

CHAPTER

7

CORPORATE GOVERNANCE OF COMPANY GROUPS

How a parent company governs its subsidiaries: governance models, group policies, intra-group transactions and the position of minority shareholders.

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7.1
INTRODUCTION TO GROUP GOVERNANCE

A common structure of a company group is a holding company that owns several subsidiaries (controlled entities), often with different business lines. In a group, decision-making is more complex than in a stand-alone company, so it is important to establish a group governance framework. The Board of the holding company should assume responsibility for governance across the group. It exercises this responsibility by adopting a framework that sets out how the relationship between the holding company and its subsidiaries is structured and managed.

7.2

ADDRESSING THE GROUP GOVERNANCE CHALLENGES

Every company, whether a holding company or a subsidiary, is a separate legal entity with its own rights and obligations. The objective of the holding company is to achieve the group's strategic targets while respecting the roles and boundaries of the subsidiary and its Board members.

A common perception is that Board members nominated to subsidiary Boards by the holding company (the controlling shareholder) act as "representatives" of that shareholder. In principle, nominee Board members owe their duties to the company on whose Board they serve and are required to act in the best interests of all its shareholders, not solely for the benefit of the shareholder that nominated them. Shareholders should therefore always be mindful of the fiduciary duties that apply to Board members. Shareholders usually form subsidiary Boards with a majority of related Board members, to ensure that the necessary decisions are adopted, while an external perspective is obtained through the participation of non-executive or independent Board members.

The holding company usually achieves its group governance targets through the following main measures:

- establishing the group corporate governance framework (purpose, mission, vision, values, strategy, objectives and policies);
- ensuring clear communication of the group's general strategy and objectives;
- appointing the holding company's representatives to subsidiaries' Boards;
- setting the consent rights of the shareholders' meeting (the holding company) for specific matters;
- approving corporate policies and procedures for key matters, to be adopted by the subsidiaries;
- participating in the selection of the CEO at subsidiary level;
- ensuring regular monitoring meetings between representatives of the holding company and of the subsidiary;
- establishing a unified and efficient internal audit function within the group;
- participating in the selection of the external auditor of subsidiaries;
- implementing unified and efficient risk management practices;
- setting and monitoring key strategic indicators;
- centralising competencies and functions within the holding company.

Being required to act in the best interests of the subsidiary does not mean that the members of the Board of a subsidiary should disregard the role, expectations or strategic direction of the holding company. Effective cooperation with the holding company, including alignment with the group's overall objectives, may also be in the best interests of the subsidiary, provided that such alignment is consistent with the subsidiary's own legal duties, business needs, risk profile and stakeholder interests.

At the same time, the subsidiary Board should not treat group interests as automatically overriding the interests of the subsidiary. The subsidiary is a separate legal entity, and its Board has a duty to act in the interests of that subsidiary. This means that the Board should assess group strategies, policies, targets, transactions and decisions from the perspective of the subsidiary and should satisfy itself that they are appropriate for the subsidiary before approving or implementing them.

The relationship between the subsidiary and the holding company should therefore be based on cooperation, transparency and proper governance, rather than automatic subordination. The subsidiary Board should have an effective opportunity to provide input on matters affecting the subsidiary, including at holding company level where relevant. This is particularly important where group policies, internal processes, financing arrangements, shared services, intra-group transactions, risk management frameworks or strategic initiatives may have a material impact on the subsidiary.

The subsidiary Board is primarily responsible for overseeing the management, performance, risk profile and operations of the subsidiary. It should also contribute to the effective integration of the subsidiary within the wider group where this supports the subsidiary's interests. However, decisions should not be justified solely on the basis that they benefit the group or the holding company. Where a proposed decision benefits the group but may create disadvantages, risks or obligations for the subsidiary, the subsidiary Board should carefully assess the implications, consider whether appropriate safeguards or compensating measures are needed, and ensure that the decision can be properly justified as being in the interests of the subsidiary.

In practice, good group governance requires a balanced approach: the subsidiary should be aligned with the group where this is appropriate, but the subsidiary Board must retain sufficient independence, information and authority to discharge its own duties. Group coordination is important, but it should not remove the responsibility of the subsidiary Board to exercise judgement in the interests of the subsidiary.

7.3

MAIN GROUP GOVERNANCE MODELS

Holding companies may choose different parenting strategies, ranging from a hands-off strategy, with no ambition to exercise central control over strategic or operating functions and with the business units managed as purely financial assets, to a hands-on strategy, in which the holding company becomes deeply involved in the management of the business units by influencing operating decisions at the level of the individual business. Different models may be applied to different subsidiaries, depending on the goals set. The four main models are compared in the table below.

Table 7.1 **Main group governance models** [31]

	INVESTMENT MANAGEMENT	STRATEGIC MANAGEMENT	ACTIVE MANAGEMENT	OPERATIONALLY INVOLVED MANAGEMENT
Description in simple words	"We just want to know your results"	"We want to know what you do"	"We want to know how you do it"	"We will work with you to do it"
Who we are	A holding company or head office	The strategic leadership of a collection of subsidiaries	Both consultants to, and the strategic leadership of, the subsidiaries	The key managers of all subsidiaries
Who creates value	Head office creates and enforces a disciplined management model; value is created by the individual subsidiaries closest to customers	Head office adds value in the linkages between subsidiaries; value is created by the individual subsidiaries closest to customers	Head office provides guidance to subsidiaries through its expertise; value is created by the subsidiaries using head office expertise	Head office makes the key decisions for subsidiaries; value is created by head office expertise and control

31 Adapted from Couto, V., Neilson, G. and Karlsson, P.-O. (2008), A Lean, Global Corporate Core: Putting Headquarters in Its Place, Booz & Company (now Strategy&, PwC).

	INVESTMENT MANAGEMENT	STRATEGIC MANAGEMENT	ACTIVE MANAGEMENT	OPERATIONALLY INVOLVED MANAGEMENT
Responsibility	Head office sets high financial goals; subsidiaries are fully accountable for achieving results. Subsidiaries commit to multi-year strategic plans; if these are met, no annual review is necessary	Head office sets key financial and operational metrics; subsidiaries are accountable for results. Subsidiaries commit to multi-year plans; head office ensures strategic coherence across subsidiaries and performs an annual review	Head office and subsidiaries share responsibility for a broad set of financial and operating metrics. Head office proactively reviews subsidiaries' strategic plans and annual budgets	Head office is responsible for financial and operating performance. Head office dictates subsidiaries' strategic plans and budgets
Centralisation of functions	Decentralised: core and support functions are separate in each subsidiary	Partially centralised: core and support functions are separate in each subsidiary, but central support functions at head office govern the overall synergy between subsidiaries	Centralised at head office: core functions remain in each subsidiary; support functions are at head office only	Centralised at head office: core and support functions are at head office only; the subsidiaries execute plans and daily tasks
Mechanisms of integration	None	Moderate	Extensive	Extensive
Appraisal of subsidiary performance	Based on achieving financial objectives	Based on achieving financial and strategic objectives	Based on achieving plans	Based on achieving tasks
Subsidiary incentives and remuneration	Based on the subsidiary's performance	Based on the subsidiary's performance, but also linked to head office	Based on overall group performance	Based on overall group performance

7.4
GROUP POLICIES

What policies are

Policies are usually high-level statements of the main principles according to which decisions are taken and activities are carried out within an organisation. In a group context, policies should clearly explain how the group is governed and how key functions are performed. At the same time, policies should not be overly detailed, as operational details are normally set out in other internal documents, such as procedures, manuals, instructions or guidelines.

Why policies matter

Group policies help to ensure consistency, transparency and discipline across the group. They also support a common governance framework, shared standards of conduct and more predictable decision-making. Well-designed group and company policies:

- drive strategic planning and help to set expectations and performance objectives;
- provide an understanding of the goals and culture of the company;
- engage and align the values of stakeholders;
- lead to more efficient internal operations, as there is no need to discuss how to handle an issue each time it arises, and streamline the induction of new staff;
- ensure accountability;
- create transparency;
- promote ethical and responsible decision-making;
- assess and mitigate risk.

What group policies cover

Group policies may include codes of conduct and ethics, as well as policies applicable to specific types of decisions, functions or areas of activity. Common examples are policies on the approvals framework and delegation of authority, contracts and commitments, investments, financial accounting, risk management, internal control, compliance, conflicts of interest, related party transactions, information management, human resources, sustainable development and, for listed entities, market disclosure and communications. Policies also commonly address culture, values and relationships between people within the organisation. An indicative list of policy topics is given in Annex 2.

Adopting group policies at subsidiary level

In a group of companies, holding companies often develop group-wide policies with the intention that they should apply across the whole group. However, the Board of each subsidiary should not adopt such policies automatically. Each subsidiary is a separate legal entity, and its Board must act in the best interests of that subsidiary, taking into account its own legal duties, business model, risk profile, regulatory environment, financial position, minority shareholders, creditors, employees and other relevant stakeholders.

Therefore, the Board of a subsidiary should review each group policy carefully before approving or implementing it at subsidiary level. The Board should consider whether the policy is appropriate for the subsidiary, whether it complies with applicable local law and regulation, whether it reflects the subsidiary's specific circumstances, and whether any amendments, exceptions or additional procedures are required. Where necessary, a group policy should be adapted to the needs of the subsidiary rather than adopted in identical form.

This does not mean that subsidiaries should ignore or unnecessarily depart from group standards: a coherent group policy framework is important for effective governance, risk management, compliance, internal control and reputation management. Group consistency should, however, be balanced with the subsidiary Board's independent responsibility to ensure that each policy is suitable for the subsidiary and supports its own interests and long-term sustainable success.

7.5

INTRA-GROUP TRANSACTIONS, FINANCING, MINORITY SHAREHOLDERS AND INFORMATION FLOWS

Companies in a group deal with each other constantly: they buy and sell goods and services, share support functions such as IT, finance, human resources or procurement, license brands and know-how, and provide guarantees. Each of these is a ***related party transaction*** (see sub-chapter 5.3.5). The subsidiary Board should satisfy itself that intra-group transactions are concluded on arm's length terms, that the allocation of shared-service costs is transparent and reflects the services actually received, and that the subsidiary is not made to bear costs or risks for the benefit of other group companies. Material intra-group transactions should be approved by the subsidiary Board, documented in written agreements and disclosed in accordance with the applicable accounting and, for listed companies, market rules. Transfer pricing rules add a tax dimension that neither Board should overlook.

Group financing arrangements, such as cash pooling, intra-group loans and guarantees and dividend policies set at group level, deserve particular attention. They are efficient for the group, but they can move liquidity and risk from one entity to another. The subsidiary Board should ensure that the subsidiary retains enough liquidity to meet its own obligations; that loans and guarantees provided to the holding company or to other group companies are on market terms, secured where appropriate and within the limits set by company law on capital maintenance and distributions; and that the subsidiary would not be put at risk if the holding company or another group company ran into financial difficulty.

Where a subsidiary has ***minority shareholders, the balance of interests*** becomes more delicate. Minority shareholders bear part of the subsidiary's risk but have no say in group decisions, so they are exposed to the holding company using its control to extract value, for instance through transactions on unfavourable terms, excessive management fees or the diversion of business opportunities to other group companies. The subsidiary Board should treat all shareholders equitably; Board members with a conflict of interest should abstain from decisions on transactions with the holding company; and independent Board members, the audit committee or an independent fairness opinion should be involved in material related party transactions. The company laws of the Baltic states give minority shareholders rights of information and of challenge, and listed companies are subject to the related party transaction rules described in sub-chapter 5.3.5.

Finally, the Board of the holding company can discharge its responsibility for governance across the group only if it ***receives adequate information from the subsidiaries***. The group governance framework should define what the subsidiaries report and how often: at a minimum, financial results against budget, key performance and risk indicators, compliance and whistleblowing matters, material litigation, major transactions and events, and the results of internal and external audits. Reporting should follow a consistent format across the group, subsidiary Boards should know what is reported upwards, and the holding company Board should in turn ensure that its own decisions and expectations reach the subsidiaries clearly and in good time. Regular meetings between the holding company's representatives and the subsidiary's Board and management complement the written reporting. In regulated sectors and in listed groups, the exchange of information within the group must also respect the rules on confidential and inside information and on data protection.

KEY TAKEAWAYS

A. A company group is a set of separate legal entities. The Board of the holding company is responsible for governance across the group and sets the framework that defines how the relationship with the subsidiaries is structured and managed.

B. Board members nominated by the holding company owe their duties to the subsidiary on whose Board they serve. Alignment with the group is usually in the subsidiary's interest, but the subsidiary Board must assess every group policy, transaction and decision from the subsidiary's own perspective.

C. The holding company can choose between four parenting models, from investment management to operationally involved management, and may apply different models to different subsidiaries. The choice determines how functions are centralised, how performance is appraised and how incentives are set.

D. Group policies bring consistency and discipline, but each subsidiary Board should review them, check their compliance with local law and adapt them where necessary before adopting them.

E. Intra-group transactions, shared services and group financing must be on fair terms, approved and documented; the subsidiary Board protects the subsidiary's liquidity and the equitable treatment of its minority shareholders, and the group governance framework defines what information the subsidiaries report to the holding company Board and how often.

QUESTIONS FOR THE BOARD

1. *Do we have a written group governance framework that sets out the roles of the holding company and the subsidiaries, the matters requiring the holding company's consent and the reporting lines?*
2. *Which parenting model do we apply to each subsidiary, and is it the right one for that subsidiary's business, risks and maturity?*
3. *Do the members we nominate to subsidiary Boards understand that their duty is to the subsidiary, and how do we handle situations where group and subsidiary interests differ?*
4. *Have all group policies been reviewed and formally adopted by each subsidiary Board, with any local adaptations recorded?*
5. *How do we ensure that intra-group transactions, financing and shared services are on fair terms and do not disadvantage a subsidiary or its minority shareholders?*
6. *Are internal audit and risk management organised group-wide, and does the Board of the holding company receive sufficient and timely information on the subsidiaries?*