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Corporate Governance of Subsidiaries: Board Responsibilities, Interplay With Parent, Liability Risks

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Corporate Governance of Subsidiaries: Roles and Responsibilities, Interplay with Parent Board, Liability Risks

Chip Presten, Esq.
Mercer Thompson LLC

GOVERNING DOCUMENTS FOR DIFFERENT TYPES OF LEGAL ENTITIES

CORPORATION – Articles/Certificates of Incorporation and Bylaws

- Location of offices
- Rules governing meetings of Shareholders and Board of Directors
- Number, election and removal of directors and creation of Board Committees
- Titles and duties of officers

GOVERNING DOCUMENTS FOR DIFFERENT TYPES OF LEGAL ENTITIES

- LIMITED LIABILITY COMPANY – Operating Agreement
    - Style of management (member managed or manager managed), meetings, admission of new Members, indemnification)
    - Number, election, removal, resignation, vacancy, powers and authority of managers
    - Officer titles and appointment and removal of officers
- PARTNERSHIP – Partnership Agreement

TYPE OF ENTITY: SELECTION OF OFFICERS AND DIRECTORS

CORPORATIONS

- Business and affairs managed by or under the direction of a Board of Directors
- Number of directors and duties and titles of officers specified in the bylaws
- Directors elected by the shareholders at the annual meeting
- Director vacancies can usually be filled by the remaining directors or the shareholders
- Board of Directors can create Board Committees
- Required officers are President, Secretary and Treasurer; one person can hold more than one office
- Officers make operating decisions; Board of Directors makes directional/policy decisions

SELECTION OF OFFICERS AND DIRECTORS

LIMITED LIABILITY COMPANIES

- May be Member-managed or manager-managed
- Members may be legal entities
- Each Member has equal voting rights unless the operating agreement allocates voting rights based on capital contributions or other criteria
- Each Member can bind the limited liability company
- Limited liability companies may appoint officers and committees

ROLE OF SUBSIDIARY BOARD VS. PARENT BOARD

GENERAL PRINCIPLES

•Good governance includes the management of the structure of all of a company's legal entities

•Companies of all sizes have to comply with applicable corporate governance requirements

•It is important for a parent company to manage the various corporate governance requirements, policies and procedures that are relevant to its subsidiaries

•A company should determine the reasons that each of its subsidiaries exist from managerial, legal and operational perspectives and eliminate those that are not needed

ROLE OF SUBSIDIARY BOARD VS. PARENT BOARD

SUBSIDIARY BOARD STRUCTURE

- Parent companies typically implement measures intended to maintain control of their subsidiaries via:
  - The composition of subsidiary Boards of Directors
  - Maintenance of substantial ownership
  - Control of subsidiary business operations

ROLE OF SUBSIDIARY BOARD VS. PARENT BOARD

SUBSIDIARY BOARD STRUCTURE

•Each subsidiary should have an active, engaged and functioning Board of Directors and Officers for the supervision of the subsidiaries' operations instead of having either Boards and Officers that are merely formal and inactive or no Board or Officers at all

•The subsidiary Board of Directors should also oversee the effectiveness of the subsidiary's corporate veil to shield the parent company from subsidiary liabilities

•There should be a robust subsidiary corporate governance framework in place

•The responsibility for administering corporate governance policies, processes and procedures should be with the subsidiary's elected Corporate Secretary (who may be a member of the parent company's Office of the Chief Governance Officer)

ROLE OF SUBSIDIARY BOARD VS. PARENT BOARD

SUBSIDIARY BOARD STRUCTURE

•The parent company's Chief Governance Officer should implement good corporate governance practices at the subsidiary level

•Directors of subsidiary Boards of Directors have the same fiduciary duties as Directors of the parent company or any other Board of Directors

- Director Standards of Conduct
  - Duty of care - Business Judgement Rule
  - Duty of loyalty

ROLE OF SUBSIDIARY BOARD VS. PARENT BOARD

SUBSIDIARY BOARD STRUCTURE

•The subsidiary Board should:

- Supervise subsidiary management but not actually manage the day-to-day affairs of the subsidiary
- Review the subsidiary's strategic plans, assess its business and regulatory risks and review its internal control processes and procedures
- Be responsible for the stewardship of the subsidiary and act in the best interests of the subsidiary in order to deliver value to its shareholder, the parent corporation

ROLE OF SUBSIDIARY BOARD VS. PARENT BOARD

SUBSIDIARY BOARD STRUCTURE

•It is important for a parent company to establish a corporate group culture that forms the backbone of subsidiary corporate governance

•Officers of each subsidiary should know and understand the parent corporation's guidelines on management, individual conduct and corporate social responsibility

•Boards of both parent and subsidiary corporations should insist that transactions between the parent corporation and its subsidiaries and between subsidiaries should be conducted at arms length and be documented utilizing inter-company agreements

ROLE OF SUBSIDIARY BOARD VS. PARENT BOARD

SUBSIDIARY BOARD STRUCTURE

- Joint ventures present unique challenges for the Office of the Chief Governance Officer
  - The joint venture agreement should specify how governance issues will be handled
    - Composition of the Board of Directors
    - Appointment of Corporate Secretary
    - Maintenance of corporate records
    - Designation of Signature Authority
- Directors and officers of joint ventures need to fully understand their duties and responsibilities and significant risks of conflicts of interest

ROLE OF SUBSIDIARY BOARD VS. PARENT BOARD

SUBSIDIARY BOARD STRUCTURE

- In addition to protection of subsidiary corporate veils, subsidiary Boards of Directors should insist on the observance of subsidiary corporate formalities for purposes of being prepared for:
  - A potential sale of the subsidiary
  - A potential subsidiary financing transaction
  - A potential IPO of the subsidiary
  - Financial statement and audits and reviews and tax audits

ROLE OF SUBSIDIARY BOARD VS. PARENT BOARD

BOARD COMPOSITION

•Depending on the size and complexity of a subsidiary's operations, it is important that subsidiary Directors bring the right skills to the subsidiary's Board to provide effective oversight of subsidiary operations

•Representatives of the parent corporation who are knowledgeable about a particular subsidiary's business and operations are good candidates to be Directors and Officers of that subsidiary

•A subsidiary Board of Directors should not be mirror image of the parent corporation's Board of Directors or Executive Management Team

- Parent corporations often do not understand the risks attached to their subsidiaries. These risks can arise from:
  - Regulatory violations and related fines and penalties
  - Subsidiary legal liabilities (e.g. products liability verdicts)
  - Costs of retaining or dissolving the subsidiary
- A parent company should decide whether a subsidiary Board should have independent directors or whether individuals from within the organization who know the industry and company strategies should be members of the subsidiary's Board

- Parent companies often focus on their own governance and neglect subsidiary governance
- There is increased interest by shareholders and regulators in how legal entity governance is managed
  - Subsidiary directors need to understand their fiduciary duties.
  - Parent companies should provide sufficient support for subsidiary directors regarding their duties and liabilities

To deal with legal and regulatory liabilities, the Corporate Secretary managing subsidiaries must be familiar with:

- Which businesses and assets the subsidiary owns and where they are located

- Which governmental regulators are relevant to the subsidiary and what activities of the subsidiary they are regulating

- The reporting and compliance obligations of the subsidiary

- It is not uncommon for a parent corporation to have many subsidiaries

- Uniform governance frameworks can be utilized to minimize liabilities associated with having many subsidiaries

- Creation of a Subsidiary Management Committee may help to mitigate these risks

    - Chaired by the Corporate Secretary and consist of professionals from multi-disciplinary functions in the parent company

    - Helps to ensure consistency and coordination in implementing best practices and policies relating to subsidiary governance

- It is important to manage the creation and dissolution of subsidiaries
  - Identify subsidiaries and determine which are needed and which can be eliminated and associated risks
  - Analyze cost to parent of keeping an inactive subsidiary
  - Create new subsidiaries when business conditions or limited liability concerns merit. Examples:
    - Services subsidiary
    - Finance subsidiary

DISSOLUTION OF SUBSIDIARIES

•Execute directors consent resolution recommending the dissolution and accepting the resignation of officers

•Provide notice to the stockholder(s) of the dissolution

•Execute stockholders' resolution consenting to the dissolution and accepting the resignation of directors

•Execute a Certificate of Dissolution (for corporations) or a Certificate of Cancellation (for limited liability companies) and file it with the Secretary of State

•Tax Department completes and files final annual franchise tax report

•Withdraw foreign corporation registrations and cancel stock certificates

- Non-U.S. subsidiary corporate governance compliance is often managed by third parties devoted to assisting clients with compliance with jurisdictional corporate governance requirements
    - There are local law limitations that affect the governance of non-U.S. subsidiaries
    - Often directors and officers need to be residents of the particular country in which a subsidiary is formed
    - There may be other local law requirements such as capitalization requirements

- There can be significant immigration, tax, liability and employment ramifications of not complying with director and officer residency requirements

- Directors and officers of non-U.S. subsidiaries should have sufficient knowledge and capability to fulfill local regulatory requirements

- The separate corporate existence of a subsidiary should serve as a corporate veil or shield to protect a parent corporation from being responsible for the debts and other liabilities of the subsidiary

- In some cases, a court will "pierce the corporate veil" of a subsidiary and hold a parent corporation liable for the debts or other liabilities of its subsidiary

- A court will consider several factors when determining whether to pierce a subsidiary's corporate veil, including:

  - Adequate capitalization for the subsidiary's business purposes
  - Solvency of the subsidiary
  - Subsidiary payment of dividends to the parent company
  - Subsidiary maintenance of proper corporate records
  - Proper functioning of subsidiary directors and officers
  - Observation of subsidiary corporate formalities
  - Overlapping directors and officers at parent and subsidiary levels
  - Subsidiary use of parent assets without inter-company agreements

- Managing the risk of corporate veil piercing:
  - The parent corporation should treat the subsidiary as a separate legal entity with separate directors, officers, facilities and operations
  - The subsidiary should observe all corporate formalities, including:
    - Filing of articles of incorporation with Secretary of State
    - Adopting by-laws and electing directors and officers
    - Conduct and document periodic subsidiary Board meetings

- Develop standard policies, practices and procedures for subsidiary governance
- Ensure that all corporate constituencies (legal, tax, treasury, risk management, accounting, compliance and operations) are aware of and have signed off on actions to be taken at the subsidiary level
- Communicate, coordinate and collaborate with the parent's finance, tax and business development teams regarding subsidiary management issues

- It is important to know and review corporate governance service providers
  - Maintain a database of service providers
  - Be reasonable about what can be done in-house and what should be handled by outside corporate governance service providers
  - Seek cost savings through consolidation of service providers

USE OF TECHNOLOGY

- Adoption of technology can make the process of managing risks associated with subsidiary maintenance less burdensome on parent corporations
- Information should be organized to enable directors to easily identify subsidiary policies, procedures and best practices
- Utilizing a Board portal helps to:
  - Manage Board communications
  - Provide subsidiaries with tools to meet governance requirements

- The goals of implementing the use of technology in subsidiary governance are:
    - Create a central database for all corporate records
    - Utilize software to create a web-based intranet to allow company-wide access to governance policies and procedures
    - Accurately oversee subsidiary activities
    - Provide regulators, management and directors with accurate and timely information
    - Allow the Corporate Secretary to ensure consistency in the application of governance policies and procedures

- Subsidiary management systems are used to:
  - Allow for a safe and secure way to store information regarding subsidiaries
  - Provide a reliable method for maintaining, tracking and accessing subsidiary information via a central database of corporate records
  - Allow directors to access information to make informed decisions regardless of their geographic location

- Technology can provide directors, management and regulators with accurate and timely information about a subsidiary, its Board contact information and its policies and procedures

- Technology allows the Corporate Secretary to ensure consistency in the application of governance policies and procedures

- Technology allows subsidiary data to be stored on secured servers and be quickly accessible

Three Models For Subsidiary Governance:

- The subsidiary is assigned a supervisory Board to manage day to day operations of the subsidiary (often in overseas operations)
- A formal subsidiary Board of Directors is established to handle legal reporting and compliance requirements or issues in the subsidiary’s jurisdiction
- The subsidiary has no Board and all decisions are made by the parent corporation; subsidiary management does not serve as a decision-making body but serves as a conduit of information to and enforcer of parent corporation policies and procedures

- The Corporate Secretary has become a corporation's chief governance officer and the "custodian or steward of corporate governance"
  - Has become a strategic executive
  - Supports the parent company Board and assists directors in managing their responsibilities
  - Supports subsidiary corporate governance

- Assists Board members in ensuring that the parent corporation and its subsidiaries are properly directed and controlled
- Ensures compliance with various corporate legal filing requirements related to the parent corporation and its subsidiaries
- Stays current on corporate governance best practices and developments
- Serves as a conduit between parent corporation and subsidiary Boards of Directors

- Manages the legal entity lifecycle
  - Understands the business need for legal entities
  - Plans and executes legal entity formation
  - Prepares legal entity documentation
  - Attends to legal entity registrations and filings
  - Begins initial organizational activity
  - Attends to ongoing legal entity maintenance

- More focus is being placed on the composition of subsidiary Boards
- Establish uniform guidelines for Board composition and better guidance for Directors via creation of a Directors Guide
- Perform a comprehensive governance assessment of the corporation and all its entities
- Subsidiary Boards should include directors from various business units, such as finance, legal, risk management and compliance to determine subsidiary risks, cost and legal implications

- Subsidiary Boards should include a corporate executive from the parent company to make sure that concerns and interests of the parent company are taken into consideration
- Special consideration should be given to a subsidiary's size and scope, geographical presence, regulatory profile, financial materiality and complexity of operations when determining the appropriate composition of a subsidiary Board
- The parent company Board should play an advisory rather than a decision-maker role

•A subsidiary Board must act in the best interest of the subsidiary while taking into account the interests and strategic direction of the parent corporation

•Subsidiary director fiduciary duties to the subsidiary are the same as parent corporation director fiduciary duties

•Subsidiary directors should promote the best interests of the subsidiary in the exercise of their fiduciary duties to the subsidiary and its shareholder, the parent corporation

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