Subsidiary governance is emerging as one the key topics in the theory and practice of corporate governance, yet very few best practice principles have been developed in this important realm. This is mainly because of the complexities and variables involved. It is for these reasons that traditional approaches by parent companies to subsidiary governance have been ad hoc rather than strategic.

This issue of the Hawkamah Journal contains four separate articles on subsidiary governance, each with its own perspective on corporate governance in group companies. This first article "Scanning for Scope" examines the concept of subsidiary governance and argues that the topic needs a "multi-lens" approach. This is then followed by three articles in which the authors share their perspectives on the matter.

SUBSIDIARY GOVERNANCE
SCANNING FOR SCOPE

The case for Subsidiary Governance

Much has been written about the importance of good corporate governance at the helm of an organization. However, the reality is that corporate governance challenges are far wider and more complex in most corporations with vast subsidiary networks. It is no longer sufficient to view corporate governance as simply the way in which the board at headquarters operates. Subsidiaries are a common feature of modern-day business structures, as corporations operate across multiple jurisdictions and business areas, and as recent scandals (such as the BP oil spill in the Gulf of Mexico) clearly demonstrate, if subsidiary governance in these entities is not adequately addressed, it can have a disproportionate impact on the group as a whole.

The challenge, in essence, relates to how corporate governance principles can be cascaded, consistently and effectively, down to the level of subsidiaries. The issue is partly about how parent companies should control their subsidiaries, but such an approach may run the risk of stifling innovation at these companies. The key issues in subsidiary governance relate to alignment, efficiencies, information flow, compliance, risk management, as well as many others.

The variables

Developing a comprehensive group-wide corporate governance strategy is difficult as subsidiaries are very heterogeneous. Firstly, they come in all sizes, ranging from special purpose vehicles to multinational corporations. Secondly, subsidiaries are established for a variety of reasons. Sometimes the reasons are legal: for example, companies with fixed assets (over which they want full control) in foreign jurisdictions are required to follow the national company law and set up separate legal entities. Other times subsidiaries are set up for tax reasons, risk management reasons, fiscal reasons, brand name, license-to-operate reasons, group operational reasons, and etc. Subsidiaries also come into existence through a number of different channels, while some go through a structured formation process, others become subsidiaries through acquisitions and mergers.

Subsidiaries also fall within several categories in terms of the activities they conduct. These range from sales offices and distribution centers to companies with global, regional or local strategic mandates. Country and industry factors also influence subsidiary governance as do cultural elements. The ownership structure of subsidiaries also varies as some are wholly-owned while others may be joint ventures with a number of players. And the final, and the most crucial, differentiating element is the importance of the subsidiary to the parent.

The effect of these elements is that some subsidiaries are, and need to be, more autonomous than others. Some subsidiaries, particularly the joint ventures, have boards, while others do not. Some boards have independent non-executive directors, while others are purely executive. Some jurisdictions even dictate the board composition. Clearly the appropriate governance framework needs to be one that reflects the nature of the subsidiary and its legal environment. It is for these reasons that traditional approaches by parent companies to subsidiary governance have been ad hoc rather than strategic.

The issues – the economic and legal duality

Subsidiaries are often set up for commercial reasons, to fulfill a commercial need. In a group setting, this usually means that the company is set up to carry out the purpose as defined by the founder, i.e., the parent. However, upon the incorporation of a company, a new legal entity is created. And as a legal entity, its board is responsible to act in the best interests of that company as opposed to the interests of third parties or the group as a whole.

It is astonishing how often this basic legal provision is overlooked. South Africa has helpfully included a reminder of this legal point in their corporate governance code: Note 142 of the King III Report states that "the holding company must recognize the fiduciary duties of the subsidiary company's directors and particularly their duty to act in the best interest of the subsidiary company at all times whether or not the director is nominated to the board of the subsidiary company by the holding company. In the case of the conflict between the duties of nominee director to a company on whose board he sits and in the interests of his principal, the duties of the director to the company of which he is a director must prevail."

While accounting, for example, has recognized the economic substance of groups, strict legal boundaries exist in law between different entities in many jurisdictions. The implication of this is that there is no prima facie reason why subsidiaries in a corporate group should act in a coordinated manner at all.

The somewhat paradoxical character of multiplicity and unity often found in subsidiaries is party derived from this economic and legal duality. However, subsidiary boards often tend to follow the instructions from the parent , which raises questions who is ultimately responsible if things go wrong at the subsidiary and managers at the parent company may be legally deemed to have been acting as "shadow directors" or as "de-facto" directors of the subsidiary with legal liabilities.

The German "Konzernrecht" is an exception in that the German company law contains a chapter on the governance of groups, which stipulates that the management of the subsidiary can be made to take into consideration the economic interests of the group as a whole even where this is not in the own interest of the subsidiary. But this also shifts the responsibility to the parent level, and this means that in some cases a subsidiary can apply at court for compensation when they have been damaged financially by a decision of the parent.

How about the reverse scenario? To what extent are the parent company and its board of directors responsible for the decisions taken at the subsidiary level? Legally speaking, a certain degree of protection is provided by the limited liability concept, which is enshrined in most company laws. Subsidiaries operate as separate legal entities and there is no "enterprise liability" or "group liability" principle. Piercing the "corporate veil" is the single exception to the limited liability principle, which refers to those situations where the courts have regarded the distinction between the parent company and the subsidiary as inappropriate. The use of this principle is far from straight forward and the case law is rather messy, but essentially the principle has been applied in situations where a holding company does not provide a subsidiary with the normal means of being a separate entity. Factors that indicate that two or more companies are engaged in a group enterprise include overlapping directors, officers and employees, obvious influence of the control extending from the top of the corporate structure and the extent to which the companies are thought to be participating in a common enterprise with mutual advantages. The courts, however, tend to be reluctant to use this principle.

But corporate groups should take note of the legal developments in the UK, where in a recent case *Chandler v Cape*, the Court of Appeal (while explicitly stressing that this was not a case where the corporate veil could be pierced) found that a parent company owed a direct duty of care to an employee of one of its subsidiaries.

However, the bottom line is that if the malpractices, scandals or disasters are sufficiently significant, it is the parent company that pays the price in terms of damaged reputation (think Perrier), share price valuation (Ahold, BP and News Corp), demise (think Arthur Andersen) and bankruptcy (think Barings Bank).

Subsidiary governance, in other words, is about balancing the group business objectives and group companies while recognizing the independence of subsidiaries. In some cases, the first challenge of subsidiary governance relates to raising awareness among management about the difference between the legal organization and the business organization. But on a more fundamental level, what is required is systematic work to identify key challenges and identify good practices.

It is for these reasons that Hawkamah has set up an international Task Force on Subsidiary Governance to tackle this complex, yet crucial, topic. Hawkamah will be working with a number of global and regional companies, exploring their frameworks and developing case studies. The ultimate goal is to formulate a set of recommendations on subsidiary governance to support the growth and sustainability of group companies, but here some initial steps:

Subsidiary Governance in Practice – some practical steps

1. Companies should develop a process for overseeing their subsidiaries, and this should start from the very formation of subsidiaries. This process should clarify the purpose of the subsidiary to all key internal stakeholders before they are established.

2. Clear governance structures should be established at the subsidiary level. This obviously implies that the relevant laws must be followed, but internal documentation spelling out the matters reserved for the shareholder(s), matters reserved for the subsidiary level board, and matters that are delegated to the management. Boards that are not clear on their role and boards that are not empowered are not likely to add value.

3. Corporate governance should be linked with performance rather than just controls and compliance. Too often this point is forgotten and corporate governance becomes another item to be ticked by the internal audit department.

4. Boards at the subsidiary level should comprise individuals whose know how and networks support the development of the business. Parent companies will never fully know what is going on in their subsidiaries and therefore they should be able to rely on these individuals to safeguard shareholder value.

5. Parent companies should support the subsidiary boards as well as management by providing training and professional development.

6. The parent company should ensure that the boards are fulfilling their duties in ensuring that the companies are run effectively, and that various policies such as risk management, ethics, remuneration, health & safety, and etc. are in place

7. The channels of engagement should be clearly laid out. These are to give legal protection and prevent officers at the parent level becoming “de-facto” directors. In many parent-subsidiary relationships, parallel lines of communications often exist, meaning that the board at the subsidiary level is by-passed by the parent management directly instructing the subsidiary management. Similarly, the boards at the parent level may be left in the dark over the activities at the subsidiary level, because it is the Group CEO who represents the subsidiary at the parent level.

8. Transparency and disclosure standards should be clearly laid out. These should ensure the regular, timely and accurate reporting from the subsidiary and avoid unnecessary ad hoc requests for information by the parent.

9. There should be a process to review the existing subsidiaries. This should not be seen only from the control perspective, but from the strategy perspective as well. The key questions include: why do we have this particular subsidiary? Why is this a subsidiary and not a stand-alone company? Parent companies should also ask themselves whether they are the right parent for the subsidiary and whether or not their parenthood adds value to the subsidiary.

10. The parent board should set up a subsidiary committee to ensure the oversight of subsidiaries. The management of subsidiaries is often seen as territory belonging to the Group CEO, and this is indeed the case as it is with all the other functions that the board has delegated to the management. However, it is the boards that are ultimately responsible for ensuring the effective management of those delegated functions. The approach taken by the parent board should not be “hands on”, but “brains on”.