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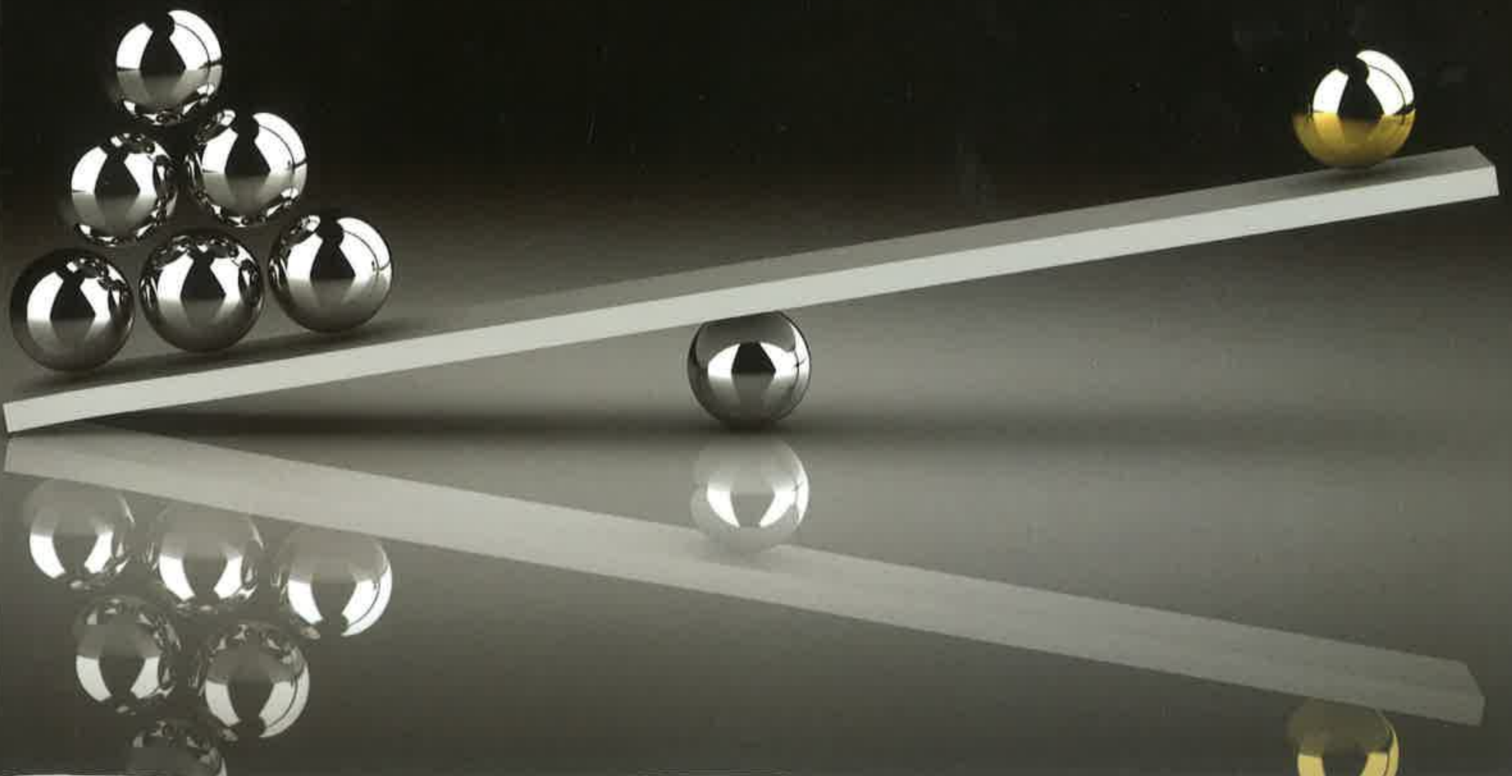

Guest Article

Best Practices for Corporate Governance in Closely Held Businesses

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Private businesses owned by a small number of shareholders often lack the corporate governance formalities found in publicly traded companies. Yet strong corporate governance practices are equally important in a closely held setting. Businesses that establish sound internal controls and procedures are better able to protect the company's assets by minimizing the likelihood and impact of wastage and misappropriation of assets, as well as the risk of legal and regulatory violations. In addition, shareholders of a business that observes best-practice corporate formalities are less likely to be held personally liable for third-party claims arising out of the actions of the company. Finally, businesses with sound and reliable governance practices are generally more attractive to purchasers, investors, lenders, and other potential business partners and can more efficiently execute such transactions.

The implementation of governance procedures in closely held companies is sometimes affectionately referred to as "SOX Lite," in reference to the stringent governance requirements set forth in the Sarbanes-Oxley Act of 2002 (SOX), a federal law that addresses reporting and disclosure requirements and board responsibilities for public companies. Private companies are not bound by most provisions of the law, and the cost to voluntarily comply with the arduous requirements of SOX can be unduly burdensome for even the most successful enterprises. Practitioners of SOX Lite thus strive to comply with the spirit rather than the letter of the law by establishing reasonable internal controls and an independent board of qualified directors with appropriate committees and expertise.

A company's board of directors (or similar governing body) sets the managerial tone for the entire organization. The board should have a strong group of independent directors, as well as relevant management, industry, and financial expertise. An ideal board features a mix of company executives, key shareholders, and unaffiliated individuals, each bringing a unique set of talents and perspectives. For larger organizations, it is often appropriate for the board to designate one or more committees to take on more direct oversight of certain corporate activities. The most common of these are Audit Committees, Compensation Committees, and Nomination and Governance Committees. In addition, special committees are sometimes formed for specific purposes (e.g., to explore a sale of the business or other strategic alternatives or to approve transactions in which managers have an interest). The board and its committees should establish regular periodic meetings, but may also be required to engage in special meetings for urgent matters.

A key objective for the board is to establish ethical codes of conduct applicable to directors, management, and their subordinates. The board should also establish policies for reviewing and addressing potential conflicts. For example, a related-party transaction between the company and a director or employee of the company (or an entity in which a director or employee has an economic interest) should be subject to the review and approval of the disinterested members of the board to ensure that the transaction is fair to the company and its shareholders. The board should also consider the company's risk management programs and assess potential governance and operational risks on a regular basis.

Of course, while it is important that the board watch over the company's operations, it is often counterproductive for the board to be overly involved. The policies enacted by the board should be carefully crafted to provide for the most efficient level of oversight. In general, the company's management should address the day-to-day operations of the business and the execution of the overall business plan, but the board should be involved in some capacity when the company is contemplating material matters outside the ordinary course of business. For example, the board may seek to set a dollar or other materiality threshold beyond which a transaction or litigation matter must be approved by or disclosed to the board.

The board of directors should also play a crucial role with respect to succession issues and continuity. When a board member or senior executive resigns or is removed from their role with the company, the board typically will play a role in appointing their replacement (in particular when it comes to replacing the chief executive officer). Like many other corporate threats, the risk of management turnover can be mitigated by proactive planning at the board level. It is advisable to put a succession plan into place in order to provide for a smooth transition in case of an unanticipated departure of the chief executive officer or other key personnel.

Maintaining strong corporate governance is a continuous process. Once the framework is put in place, written policies and procedures should be revisited periodically to confirm that they promote effective and efficient governance. The board should regularly review the company's management team and its strategic vision. Many boards go further and engage in periodic self-evaluation (a requirement of some stock exchanges), whether via self-administered questionnaires or some similar methodology, to ensure that the board's composition and its members' qualifications continue to reflect the needs of the company and promote effective oversight. Some boards encourage or require continued education for directors, whether to remain familiar with changing accounting or legal standards or to keep up with changes in the company's industry.

The ultimate objective of most for-profit entities is to maximize shareholder return and a strong and well-tailored governance program is an important aspect of achieving that goal. In closely held enterprises, family members and acquaintances of shareholders and managers are often involved in the business, heightening the potential for conflicts of interest and lack of expertise. In this setting, a strong, qualified, and independent board that engages in thoughtful governance practices is a necessity. While the needs of closely held businesses may differ from those of public companies, they will similarly benefit from the adoption of best practices for corporate governance.

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Editor's Note: This article was originally published in the Spring 2014 Edition of the SRR Journal.
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