ICGN Viewpoint

Duties of Boards in Company Groups

October 2020

To "take one for the team" is an expression originating in baseball - a sport somehow still popular among certain demographics in North America, the Caribbean, Japan, Korea and Taiwan. The team's manager directs a batter to lean into the arc of the pitch with the objective of getting hit by the ball. A hit batter is awarded a free trip to first base, allowing those that follow a chance to advance the batter along the basepath and hopefully to score a run. Taking one for the team can involve considerable pain. Pitchers today routinely hurl the ball at speeds approaching 100 mph (160 kph).

A corporate group can be described as a team of related companies. A particular company in the group may on occasion be called upon by the group's leadership to make a painful sacrifice in the hopes of advancing the interests of the group as a whole. If, when and how the directors of a company that is part of a group can allow it to "take one for the team" is the central subject of a recent OECD report on the duties and responsibilities of boards in company groups [1], written by ICGN member and Education Programme Advisor Mike Lubrano. This is a topic of great relevance to ICGN members, particularly for investors with holdings in company groups or their individual group companies, and poses a range of key governance questions.

The study is descriptive rather than prescriptive. It narrowly-focuses on the legal responsibilities of directors and only tangentially references other sources of protection for minority shareholders of group companies. Forty-five jurisdictions, including both advanced and emerging markets, were surveyed to collect information on the legal framework, practices and experiences around the fiduciary duties of boards in company group situations. Four country studies contributed by the securities supervisors of Colombia, Korea, India and Israel are included as annexes to inform the work of the OECD Committee on Corporate Governance. The OECD report is just the latest output of OECD's on-going research in this area, work that is expected to continue to be among the main issues of focus of the OECD Committee on Corporate Governance.

[1] OECD, "Duties and Responsibilities of Boards in Company Groups", (May 2020). https://www.oecd.org/publications/duties-and-responsibilities-of-boards-in-company-groups-859ec8fe-en.htm.

Prevalence of Company Groups

Company groups are a significant part of the listed-company landscape in many developed and emerging markets. The OECD's 2019 study on owners of the world's largest companies[2] traced ownership of almost 8,000 large listed companies in 29 jurisdictions and identified 2,510 (33%) with have another corporation as their largest shareholder. This probably understates the prevalence of company groups, as many are held together not through parent-subsidiary relationships but rather by common controlling interests (often families or the state). More than half of listed companies in Argentina, Chile, India, Indonesia, Israel, Korea, Malaysia and Turkey had another company as their largest shareholder. Company groups are, of course, not limited to developing country markets. Forty-three percent of companies in France were controlled by other corporations, with an average holding of 50% of the equity capital.

Benefits and Challenges

Investors should not view company groups as intrinsically suspect. There are plenty of good reasons for business to be carried out by legally-independent and separately-listed entities under common control, "including scale economies, efficiencies in resource allocation, reduced dependence on external finance, fewer informational asymmetries, lower transaction costs and less reliance on contract enforcement".[3] Conducting business through related companies can also help protect intellectual property rights and allow more extensive cross-border activity.

At the same time, company groups by their nature present challenges for the fair treatment of minority shareholders. The groups may engage in frequent and material related-party transactions; indeed these may be hard-wired to their business models. The same trademarks and brand names may grace the products of multiple group companies. Parents and subsidiaries in a groups may engage in mutual support, such as providing cross-guarantees, shared cash management facilities and pooled service arrangements. And where the markets and product scope of group companies overlap, allocation of business opportunities within the group may have very important consequences for the relative health and profitability of particular firms (and their discrete investors). While association with a group can provide its constituent companies with important branding benefits, it at the same time exposes them to potential reputational risks arising from misbehaviour by other group companies, including compliance, anti-corruption and environmental, social and governance (ESG) failures.

Beyond the scope of this Viewpoint there is also a macro dimension to the potential abuses of company groups which can include slower development of broader and deeper capital markets; reduced competition in product and service markets; and adverse political and social impact of concentration of economic power. These issues have been explored in academic literature.[4]

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[2] De La Cruz, A., A. Medina and Y. Tang, "Owners of the World's Listed Companies", OECD Capital Market Series, Paris (2019). www.oecd.org/corporate/Owners-of-the-Worlds-Listed-Companies.htm.
[3] OECD, op. cit. pg. 7.
[4] For example, see Hamdani, Kosenko and Yafeh, "Regulatory Measures to Dismantle Pyramidal Business Groups: Evidence from the United States, Japan, Korea and Israel", Working Paper No. 542/2020, ECGI Working Paper Series in Law, September 2020.

Divergent impact of the Covid-19 pandemic.

The current global health crisis would seem to make OECD's work on the role of boards in company groups particularly timely. While Covid-19 has come as a blow to most sectors, it is now increasingly clear that its negative impact is certain to be much more severe for some industries than others. Groups whose constituent companies are in different industries, business segments or geographies are likely to find that some are better able to weather the Covid storm than others. In such cases, the temptation will be considerable to lean on the strong companies to help their more delicate siblings, through various tactics which can include pricing of related party transactions, inter-company financing, pooling of resources, allocation of business opportunities and other means. Directors who, consistent with Principle VI.A of the G20/OECD Principles of Corporate Governance, should owe fiduciary duties to the company on whose board they serve, will be pressed to "take one for the team" this time, in the interests of the overall success of the group.

Frameworks for Group Company Board Duties

The OECD report divides the existing legal frameworks into three groups – classic fiduciary duty, special frameworks for groups, and mixed approaches (including self-regulatory efforts) that attempt to reconcile the classic approach to the realities of groups without creating an explicitly separate legal framework.

The "black letter" law of jurisdictions that follow the classic fiduciary duty approach (35 of those surveyed, including practically all countries of the Anglo-Saxon legal tradition along with many common-law jurisdictions) requires directors to take into account the interests of only the company on whose board they sit. No "group interest" exception is permitted - directors of group companies may not simply rubber stamp decisions taken by the group's leadership. In jurisdictions that also incorporate some form of business judgment rule, there is probably some room for directors to balance current sacrifices against potential future benefits to its company from the group, but the scope is generally limited.

Continental Europe provides an alternative approach. Germany's *Konzernrecht* model of company group governance, along with Italy's legal framework for the protection of minority investors in companies whose businesses are under common direction and coordination, are two examples of legal frameworks that address company groups. They effectively define company groups and then provide procedures for boards to follow in deciding if, when and how to approve actions that at least in the short run involve an individual group company sacrificing for the benefit of the group as a whole.

The German model requires the board to provide a careful accounting of the costs to the company of "taking one for the team" and arrange for timely compensation from the group (usually in the same fiscal year). Italy's approach focuses on *ex ante* and *ex post* transparency, and also has implications for board structure and composition, including the requirement that risk and control committees (along with any other discretionary board committees) of companies under a group's common direction and control be composed exclusively of independent directors.

Finally, the OECD study notes important voluntary efforts to encourage boards to set expectations around the behaviour of group companies. The corporate governance codes of both Colombia and Spain make explicit reference to company groups and acknowledge the special challenges they face with respect to equitable treatment of shareholders within the group. It notes that Spain's code recommends that to safeguard the interests of the stakeholders in all group companies, the group should draw up and publish a protocol that: (1) clearly demarcates the areas of activity of each company in the group; and (2) creates a framework of rules to prevent possible conflicts. Boards of all companies in the group should frame their decision-making around group issues in accordance with such protocol.

Similarly, the corporate governance code of Colombia (one of the countries that contributed an annex to the study) recommends that group companies adopt policies implemented with respect for the balance between the interests of the group and its members. Shareholders and other stakeholders of companies that adopt well-articulated protocols and policies along the lines of those recommended in Spain and Colombia can set expectations accordingly and directors can explicitly refer to such protocols and policies in explaining the rationale for their decisions around proposed actions motivated by group concerns.

What Investors Should be Looking For

The OECD study does not take positions on whether some countries have a better framework than others for ensuring that directors of companies in groups properly carry out their fiduciary duties. Clearly, the appropriateness of a particular framework depends on a number of local factors, including prevailing group structures, industry considerations, market characteristics, legal tradition, robustness of public and private infrastructure and the effectiveness of oversight and enforcement. And regardless of the prevailing legal framework, minority investors in group companies would be unwise to rely only on the fiduciary duties of boards to ensure their fair treatment. Other mechanisms, including but not limited to minority shareholder approval of certain types of transactions and potential liability of controllers for approval of actions that are not in the interests of the company, may offer more effective protection in many markets.

From a minority investor's perspective, the clearest and simplest framework for fiduciary duties of boards in company groups is the "no group interest exception" in which the director's duty is exclusively to the company on whose board he or she sits. But recognising the realities in markets in which group ownership is common, an effective legal framework for the exercise of fiduciary duties of boards in group companies should require boards to take into account the principles common to the German and Italian models, as well as the Colombian and Spanish codes. These responsibilities include:

- Comprehensive disclosure of group structures, including the identity of all group companies and all forms of common controlling interests and cross-holdings;
- *ex ante* transparency about the role of the company within the group;
- accurate measurement and disclosure of costs associated with decisions taken in consideration of group interests;
- clear explanation of compensation, transparency and board independence;
- disclosed policy on allocation of business opportunities; and
- procedures for managing conflicts of interest.

In engaging with companies that have group affiliations, investors can raise these points to the company and its board. Regardless of legal requirements, investors should insist that boards of companies in groups be as explicit as possible about the benefits and potential costs of being part of the group, and that their boards measure the costs and benefits of actions motivated by group concerns, providing shareholders with as precise as possible an accounting. Finally, investors should encourage company groups to set expectations by publishing group policies anticipating the kinds of conflicts that are likely to arise and explaining how their boards will go about resolving them, including the role of independent directors.

About ICGN Viewpoints

While not defining a formal ICGN position on the subject, ICGN Viewpoints provide opinion on emerging corporate governance issues and are intended to inform and generate debate.
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