JUNE 17, 2015

Leading-Edge Practices in Subsidiary Governance

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At a recent presentation at the Davies Academy for Continuing Professional Development, Davies partner Luis Sarabia and Davies affiliated scholar Poonam Puri discussed recent legal proceedings in which courts have been asked to hold parent companies directly liable in negligence for the actions of their subsidiaries. Read Parent Company Liability in Tort for the Actions of Foreign Subsidiaries.

These cases suggest that we may be entering a new era of corporate governance in which courts are more willing to look beyond the separate legal entity to hold parent companies liable in negligence for the conduct of subsidiaries. Factors that may be relevant in determining whether a Canadian parent company owes a duty of care to third parties for subsidiary conduct include the following:

- ownership and effective control of the subsidiary (for example, whether the subsidiary is wholly owned or not);
- the degree of control exercised by the parent over the situation giving rise to potential liability;
- assumptions of responsibility by the parent regarding the situation giving rise to potential liability;
- public representations by the parent regarding its relationship with its subsidiary;
- employment by the parent, rather than the subsidiary, of the individuals responsible for the subsidiary's activities;
- adoption of policies by the parent that apply to its subsidiary.

Against this backdrop, it is critical that parent and subsidiary corporations strategically develop leading-edge governance structures, policies and practices to address this new risk. Below we raise a number of key governance issues relevant to the parent-subsidiary relationship and potential parent company liability.

To whom do subsidiary board directors owe a fiduciary duty?

Under Canadian corporate law, directors of a subsidiary owe a fiduciary duty to act in the best interests of the subsidiary. This is despite the fact that nomination decisions are often made by the parent, and subsidiary directors may be officers and employees of the parent. Complex governance issues arise when the best interests of a subsidiary diverge from those of a parent – for example, when the subsidiary's stakeholders include not just the parent shareholder but also creditors and minority shareholders, if the subsidiary is not wholly owned by the parent. The interests of the subsidiary's creditors or minority shareholders may need to be considered – for example, in decisions relating to intercorporate transfer pricing arrangements or when one of the companies faces financial distress. In such situations, officers and directors of a subsidiary should take care to ensure that they clearly delineate and separate their duties and responsibilities in respect of the subsidiary and the parent. Further, corporate records and minutes should reflect that the subsidiary board turned its mind to the particular impact of a corporate transaction or contract on the subsidiary and was not merely subservient to the requests of the parent's board or the parent's advisers.

How is alignment with the parent company's strategic objectives achieved while maintaining the subsidiary's independence and autonomy?

A fine balance is required to achieve strategic and operational integration between a parent and its subsidiaries, while allowing subsidiaries to retain a sufficient level of autonomy and independence. Best practices may include a process whereby the subsidiary's

board approves its strategic plans, which then feed into the parent's strategic plan. Parent employees and advisers can provide advice to the subsidiary regarding various strategic alternatives, but the subsidiary board must approve any decision before it is entered into.

What factors should be considered when creating new subsidiaries?

There should be compelling reasons for creating a new subsidiary. Parent corporations should consider implementing a written policy and approval process governing the creation of new subsidiaries, including approval by a senior officer of the parent, where appropriate. Choice of jurisdiction for incorporation of a new subsidiary will be driven by business considerations, regulatory requirements and tax considerations.

What factors should be considered when nominating subsidiary directors?

Although external directors will be present on subsidiary boards when required by law or encouraged as a best practice, most subsidiary boards comprise management directors who are senior officers of the parent or another subsidiary. Best practices for major subsidiary boards may include the following:

- Consider setting up a structure and process to identify necessary skills, qualifications and competencies required of subsidiary board members.
- Consider separating the chair of the subsidiary board from the president of the subsidiary corporation. The chair may be a senior officer from another business line or geographic region.
- Similarly, consider appointing subsidiary board directors from other business lines or geographic regions rather than employees from the revenue-generating operations of the subsidiary itself.
- Consider appointing a majority of board members who are tax-resident in the jurisdiction where the subsidiary is incorporated or, if this is not feasible, appointing a majority of board members who are not tax-resident in Canada.

Interlocking or mirror boards may provide some efficiencies when a parent is a holding company and a subsidiary is an operating entity. However, directors who serve on both boards must be alert that lack of independence can be relevant to tax considerations, and can give rise to the potential for conflicts and increased risk of parent liability for the subsidiary's conduct.

How much direction and oversight should a parent corporation exercise over its subsidiaries?

A parent needs to assess and implement the appropriate level of oversight it should exercise over its subsidiaries. The following issues need to be considered.

- **Local versus enterprise-wide corporate policies:** Although enterprise-wide corporate policies implemented by a parent are designed to promote corporate coherence and operational efficiency, they may also accentuate legal risk. Subsidiaries should ensure that they independently evaluate and consider the impact of enterprise-wide policies on the subsidiary before adoption. Subsidiaries should have the latitude to make changes, as appropriate, to reflect their operational needs, and comply with the local jurisdiction's legal rules and local context. All implementation should be carried out by the subsidiary itself.
- **Centralized versus decentralized compliance, regulatory filings and record-keeping:** In large organizations, the logistics associated with overseeing a large number of subsidiaries can present a formidable challenge. Parents should evaluate the need for and extent of a centralized system for compliance, regulatory filings and record-keeping, in addition to any systems implemented at the subsidiary level. A centralized system allows a parent corporation to better monitor, evaluate and address trends and risks at the enterprise-wide level. However to minimize parent liability exposure, a centralized system should be for oversight purposes only. Subsidiaries should directly ensure compliance, such as through the implementation of an EHS audit and responding to any findings.

Where is the location of the mind and management of the subsidiary corporation?

A subsidiary will need to comply with residency requirements for directors under the jurisdiction's corporate law where it is incorporated. Local regulators often wish to see that the mind and management of the subsidiary is in the local jurisdiction and want to ensure that the subsidiary is making decisions in the local jurisdiction. In addition, for Canadian tax purposes, the residence of a corporation will generally be located where mind and management is exercised. This is typically where the board carries out its functions. However, if the facts suggest that a Canadian parent corporation is making the key decisions regarding its foreign subsidiary's business and the subsidiary board does not review and fully consider the parent's proposal, the subsidiary may be found to be resident in Canada for tax purposes. Board meetings by conference call and electronic meeting platforms may provide a certain level of efficiency, but may present challenges in respect of the mind and management tests. Best practices may include a corporate requirement that directors of subsidiaries personally attend most board meetings in the local jurisdiction and that full minutes be kept by the subsidiary board evidencing all of the factors that were considered in reaching a particular decision.

The needs of each organization will be different and counsel can be consulted to assist in designing the best approach in any given situation.

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