family representatives may want to be involved at this stage to judge the cultural fit. These meetings are not simply ways to learn about the candidate—you'll also share information on the company's history, culture, values, and strategic vision.

Another element to consider is whether the candidate has the time available for the commitment you're asking him or her to make. According to the *NACD 2013-2014 Private Company Governance Survey*, directors spend an average of 180 hours per year on board activities. This includes time preparing for, traveling to, and attending meetings. The survey also indicates that, on average, private companies have 5.3 board meetings per year and those meetings each last just over five hours. In PwC's 2013 survey of family business CEOs and CFOs, 46% said their boards meet quarterly and an additional 22% meet even more often.

It's not always easy to attract directors to a private company board. Some of the people you might want to attract simply won't have the time.

At the same time you're checking on candidates, they will be performing their own due diligence. Candidates will likely look into the reputations of both the company and its leaders—and even the family. (For example, a founder who has a domineering style may turn off certain candidates.) They'll also typically ask to meet other directors, visit business locations, review financial statements, and understand what directors and officers (D&O) liability insurance you have. Since much of this information is confidential, the company will likely want the candidate to sign a nondisclosure agreement.

Interview insight

We're developing a director recruitment process and procedures so when our current long-serving outside directors roll off the board we don't have to reinvent the wheel.

—An executive at a family company

Interview insight

I shied away from one board recently because the dynamics looked messy. Plus, the chair had a big ego.

—An outside director at a family company

Interview insight

What I value about the CEO (who now owns the entire company) is that she's a great listener. She wants perspective on how things work in other companies and she acts on what she hears. That has allowed our board to have a huge impact.

— An outside director at a family company

Another element candidates will consider is whether the board is a good fit for them. Will they find the discussions and work interesting? Will they enjoy working with the other directors who are on the board? Do they get the sense that they'll be able to have influence and their input will be respected?

Finally, you'll have to consider what compensation, if any, you'll provide to outside directors. The NACD *2013-2014 Private Company Governance Survey* notes that 81% of private companies compensate their directors.

How do private companies compensate their directors? Per the NACD survey, 89% of private companies use cash and 34% use equity (which could be stock, stock options, or phantom stock). The table below shows average cash compensation levels.

Average annual cash compensation levels for directors

Annual retainer	\$36,683
Committee chair fee	8,226
Board meeting fees	2,662
Committee meeting fees	1,350

Source: NACD *2013-2014 Private Company Governance Survey*

What about nonfamily owners?

Some family businesses have minority investors from outside the family. These investors could be from venture capital or private equity firms, or result from shares issued to employees as part of a traditional stock compensation plan.

In some cases outside investors may have the right to place a certain number of directors on the board. In particular, a private equity firm may get board seats as a condition of its investment. That said, PE firms typically have a time frame for exiting their investments, at which point their representatives would step off the board. Active PE investors typically bring intense focus on the bottom line, and may change the dynamic in the boardroom.

In any event, it's important for the directors who are on the board to understand that, by virtue of the duty of loyalty (see the Appendix), they represent all shareholders—not just family owners or certain family members or the owners of minority interests.

In some cases outside investors may have the right to place a certain number of directors on the board.

Questions to consider

1. Do we have directors with the right knowledge and skills?
2. Would adding outside directors enhance board effectiveness?
3. Do we need to implement or update a policy on how we determine which family members serve on the board?
4. Do our directors understand their fiduciary duties (see the Appendix)?

Appendix—Director fiduciary duties

By accepting a role on a board, directors assume certain legal duties to the company and its shareholders. If there are disputes about the actions a board has taken, the courts judge director conduct based on whether directors have fulfilled their fiduciary duties.

A majority of US companies incorporate in Delaware because many believe the state has a favorable legal environment for business. Delaware's court system is also recognized for quickly and competently addressing complex corporate legal issues. Under the laws of Delaware and many other states, directors have two fiduciary duties:

- **The duty of care**, which requires them to exercise diligence and make informed decisions. Directors must commit appropriate time to their deliberations, consider material information relevant to their decisions, and exercise prudent judgment. In practice, what does this look like? It involves asking probing questions of management and seeking additional information—perhaps also seeking outside expertise, if needed, for directors to reach informed decisions.
- **The duty of loyalty**, which requires them to always put the interests of the company and shareholders before their own. This means directors avoid participating in decisions that would benefit themselves at the expense of the company. Directors must disclose to the board situations in which they have a potential conflict of interest and recuse themselves from board discussions relating to that matter. As part of the duty of loyalty, directors also have a duty to act in “good faith.”

The corollary duty of good faith means that a director acts with honest intent, without taking unfair advantage of his or her position in the company. “Good faith” is a common term in the legal context.

Another legal term directors should be familiar with is the “business judgment rule.” This is an important legal concept that relates to directors' duties. It assumes, absent evidence to the contrary, that directors complied with their fiduciary duties. It is an important protection because the courts won't find directors liable for a decision made in good faith and with due care even if the decision later turns out to be a poor one.

In a few states, directors owe fiduciary duties to a broader group beyond the company and its shareholders. This could include employees, suppliers, and the communities in which the company operates. In the case of an insolvent company, directors' fiduciary duties expand to include creditors. In discharging these expanded duties, directors are expected to protect the value of the company for all stakeholders.

About the authors

Catherine Bromilow is a partner in PwC's Center for Board Governance. She works with boards of directors and audit committees of major public and private companies and institutions, providing insight on leading practices. She has worked extensively with boards and directors from a number of countries, including the Bahamas, Barbados, Bermuda, Brazil, Canada, Chile, Israel, Mexico, South Africa, the United States, and Venezuela.

For the past 16 years, Catherine has been active in researching and advising on matters relating to board-level governance. She oversees numerous publications for audit committees and boards. She authored the second, third, and fourth editions of *Audit Committee Effectiveness—What Works Best*, as well as the first and second editions of *Board Effectiveness—What Works Best*. In 2014, for the eighth consecutive year, *NACD Directorship* magazine named her as one of the 100 most influential people in corporate governance in the United States.

Catherine speaks frequently about corporate governance leading practices with boards and at conferences and seminars. She is a Certified Public Accountant (licensed in New Jersey) and a Chartered Professional Accountant, CPA CA (from Canada) and holds a Master of Accounting degree from the University of Waterloo in Canada.

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Prior to rejoining PwC in 2008, John wrote the *AICPA Audit Committee Toolkit* and edited the spin-off versions for not-for-profit organizations and government entities.

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About PwC

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For more information, visit our website at:
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* Forbes 2013 List of America's Largest Private Companies

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