Starting from Scratch: How to Build a Board during a Spin-off

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The rationale for a spin-off is that, once separate from the bigger business, the newly created entity has more strategic and operational freedom. A spin-off also brings greater transparency to the value of the assets. Getting to a win-win outcome and creating value for both, the parent company («ParentCo») and the spin off company («SpinCo»), is often easier said than done.[1] Unlike in an initial or secondary offering of company shares to raise capital, there is no cash benefit to the ParentCo. The company is essentially split and shares in the new entity (the «SpinCo») are allocated to the ParentCo's existing shareholders.

Senior leaders who have been part of a spin-off attest to how challenging it can be. There is a long inventory of critical decisions that need to be made in order to disentangle the two entities and ensure that the SpinCo can operate effectively from the day it is listed on the stock market. The ParentCo will need to decide which assets will be part of the SpinCo, for instance, and how to manage the interdependencies that still exist – the manufacturing sites that both might still be using, for example, or the allocation of pre-existing debt and liabilities. It will need to decide the organizational structure of the new company. And arguably some of its most important decisions will be those concerning the set-up of the new board.

As in any company, the board will play an important role in the SpinCo's success. The difference here, however, is that a SpinCo board is set up from scratch. This can be a great opportunity. «Everyone joins on the same day,» said one interviewee. «There's no baggage, no established procedures, no cliques – a rare chance to begin with a clean slate.» But it can also be a challenging endeavour, not least because of the limited amount of time ParentCo has – on average six to nine months – to set up a full board equipped with the skills, experience, values, and ways of working that will ensure its effectiveness from the get-go.

1 «Achieving win-win spin-offs», McKinsey Quarterly article, October 2021.

Relatively little has been published regarding how to establish a SpinCo board. Hence this research. We analysed the 11 spin-offs made by companies in Switzerland between 2012 and 2023, where the SpinCo became a listed company in Switzerland. We also conducted multiple interviews with leaders of search firms, transaction experts, board directors, and other senior leaders of SpinCo's.

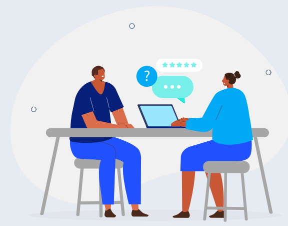
One clear message from the research is that companies committed to a spin-off will need to move swiftly to ensure a high-performing board is in place by the time that the SpinCo is listed. Investors and analysts will be watching. With that in mind, this article provides some suggestions on how best to proceed in a spin-off when considering the board's structure and composition, the selection process for board members, and how to start building the team (see also exhibit 1).[2]

Exhibit 1: Illustrative timeline - Building a board during a spin-off

Board structure and composition

Critical decisions:

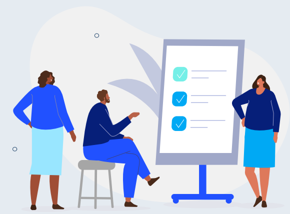
- Board structure and level of independence
- Board size
- Number and type of board committees



Chair and board member selection

Major selections:

- Appointment of the chair
- Appointment of core board committee chairs
- Appointment of remaining board directors



Building the team

Main objectives:

- Establish trust and respect
- Give directors an opportunity to familiarize with the sector, the company, its strategy and its stakeholders
- Define the working norms
- Help ensure key decisions are made quickly
- Provide CEO and management team initial guidance and support

Announcement — Spin – [6 – 9 months] — Spin – [3 – 6 months] — Spin – [2 – 3 months] — Spin-off

Note: Timings are indicative. Some activities can take place prior to spin-off announcement (source: McKinsey & Company)

2 Recognize that some of the findings may not be appropriate in other regions and jurisdictions.

1. The board structure and composition

It falls to the ParentCo to consider the structure and composition of SpinCo's board. It's tempting to replicate the ParentCo's board set-up, perhaps choosing the same number of board members, setting up the same board committees, hiring some of the same people that sit on the ParentCo's board, or selecting people with similar profiles. However, the very reason for the spin-off is to differentiate the two entities, which means that replication is unlikely the right answer. Rather, the structure and composition of SpinCo's board needs to reflect the new company's needs. Getting this right can have significant impact on new company's immediate future as well as its success over the medium to long term. Several of our interviewees who had overseen or been part of a successful spin-off stressed the value of dedicating attention to this at the outset.

Structure

Defining and agreeing upon the board's structure – its size, its committees, and its responsibilities – is a decisive step, as revisions can be time-intensive and costly given that they may have to be put to shareholders and require formal amendments. Decisions made should therefore not only reflect local legal requirements but the SpinCo's strategic objectives and the specific challenges that SpinCo might face.

The ParentCo should decide three main things:

1. Whether the board should have a one- or two-tier structure – a decision sometimes, but not always, stipulated by local legislation as well as the ideal percentage of independent board directors.

2. The size of the board. There is no right size, so a governance charter that allows for some flexibility, perhaps between seven to nine members, can prove helpful. Our interviewees expressed no clear preference for an odd or even number of board members.

3. The number and types of board committees. An audit committee is standard for any listed company, as are one or two committees focused on people-related topics – governance and nomination, and compensation, for example. Other choices will depend on the industry and core functional requirements and should add real value. Pharmaceutical companies tend to have a separate R&D committee, for example, mining companies a sustainability, health, risk, and governance-focused committee, and in most jurisdictions, financial services companies will have a separate risk (and ethics) committee.

Composition

With the structure decided, attention can turn to the board's composition in terms of knowledge, experience, skills, and capabilities. It is premature to begin identifying specific candidates for the board at this stage.

The chair – way and above the most influential board member in determining the board's success – will need a certain degree of relevant sector and functional knowledge. And every SpinCo board will need directors with in-depth finance expertise and experience handling remuneration, talent, organizational, and cultural issues in order to set up new structures and activities to govern these areas and lead the relevant committees. Digital and technology skills, risk management expertise, and governance capabilities, all ideally gained in similar sectors, are important too.

But it's not just industry or functional knowledge and experience that count. Perhaps most important for a SpinCo board is the leadership experience of the board chair and of the chairs of the core board committees. These are the people who lead and facilitate discussions, who decide what will be discussed, and who allocate time for discussions. They set the tone for the new board's work. Ideally, the chair of the board of a SpinCo will also have experience in building an effective board and determining its ways of working – drawing up a board agenda and ensuring inclusivity, for instance. So, while it's important to have people with deep industry expertise at board level, that expertise does not necessarily have to sit with the board chair or the chairs of the committees.

The chairs can acquire more knowledge over time, and experts can be drawn in to advise on specific issues when needed.

Diversity matters also when composing the board. One chair we spoke to emphasized «Don't back away from diversity even if it seems difficult at the start. Stick to it, there is fantastic diverse talent out there and you will find it and it will make a big difference to the successful composition of the board.»

The personal characteristics of board members matter too. Everyone is starting afresh, which brings a rare opportunity to build a culture of trust and collaboration. Hence the importance of recruiting those who value teamwork. The ability to listen and to ask the right questions, integrity, credibility, independence of thought, and sound judgement are all important qualities too. Our interviewees set the bar high in terms of personal qualities. «There's a «no jerks» rule,» said one interviewee bluntly. «There is too much to do from scratch, so you need people who work towards one common objective: helping the new company become successful.» Another put it like this: «Heavyweights on the board sometimes don't give others the space to express their opinions. You don't need big shots that will wow investors. You need people who will be great members of a high-performing team».

Finally, bear in mind the importance of independence when considering the board's composition and the profiles of its members, as well as the time commitments required. The majority of SpinCo board directors should, ideally, be independent from the ParentCo as well as from anyone else involved in the spin-off process in order to avoid conflicts of interest. It's wise not only to avoid directors who sit on the board of both the ParentCo and the board of the SpinCo, but also third parties who might be involved in the spin-off process. In the companies we reviewed, the median proportion of independent board directors was ~90% percent. In several instances the board was either fully independent or exclusively composed of non-executive directors.

Being a board member of a SpinCo board is often more time consuming, especially in the beginning because in addition to the normal board work there is additional set up work to be completed. The board should therefore also comprise of people who have enough time to devote to the tasks of a SpinCo board – time that directors may not have if they serve on several other boards. One interviewee said he had spent two weeks working for SpinCo's board in the two months preceding its stock market listing. In his other board positions, he wouldn't expect to work for more than two weeks over the course of six to nine months.

Adequate bandwidth is a particularly important requirement for the chair of a SpinCo, who may have to begin work as early as six months before the listing to drive the board selection, define the way the board will work, host the first board meetings, and support the CEO with major strategic decisions regarding, for example, capital allocation, service agreements, legal issues, and debt and liability commitments.

2. The selection process

The first appointment should be that of the chair, as the chair has a key role in proposing other board members and ultimately establishing the quality of the board. Moreover, the chair's reputation can influence who else agrees to join the board. Bear in mind that prospective board members are being approached to join a company for which there is limited financial information and without knowing who else will be sitting on the board. Time and again therefore, interviewees emphasized the critical role the chair plays in the selection process for other board members. «He or she can be the magnet for filling other roles», one interviewee said.

Interviewees were unanimous in expressing that the chair should be appointed soon after the intended spin-off was announced so that work could begin swiftly to assemble the full board. Ideally, the new CEO will have the opportunity to give some input on the choice of the board chair, as the two will need to work well together. But the choice is not ultimately the CEO's. Some search firms suggest the ParentCo pick two suitable candidates, then request that the CEO meet both, perhaps over dinner, with a view to getting a feel for the chemistry between them and how this might impact their working relationship.

Once the new chair is appointed, attention can turn to selecting the chairs of the core committees – in particular the audit and nomination and the remuneration committees. These appointments may prove to be among the hardest to make given the precise functional expertise required, so work needs to start soon. Thereafter, other roles can be filled. «Think board chair, audit chair, and then backfill other key committees», was the approach of one interviewee. All this happens well in advance of the spin-off, however. The majority of SpinCo board directors we interviewed were approached four to six months before the listing to sound out their interest in joining the new board.

To help with the selection process, companies often turn to search firms that scan the market and screen appropriate candidates. The search firm might also conduct initial conversations with candidates and can support the chair through all the necessary process steps – short-listing candidates, running and coordinating interviews, synthesizing feedback, and conducting background checks, for instance. But several interviewees stressed that, while it was important that the chair had confidence in the search firm, the chair should be closely involved at every step of the selection process, not hand over all responsibility. Some of the chairs interviewed even ran background checks themselves.

In Switzerland as in many other jurisdictions, the final appointment of the chair and all directors will need to be approved by the shareholders.

3. Building the team

An early start in defining SpinCo's board's structure and its composition and selecting the right candidates helps set the foundations of a successful board. But there is more to do to strengthen them. The board needs to learn to function well together – and fast.

Holding shadow board meetings before the new company is listed can help in this respect. Interviewees who had sat on the board of a SpinCo said the full board had met two or three times in advance, as had the board committees. The board will not yet have any voting rights – overall liability still sits with the ParentCo. Nonetheless, such meetings serve five important purposes:

1. Establish trust and respect amongst board directors.

2. Give new directors an opportunity to familiarize themselves with the sector, the company, its strategy, and its stakeholders. All our interviewees said that their boards had set aside time to run onboarding sessions. Some also organized site visits or invited external experts to speak on relevant topics.

3. Define the working norms. They set dates for future board meetings, for example, and indicate which topics will be discussed, when. And they ensure relevant charters, standards, and processes are clear, determining matters such as how many days in advance of a meeting reading material should be shared. Pre-launch meetings can also make clear the roles and responsibilities of the board versus those of the management team after the spin-off. Before the closure of the transaction the board sometimes even becomes involved in negotiations regarding the separation of the two businesses, be that concerning debt and liabilities or the compensation of C-level executives, for instance. The post-launch allocation of duties will therefore need to be clarified. Pre-launch meetings are also an opportune time to establish a collaborative working relationship with the management team.

That might mean requesting a monthly CEO memo to the board, or meetings between relevant parties – the chief human resources officer and the chair of the nomination and / or remuneration committee, for example. Establishing these relationships can be easier when there are no live, difficult issues to address, and may stand the company in good stead for when there are.

4. Help ensure key decisions are made quickly after the spin-off. Certain decisions that are the board's responsibility will not be possible until the new company is listed – the incentive structure for executives, for example, or the appointment of external auditors. But the board and relevant committees can do preparatory work: the audit committee can review and assess potential external auditors, for example.

5. Provide initial guidance and support for the CEO and management team when making important decisions or entering into negotiations with the ParentCo on issues that will have a long-term impact on the SpinCo.

4. Conclusion

Companies that are contemplating a spin-off, and members of the new board they create, have a unique opportunity to help shape the new entity's success from its inception. It is a privileged role to play. But setting up a SpinCo board carries challenges that, if not well managed, could hamper not only the short-term success of the new company but also have more lasting consequences. Fortunately, by studying the lessons and best practices of those who have helped lead successful spin-offs before, leaders today can be better prepared to meet a spin-off's critical challenges and build an enduringly successful board team.

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