The Case for Subsidiary Corporate Governance

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Subsidiaries have long been part of the organizational make-up of corporations. They often serve only to create tax efficiencies or to expand businesses into broader geographic or regulated areas. Over the years, as companies grew in size and scope, their structures became more complex as subsidiaries quickly proliferated the corporate landscape. Often they came as part of an acquisition, when the target company came with a number of other legal entities hanging off its corporate chart. In other cases, they became the means by which companies created autonomous business units or divisions to download accountability by either product line or geography.

There are several reasons why companies create subsidiaries. Some are created as a means to cleanly execute a business transaction with a third party, such as the sale of real estate or part of the business others are joint ventures that can become subsidiaries. Some countries may require that foreign corporations do business through a domestically incorporated entity.

The bottom line is that there will always be a need to use subsidiaries or special purpose entities (SPEs) as a means to conduct business.

There are companies that use subsidiaries as a vehicle to mitigate risk and protect the parent company from litigation. This may be true at a purely transactional level but not necessarily so at a broader corporate level, especially in areas of public or social interests. The Bridgestone / Firestone ordeal is evidence of this. Parent Bridgestone bore much negative publicity because of the allegations made against its subsidiary, Firestone, and the quality and safety of some of its tires. Today, as the Enron and Worldcom failures unravel, we see how they used subsidiaries and special purpose vehicles to manipulate the balance sheet and hide losses. We also know that the Enron network consisted of over 3000 entities, which in itself is not surprising. Many of today’s large corporations have several hundred subsidiaries and many have over a thousand entities spread across several countries. We also know that not all these entities exist for the same reasons and each one can have a very different impact on the bottom line of the ultimate parent and the value to the shareholders.

A Corporate Parent is often a holding company or sometimes a corporate identity holder. It is a name that the public and investors can identify with. Names such as Ford Motor Company, Bank of America, IBM and Daimler Chrysler are easily identified and we can chose to buy their products or invest in their stock because they are sound well run companies with solid historical performance. But when we buy their products or invest in their shares, do we wonder about the factory they may own in Brazil or the company they may now own in Vietnam? Do we wonder what impact the failure of any of their legal entities can have on the company as a whole? Or how about the failure of a government in a third world country or the repatriation of divested assets by a hostile regime? Most of us do not even consider these things, (unless an event makes them newsworthy, such as the Bridgestone / Firestone story) because we have faith in the company’s management and governance. In most organizations, (such as those mentioned above), history tells us that while we may not consider their global reach, we trust that they have systems and procedures in place to ensure that their subsidiaries and their investments are properly cared for.
Subsidiaries and SPVs are creating scepticism, rather than presenting a corporation as well managed and structurally efficient. My view is that if we are unable to explain to investors and analysts in plain English why an entity exists then we will appear to be trying to put something over on them.

Going forward, companies will need to show that they have sound governance practices throughout the organization. This will take a rethinking of governance policy, it will take conviction on the part of senior management and in some cases it will take resources. This last point is not to suggest there is a need to hire more corporate secretaries, but rather, in most large organizations, may require technology and people dedicated to subsidiary corporate governance.

*The day has arrived when sound governance practices at the top of the organization will no longer suffice. Regulators, Investors and the General Public expect more.*

Regulators, analysts, investors and even employees now want to understand more about subsidiaries and how the parent company oversees and entrenches sound corporate governance concepts across its empire. Enron was a wake up call for trusting investors, complacent employees and benign regulators. Investors were more than willing to put their money in blue-chip stocks. They trusted their brokers, who trusted analysts who trusted audited financial reports and forward-looking statements. Corporate governance was the last thing on the minds of those who invested in Enron stock. All stakeholders had blind faith in a system that had more or less held true for many years and, up until now there was no reason not to believe management or the analysts. Enron is also a good example of how far reaching a major corporate failure can be. The devastation reached many average people who lost more than jobs, but also pensions and retirement savings. The collateral effect to suppliers and creditors is massive and to some degree, long-term.

As the reasons for Enron’s collapse become public we can expect new regulations, new disclosure requirements and most certainly increased access to corporate information below the parent company. The ability of the Corporate Secretary and the Legal Counsel functions of large companies to respond to requests and report on downstream governance / compliance activities will have to increase dramatically.

This does not imply a need to move toward heavily centric organizational structures, but rather having governance systems that permeate all levels of the enterprise. Technology will drive the governance framework as well as good policies and processes that will allow a cohesive approach to governance across business lines and across jurisdictions.

*Corporate Governance once focused mainly on the caring and feeding of the main board and corporate record keeping. Today, the world of the Corporate Secretary is evolving into a key strategic player in corporate decisions and matters of governance.*

Like many other core functions that support corporations, both big and small, the Corporate Secretary’s department has evolved considerably. Supporting the main board and other stakeholders is still a key activity, but increasingly there are pressures both internally and externally to support downstream corporate governance. Large operating subsidiaries need to shore-up their governance and start behaving more like their parent companies.
The Corporate Secretary today (both as a person and a function), is evolving into a specialized resource that is critical to the ongoing viability of the business. As a strategic player in large organizations, we see the role increasingly shift to that of “Chief Governance Officer”. It may seem like a lofty title, but we have to wake up to the fact that corporate governance is the hot topic that is keeping some CEOs awake at night.

The OECD defines corporate governance as follows;

“Corporate Governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides a structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance”.

This is a fairly comprehensive definition of corporate governance and articulates in broad terms the framework in which governance exists. The challenge we face is to extend sound corporate governance practices and policies downstream to the subsidiaries. This challenge embodies many dynamics that must be embedded in creating a harmonious governance system.

Large organizations need a Corporate Gatekeeper, someone who will manage the life cycle of its subsidiaries. There needs to be policies and boundaries for who can create a legal entity and the reasons for creating it.

A problem that plagues many conglomerates, is keeping track of the subsidiaries they have and why they exist in the first place. Most corporate secretaries or general counsel will agree that creating a legal entity is usually much easier than getting rid of it. In fact, most subsidiaries that are sitting inactive or dormant are there because nobody knows what to do with them. If organizations went through their structure, entity by entity, they would likely find an opportunity to clean house and dissolve or amalgamate numerous entities.

Cleaning up the corporate chart is only the beginning. There needs to be a mechanism in place that will control the very creation of the entity in the first place. Depending on the nature of your business, specific rules should be implemented, stipulating the conditions for creating a subsidiary. The business case for creating a new entity needs to be clear and factual and justify a real need. In most cases, it should be driven by tax, legal or regulatory requirements of the jurisdiction that will house the subsidiary.

Subsidiaries cost money to own and manage. Even a dormant subsidiary is costing money just sitting on the shelf.

A subsidiary sitting inactive somewhere in the corporate maze is costing you money. Most of the time, it is incurring some system costs, either on your GL or on your records management system. Some entities require annual returns to be filed and possibly other regulatory filings. Costs will vary greatly, depending on whether or not the subsidiary has an active board with regular meetings and whether the Corporate Secretarial and legal support is provided in-house or outsourced. Either way, there is a cost associated with it. Our own analysis
suggests that the minimum cost for a subsidiary is in the $40,000 range. This grows quickly with larger operating entities with active boards.

These costs will vary from company to company, but I suggest that if you were to conduct a similar analysis in your shop you would be surprised at the costs. Once you complete your analysis, then consider the financial implications of reducing the total number of your subsidiaries by 15 or 20%. You will likely find that this will more than adequately fund any additional resources you will need to oversee the governance of your subsidiaries.

Costing a subsidiary:

- Systems costs – GL, Finance & Accounting
- Legal & Regulatory – Filings / Returns
- Records & Administration – Articles, Resolutions, Minute book
- Governance (Operating Subsidiaries – Board Meetings, Material Costs, Time)
- Audit – Internal and External
- Financial Reporting – Must roll up somewhere
- Risk – Assess a dollar figure based on contribution or purpose
- Staff Costs – Somebody has to deal with this entity

Technology needs to play a key role in any framework that will harmonize governance and oversight across subsidiaries. This is essential for large companies, especially if they are multinational.

Best in class companies around the world maintain a common central database for all their corporate records. One system, one place to hold, store and retrieve information from. This will become even more important as regulators look for increased reporting of subsidiary business.

We identified quickly in our company the need for a Web-based solution if we were going to have a viable governance system. Also critical was the need for high data integrity, something that was not true of our current system. Today, we have a system that is accessible through our intranet by designated Corporate Secretaries around the globe. They are accountable for all entities within their purview and update corporate information as events happen.

This includes the addition or dissolution of entities, appointment / resignation of directors and officers, minute books, share capital and a myriad of other pertinent data.

There are several off the shelf products on the market that can provide these functions, many of which appear similar on the surface. Once you have determined your own internal needs, we recommend you do some very diligent comparative shopping. While technology in itself is not the solution to achieving better governance in your subsidiaries, it is the most significant component of a total governance framework. Choosing the right system and the right supplier are critical to the success and viability of your governance system. It will be your mechanism for tying together your company and your entire downstream governance strategy. The time you spend up front selecting the best solution for your company will be well worth it when it comes to implementation, adaptability and sustainability in the years ahead.
Subsidiary Board Composition should be given similar care and scrutiny as the directors of the parent board.

Our internal review of subsidiary board structures revealed a need for a uniform guideline on board composition and better guidance for directors. Our view was that the approach to board composition should be similar to that of the main board, but adjusted for the fact that the entity is a subsidiary.

Depending on the size and nature of the business, it is important that directors bring the right skills to the table to offer effective oversight. The size of the board will ultimately depend on the size and complexity of the subsidiary’s operations. Representation from key functional areas such as Finance, Tax or Law may be justified where size and scope of the business warrant. For increased objectivity, it may be advisable to have a director from outside the business unit or from another division. This will vary from entity to entity and each board should be assessed according to the size and scope of the subsidiary, its geographic area (to respect the rules of independent mind and management), regulatory relationship and financial impact of the subsidiary on the parent. This last point should influence the decision of having someone from the corporate executive sitting on the board.

Directors on subsidiary boards have the same fiduciary responsibilities as those of the parent board. The board must supervise management but not supplant it. It should review the strategic plans, assess the risks and controls, review internal policies and ensure sound governance. The board is responsible for the stewardship of the subsidiary and owes a duty to act in its best interest with due regard for the interests of the parent, the ultimate shareholder.

Just as with the main board, subsidiary directors need orientation, guidance and support. Some officers may be experienced and familiar with their responsibilities on internal boards, others will need assistance. An internal support structure, including a Director’s Guide should be written to support internal directorships. Not only will this serve as a reference tool for them, but it should also spell out their obligations, risks and corporate indemnification policy.

The issue of outside directors on main boards has often come up. In our opinion, this should be only an exceptional basis and only if required by law. The reason is that if the subsidiary is wholly owned, then there has to be congruence between the parent’s strategic direction and that of the subsidiary. An outside director, not familiar with the inner workings of the company, risks impeding initiatives and slowing the business process. If the subsidiary is seeking objectivity on the board, then in should come from cross-business representation.

The Subsidiary Corporate Secretary is a key strategic officer in the governance framework. The incumbent should have the credentials and the experience to fulfill the mandate.

Just as with the parent’s main board, not just anyone should serve as Corporate Secretary to subsidiary boards. The role is not one of minute taker and refreshment coordinator, but rather the key person responsible for governance oversight at the subsidiary level.

The Corporate Secretary today is a senior officer with the skills necessary to ensure board effectiveness, keep proper corporate records and serves as a focal point for directors and senior management. He or she is also responsible for all returns and regulatory filings that may be associated with the subsidiary as well as staying current with local jurisdictional requirements.
Often, for smaller subsidiaries or in remote geographic regions, the title of Corporate Secretary is given out based on convenience or the administrative role of the individual.

One way to build expertise and control is to create corporate secretarial hubs in key areas of the organization. This could be done within a division, as a subset of a larger corporate secretarial function or on a geographic basis. For example, you could have a regional Corporate Secretary for Europe, or the Caribbean, which would oversee governance systems for all the subsidiaries in those geographic areas.

**Subsidiary Corporate Governance needs to evolve into a tangible and measurable activity in large corporations. The risks of downstream governance failures can have devastating impact on the company as a whole.**

One of the challenges of implementing a governance framework that permeates the company is to not create unnecessary bureaucracy. Oversight and control will be the success drivers, regardless of the governance system. You can download process and accountability for information management, but there needs to be a mechanism to track and evaluate the process. The Internal Audit function may be one way to ensure that the policies and internal governance systems are being adhered to. Another way is to leverage technology and use built in audit trails and triggers to monitor activity.

**The objective should be to apply the same governance principles and ethics across the enterprise to create a new heightened awareness of corporate governance. This should be the new common thread that binds a company’s culture regardless of where the entity sits in the corporate structure.**

There is not a great deal of space between a company’s culture and its governance systems. Both imply a combination of rules and procedures that drive behaviour. There really should be a close resemblance between the Code of Ethics of a company and the principles that guide its corporate governance. In some cases they may be one and the same.

Multinational companies will always face cultural and jurisdictional issues. Following a merger or acquisition of international companies the question of cultures and ethics is always the hardest one to deal with. Some of the strengths that are built through mergers and acquisitions lay in the diversity of the cultures and that leverage should be preserved. The focus in a newly merged company should be on the fundamental governance framework that will become their common thread.

Achieving this requires a strong central tendency to a core governance system. Having the subsidiary governance system already in place, along with the early participation of the legal and secretarial functions in the integration of new entities will mitigate the risk of future governance failures. It will also ease the transition for the newly acquired entities by having clear guidelines in place.

**Oversight of subsidiaries and new corporate governance standards are hot topics and will no doubt lead to regulatory and reporting changes. Many Corporate Secretaries may soon find themselves having to address these changes and increase their focus on subsidiary corporate governance.**
There are many things that need to be considered in going ahead with any subsidiary governance strategy. It should start with a fundamental analysis of your company and all its entities. Learn more about what you have in place now and ask some basic questions.

Some fundamental questions to consider:

- How many subsidiaries do we have?
- Do we have common governance principles in place?
- What is the process for creating new subsidiaries?
- Who can approve them & what is the criteria?
- How is a subsidiary’s life cycle tracked?
- Who is responsible for dissolving unnecessary subsidiaries?
- How are the directors selected for subsidiary boards?
- Who are the corporate secretaries?

Subsidiary Corporate Governance is not rocket science, but rather much of the same common sense that was applied to the top of the enterprise for years. While it is a little more challenging, and possibly even daunting in really large corporations with hundreds and perhaps thousands of subsidiaries around the world, it can be achieved.

Technology and the Web have made managing global companies easier and have had a positive impact on the speed of business. The same can be true for subsidiary corporate governance. Technology should become the anchor of the governance framework. It is the means by which a global company with hundreds or thousands of legal entities can accurately oversee the activities of its subsidiaries. The parent company will know how many entities it has at any given time and will be able to provide regulators, management and directors with accurate timely information. It will allow the Chief Governance Officer to ensure consistency in the application of policies and procedures. These elements are critical to an effective and reliable subsidiary governance system. For any global or large domestic public company with multiple business entities, technology will become the only way that increased regulatory demands are going to be met.

What I have discussed here does not suggest creating a large infrastructure to baby-sit subsidiaries. It should involve a well thought out plan that fits your organization. Obviously the number of subsidiaries you have and the more jurisdictions they operate in will influence the structure you will need to support governance enterprise wide. While this is by no means a small task, it need not be complex. Our experience in structuring our subsidiary governance framework has been that most of the talent and information needed to achieve our goal already existed in the company and what we needed to do was to consolidate and re-align resources where it made sense to do so. The end result should be a cleaner and leaner organization where all entities exist for a value-add purpose and are governed with the highest level of fiduciary responsibility. The real achievement is that implementing an enterprise governance framework is going to help protect stakeholders and create economic value at the same time.

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