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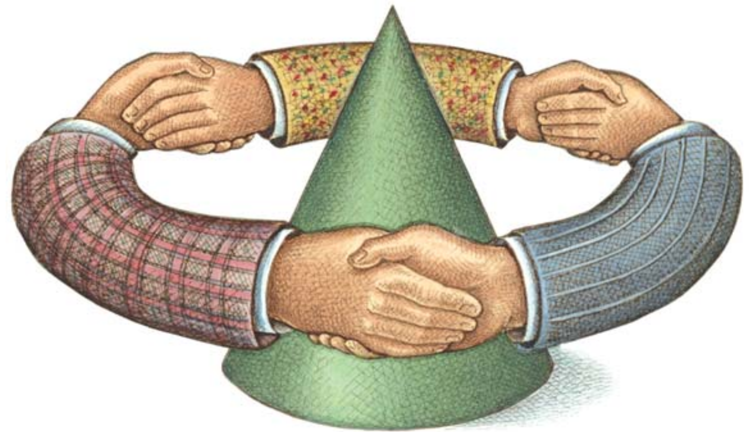
CORPORATE GOVERNANCE

When Parent and Subsidiary Are Public

Overlapping responsibilities require coordination.



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BY JEFFREY W. RUBIN

A NUMBER of U.S. publicly traded companies are "controlled companies." A controlled company is an entity of which more than 50 percent of the voting power is held by an individual, a group or another company (the parent).[1] Although in most situations the parent of a controlled company is an individual or a non-public entity, in some instances controlled companies are, or may become, controlled by a public parent. A multi-tiered corporate structure where one or more subsidiaries of a public parent is also a public company presents a complicated series of governance issues, at both the parent and subsidiary levels. This article will review certain of these considerations, and will focus in particular on the obligations imposed by securities law requirements and securities exchange rules.

Corporate structures involving the control of a public subsidiary by a public parent may arise through a variety of means, including carve-outs, in which a parent or its controlled subsidiary sells a minority equity interest in the subsidiary by means of a public offering, and acquisitions in which a public company acquires, directly or indirectly, a majority interest in another public company that remains public immediately following the acquisition. Although the potential for conflicts in the discharge of fiduciary duties exists in any controlled company structure, certain issues are more pronounced when both the parent and one or more of its subsidiaries are public.[2]

Even though a parent and its subsidiaries may have numerous intercompany business relationships, under state corporate law a parent's control of its subsidiary is manifested by the parent's ability to approve the articles of incorporation and bylaws of the subsidiary, to elect directors to the subsidiary's board of directors, and to vote on other matters submitted to a vote (or consent) of shareholders. Even though the parent may have a significant interest in the management and operations of the subsidiary, the directors of the subsidiary owe their fiduciary obligations to all the subsidiary's shareholders, and not merely to the parent.[3]

Unique Governance Issues

The governance reforms of the past few years, especially those implemented pursuant to the Sarbanes-Oxley Act of 2002[4] (SOX) and by the principal national securities exchanges, reflected the view that corporate fraud and abuse can be reduced by, among other things, enhancing the role of directors independent from management.[5] As a result of these changes, a listed company[6] is, in general, required to have a board of directors consisting of a majority of independent directors,[7] and an audit, compensation and nominating committee comprised exclusively of independent directors.[8]

Because the imposition of certain of these governance requirements could prevent a parent from being able to manage its controlled subsidiaries, the principal securities exchanges have permitted "controlled companies" to elect to be exempt from the requirement that a majority of the board consist of independent directors, and from the nominating committee and compensation committee requirements.[9]

Notwithstanding the controlled company exemptions, in certain situations the corporate concept of entity integrity becomes a bit blurred against the backdrop of a public company's governance obligations. None of these situations presents an insurmountable obstacle to governing a public company in compliance with state corporate law, federal securities law, and stock exchange requirements, but these situations do

Jeffrey W. Rubin *is a partner with Hogan & Hartson's New York office.*

require some sensitivity to the issues involved. Indeed, an appropriate response to these issues by both the parent and the controlled subsidiary would be to identify the areas of overlap and to encourage communication and coordination between the parent and the subsidiary to avoid unanticipated issues. Although some of these issues are conceptual, an understanding of their scope may assist in anticipating, responding to and resolving any real world issues.

Among the areas where overlap of responsibilities exists in a public parent-public subsidiary relationship are audit committees, attorney reporting-up requirements, executive compensation and SEC disclosure.

Audit Committees

Pursuant to Rule 10A-3(b)(2) under the Securities Exchange Act of 1934 (the Exchange Act), the audit committee of each listed issuer "must be directly responsible for the appointment, compensation, retention and oversight of the work of any public accounting firm engaged (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed issuer, and each such registered public accounting firm must report directly to the audit committee." In the case of a listed parent and listed subsidiary, two audit committees would exist, each comprised solely of independent directors,[10] and each vested with its own set of responsibilities. In this instance, coordination between the two audit committees would be appropriate in order to avoid problems or inefficiencies in a number of areas:

(a) The selection of auditors. The selection of auditors by the parent or the subsidiary could affect the selection by the other, especially if the subsidiary represents a material portion of the parent's assets or operations.

(b) The resolution of disagreements between the auditors and management regarding financial reporting. Pursuant to Rule 10A-3 under the Exchange Act, the audit committees of the subsidiary and the parent may each be involved in the resolution of disputes involving the subsidiary.

(c) Audit committee investigations of allegations of financial impropriety and the consequences of any such investigations. Both audit committees may share responsibility for such matters involving the subsidiary.

(d) The receipt, retention, and treatment of complaints received by each listed issuer regarding accounting, internal accounting controls, or auditing matters, and the confidential and anonymous submission by employees of the listed issuer of concerns regarding questionable accounting or auditing matters. Both auditing committees may have responsibility for such matters.[11]

In these situations, each of the audit committees will need to satisfy itself that it has appropriately discharged its responsibilities.

> In each situation where a public company controls a public subsidiary, there exists a need for the board and management of each company to understand the roles and responsibilities of the board and management of the other.

Because matters affecting one entity may also affect the other, it would be prudent for the entities to agree to a protocol for the disclosure to the audit committee of the parent of matters brought to the attention of the subsidiary, and for the disclosure to the audit committee of the subsidiary of matters brought to the attention of the parent that may involve or relate to the subsidiary.

Attorney 'Reporting Up'

Another example of overlapping responsibility is the obligation, under the SEC's attorney conduct rules,[12] for an attorney appearing and practicing before the SEC to report evidence of material violations and to take certain other actions. In many situations, an attorney within the scope of the rules may be appearing and practicing on behalf of both the parent and the subsidiary.

The attorney's obligation in the event the attorney has information that would constitute evidence of a material violation applicable to both the parent and subsidiary would appear to require the attorney to communicate such information in the manner prescribed at both the parent and the subsidiary levels, and to follow up based on the responses at each such level. In addition, at each of the parent and the subsidiary levels, the receipt of a report from an attorney would require the recipient to investigate and respond to the report. There is nothing in the rules that would prevent an investigation and response to be effected on a coordinated basis, assuming both entities agree with the substance of the response.

Executive Compensation

As discussed above, under securities exchange listing rules, the compensation committee of a listed company (or in some instances the independent directors) is required to approve the compensation of the chief executive officer and to review the compensation of the other executive officers. Although under the controlled company exception, a controlled subsidiary is not required to have a compensation committee, any determinations by a subsidiary to compensate a person who is an executive officer of the parent (whether or not such person is also an executive officer of the subsidiary), may conflict with the designated responsibility of the parent company's compensation committee.[13]

In addition, a determination by the subsidiary to compensate (in any respect) a director of the parent or a relative of the director, or to do business with an entity in which the director has a substantial interest, may affect the status of the director as an independent director of the parent. Accordingly, it would be prudent for a subsidiary to refrain from compensating, or entering into a business relationship with, any director or executive officer of the parent without first considering the implications of such a transaction to the parent.

SEC Disclosure

There are significant benefits to the

coordination of public disclosure by a public parent and public subsidiary. Some of these, such as coordinated business descriptions in annual reports and the MD&A disclosure relating to the subsidiary's operations, help to avoid investor confusion and to promote transparency. Other disclosures, such as executive compensation at the subsidiary level, may directly affect parent company disclosure. Although a full discussion of the coordination of parent-subsidiary disclosures is beyond the scope of this article, it is critical that in the area of Form 8-K disclosure, public parents and public subsidiaries implement communications and response procedures to assure that neither entity will fail to satisfy its disclosure obligations. While Form 8-K reporting procedures are important within any corporate structure, the dual reporting obligations in a public parent/public subsidiary situation, together with the existence of compliance personnel at two levels, may increase the need for sensitivity.

In 2004, the SEC amended Form 8-K to add additional matters triggering filing requirements and in many instances to reduce the filing deadline to four business days after the event reported.[14] Although a number of items refer to events involving the registrant, the staff of the SEC has made clear that it interprets this requirement to include triggering events occurring at the subsidiary level.[15] Although the relevant materiality standards may differ at the parent and subsidiary levels, in view of the short filing deadlines applicable to many Form 8-K items, it is important that a procedure be in place to assure that any event giving rise to a Form 8-K analysis at the subsidiary level also be reviewed at the parent company level.[16]

Conclusion

In each situation where a public company controls a public subsidiary, there exists a need for the board and management of each company to understand the roles and responsibilities of the board and management of the other, and, consistent with corporate law obligations, to coordinate their activities in order to avoid conflict and unnecessary duplication or expense. The existence of two listing and reporting obligations, and two public shareholder constituencies, imposes greater obligations on managements and boards to be sensitive to this overlap of responsibilities.

1. This is the New York Stock Exchange definition. See Note 9, infra.

2. This article is not intended to address the governance issues inherent in every parent-subsidiary structure, such as the duty of loyalty (including the treatment of corporate opportunities and conflicts of interest) and duties relating to both disclosure and confidentiality.

3. "As the overarching consideration bearing on all that directors do, a director must keep in mind, throughout activities undertaken on behalf of the corporation, that the director is representative of all of the shareholders." ABA Corporate Director's Guidebook (Fourth Edition, 2004), Section 3(I).

4. Pub. L. No. 107-204, 116 Stat. 745.

5. See, for example, "Corporate Governance: The View From NASDAQ" by Michael S. Emen, Senior Vice President, NASDAQ Listing qualifications.

6. By "listed company," we refer to companies having a class of equity security listed on a national securities exchange, such as the New York Stock Exchange or NASDAQ. A national securities exchange is an exchange registered pursuant to §6 of the Securities Exchange Act of 1934 (the Exchange Act).

7. See, for example, §303A.01 of the New York Stock Exchange Listed Company Manual (NYSE Manual) and Rule 4350(c)(1) of the NASDAQ Marketplace Rules (Nasdaq Rules).

8. With respect to audit committees, see Rule 10A-3(b)(1) of the Exchange Act, §303A.06 of the NYSE Manual and Rule 4350(d)(2) of the Nasdaq Rules. With respect to compensation committees, see, for example, §303A.05 of the NYSE Manual and Rule 4350(c)(3) of the Nasdaq Rules. Nasdaq also permits compensation of executive officers to be determined by a majority of independent directors. With respect to nominating committees, see, for example, §303A.04 of the NYSE Manual and Rule 4350(c)(4) of the Marketplace Rules. Nasdaq also permits director nominees to be selected, or recommended for the board's selection, by a majority of independent directors.

9. See, for example, §303A.00 of the NYSE Manual and Rule 4350(c)(5) of the Nasdaq Rules. Section 303A.00 provides, in part, that "A listed company of which more than 50% of the voting power is held by an individual, a group or another company need not comply with the requirements of Sections 303A.01, 303A.04 or 303A.05. A controlled company that chooses to take advantage of any or all of these exemptions must disclose that choice, that it is a controlled company and the basis for the determination in its annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC. Controlled companies must comply with the remaining provisions of Section 303A." Nasdaq Rule 4360(c)(5) provides: "A Controlled Company is exempt from the requirements of this Rule 4350(c), except for the requirements of subsection (c)(2) which pertain to executive sessions of independent directors. A Controlled Company is a company of which more than 50% of the voting power is held by an individual, a group or another company. A Controlled Company relying upon this exemption must disclose in its annual meeting proxy statement (or, if the issuer does not file a proxy, in its Form 10-K or Form 20-F) that it is a Controlled Company and the basis for that determination." The controlled company exceptions were appropriate for a number of reasons. If listed controlled companies were required to have a majority of independent directors, the parent would effectively be prevented from controlling its own subsidiary. Similarly, a nominating committee of a controlled company would not have a meaningful role if a parent could, by its vote, elect the members of the board of the controlled company. The function of an independent compensation committee of a controlled company could also interfere with the ability of a parent to determine compensation based on services within the group. A listed company that does not elect to avail itself of these controlled company exceptions is permitted, though, to comply with the general governance rules. The audit committee requirements, and certain other requirements (such as the obligation of the independent directors of Nasdaq-listed companies to meet in executive session) apply notwithstanding controlled company status.

10. Under the SEC's definition of independence, a representative of the parent would not be eligible to serve on the subsidiary's audit committee. Rule 10A-3(b)(1)(ii) provides that in order to be considered independent for purposes of the audit committee requirement, a member of an audit committee may not, among other things, be an affiliated person of the issuer or any subsidiary thereof. An affiliate is defined in Rule 10A-3(e)(1). Although the rule contains certain exceptions, and a safe harbor if a person is not the beneficial owner, directly or indirectly, of more than 10 percent of any class of voting equity securities of the specified person, it is clear from the rule that a parent entity beneficially owning, directly or indirectly, over 50 percent of the voting equity securities of a controlled company, as well as its executive officers and directors who are employees of an affiliate, are within the definition of affiliates.

11. Rule 10A-3(b)(3).

12. 17 C.F.R. §205.1 et seq.

13. Many of these issues may also apply in the case of a foreign subsidiary. A foreign Company Act or stock exchange rule may require the management of the subsidiary to be independent from the controlling shareholder.

14. See http://www.sec.gov/rules/final/33-8400.htm.

15. http://www.sec.gov/divisions/corpfin/form8kfaq.htm. Question 2 to the SEC's FAQs provides as follows: "Q: Some Items of amended Form 8-K are triggered by the specified event occurring in relation to the "registrant" (such as Items 1.01, 1.02, 2.03, 2.04). Others refer also to majority-owned subsidiaries (such as Item 2.01). Should registrants interpret all Form 8-K Items as applying the triggering event to the registrant and subsidiaries, other than Items that obviously apply only at the registrant level, such as changes in directors and principal officers? A: Yes. Triggering events apply to registrants and subsidiaries. For example, entry by a subsidiary into a non-ordinary course definitive agreement that is material to the registrant is reportable under Item 1.01. Termination of such an agreement is reportable under Item 1.02. Similarly, Item 2.03 disclosure is triggered by definitive obligations or off-balance sheet arrangements of the registrant and/or its subsidiaries that are material to the registrant."

16. It is possible that a matter may be material at the parent level even though not material at the subsidiary level, such as where the subsidiary's financial condition is significantly better than that of the parent, or where the termination of a contract by a customer of the subsidiary would not be material to the subsidiary but, by reason of other relationships with the customer at the parent level, would be material to the parent.

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