Institut Luxembourgeois
des Administrateurs

Group interest and subsidiary governance in Luxembourg

A contribution of ILA
to the business community at
the occasion of the 10th anniversary of ILA

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RECOMMENDATIONS

Whilst reasonable care has been taken in compiling this report, ILA and the individual contributors do not accept any responsibility for the completeness or accuracy of its contents, in view of the constant changes in legislation, regulations and practice. Readers should take their own professional advice in order to clarify which laws, regulations and practices apply to their individual circumstances.

FOREWORD

The Institut Luxembourgeois des Administrateurs « ILA » was created in 2005.

Over the last 10 years the working committees of ILA carried out in-depth studies and developed a wide range of publications and reference documents for directors, both linked to their sector of activity or on subjects relating to governance questions for all types of companies or directors.

Luxembourg, as we know, is the home to a multitude of subsidiaries originating from multiple countries, multiple groups, influenced by multiple regulations and governance frameworks.

In this context, the role and responsibilities of subsidiary boards are a topic of consideration in the broad business community. Should subsidiary boards be more like standalone company boards, should they focus more on strategy, should they have independent directors, is there one model which could fit all Luxembourg-based companies ?

But overiding all these concerns, a more fundamental question relates to the conflict situation between the interest of the group and the interest of the subsidiary itself.

As we are celebrating the 10th anniversary of our Institute, the executive committee of ILA initiated a study on the role of subsidiary boards in the context of group interest. This study has been conducted by a working group with the input of experienced board members of major Luxembourg-based subsidiaries. The outcome of their work is outlined in this report together with some recommendations which could be considered by both the group boards and the board of their subsidiaries.

This report and recommendations are not intended to be a comprehensive evaluation of the issue but merely a contribution to the Luxembourg business community with a view to promote best practices in the field of Corporate governance in Luxembourg.

In the name of ILA I would like to thank all the contributors to the ILA work over the last 10 years and particularly the working group and the contributors to this report.

Marie-Jeanne Chèvremont
Chairman ILA

June 2015

The mission of ILA is to promote the profession of Directors by developing its members into highly qualified, effective and respected Directors. In parallel, it will promote best practices in Luxembourg in the field of Corporate Governance of companies and institutions by actively engaging with and contributing to those institutions and trade associations charged with the introduction, application and oversight of those Corporate Governance rules and practices. It will achieve this through high quality training, forum discussion, research, publications and conferences.

ILA aims to be not only the premier interlocutor in Luxembourg on issues affecting Directors but also to play an important role at the European level.

INTRODUCTION

This report of the Luxembourg Institute of Directors (*Institut Luxembourgeois des administrateurs or ILA*) aims at providing a support to managers or directors of Luxembourg companies, subsidiaries and parents, in the financial or in the non financial sectors, about their duties when the company they direct is a member of a group, in particular in situations of conflict of interest.

This report is based on extensive interviews with practitioners, directors and experts organised in the form of round-table discussions and interviews (the Sessions). It takes into account the specificities of Luxembourg companies and the financial centre. The participants of the Sessions are business leaders, company directors (executives from within a group and non-executive independent directors), services providers from the legal and accounting profession and company administrators (*domiciliataires*). The participants were offered to freely speak on their personal experiences and on the practices/standards applied in the group of companies and sectors they have served or still serve. The open and constructive discussions form the prime basis of this report.

This report and its conclusions are also a way to inform stakeholders outside Luxembourg what is considered to be a reasonable interpretation of the concept of the interest of the group. At the same time, it is also a contribution to the European debate on what can be the "interest of the group".

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LEGAL FRAMEWORK

As stated by the report of the Think Tank on the Future of EU Company Law of 2011 « The international group of companies – not the single company – has become *the* prevailing form of European large-sized enterprises, which business activity is typically organised and conducted through a network of individual subsidiaries located in several States inside and outside Europe. The group management is the heart of this leading business organisation: the main reason for its success consists in the sophisticated and flexible management issuing from the optimal combination of central control exercised by the parent and local autonomy granted to subsidiaries. No successful regulation could ignore this central feature.[1]» A group is an entity comprising a parent company and all its national and foreign subsidiaries or entities. There is no group when companies are held at the top by one natural person. A subsidiary is any company which is controlled, directly or indirectly, by the parent company according to either accounting or company law rules. The group has no legal personality but is economically a single entity.

The reality of the group is especially important for Luxembourg because the country, located at the heart of Europe, has a large and interconnected financial sector composed mostly of subsidiaries of other Member States or countries outside the Europe Union (EU). Luxembourg also has a large number of industrial companies whose geographical activities are not limited to Luxembourg but are European and international.

Despite Luxembourg's strong integration in the European and the world economy, legislation in Luxembourg has not kept pace with the reality of groups of companies. Luxembourg companies are primarily governed by the Law of 10 August 1915 on commercial companies, as amended (the 1915 Act), and certain provisions of the Civil code relating to companies. Article 1833 of the Civil code states that a company is to be run in the "common interest of the parties" to the contract (e.g. the shareholders). Luxembourg case law adopts a wider approach on what the "common interest of the parties" should mean and holds that this should be the "corporate interest" (*intérêt social*) of the company and not just that of the shareholders (stakeholder approach). However, the academic literature insists on the importance of the interest of the shareholders in the different interests to be taken into account in the light of Luxembourg's longstanding liberal approach.

According to both the Civil code and the 1915 Act, the "corporate interest" of the company is to be analysed at the level of the company. Each company within a group constitutes a separate legal person so that, in principle, each "corporate interest" should be considered on a standalone basis. This rigid approach is neither realistic nor desirable as companies which belong to a group, especially when they are 100 % owned, behave necessarily in a different manner from companies not part of a group.

[1] Report of the Think Tank on the Future of EU Company Law of 2011, p. 59. The report of the Think Tank is available at: http://ec.europa.eu/internal_market/company/modern/

Despite the reality of the group, the Luxembourg Civil code and the 1915 Act do not recognize explicitly that alongside the social interest of the single company the interest of the group to which this company belongs should be taken into account. Case law, however, takes into account this reality: Luxembourg courts recognized that the "interest of the group" can be taken into account by the directors of a subsidiary when taking a decision. This approach reflects the so-called 1985 *Rozenblum* case law which has been developed in France and which has also been accepted in Belgium. Belgium and, to a lesser extent, France have traditionally been the source of inspiration for Luxembourg company law.

In its 1985 *Rozenblum* decision the French Supreme Court (*Cour de cassation*) recognized the interest of the group.[2] As a consequence, the directors of a subsidiary may take into consideration the interest of the group when making a decision that prejudices the subsidiary, provided several conditions are satisfied. These conditions are restrictive and rather vague because the *Rozenblum* test constitutes a protection against the criminal provision of abuse of corporate assets (*abus de biens sociaux*).[3] However, the *Rozenblum* test also applies to civil liability of directors.

First, there must be a group characterized by capital (equity) links between the companies. This condition eliminates personal groups. Private equity groups and LBOs are also excluded from such protection in France due to an increased risk of abuse. Second, there must be a business integration among the companies within the group allowing for a coherent group policy and a common interest. The common corporate interest can be economic, social or financial. The common strategy should be transparent and not be limited to circumstantial operations motivated by the needs of the moment. Within very small groups, it is usually not accepted by courts that different companies can have the same activity because it looks like an artificially-organised single company and not a group. Identical activities are accepted in larger groups. Third, financial support from one company to another company must have an economic *quid pro quo* and may not break the balance of mutual commitments between the concerned companies. Therefore, there is a need for some compensation which can be a non-monetary compensation and also represent some future compensation. Fourth, the support from the company must not exceed its possibilities. It should not create a risk of bankruptcy for either company.

Although the *Rozenblum* case law is very useful because it recognizes the interest of the group, its application is rather complex and its wording is vague. In practice, directors are well protected as long as the company stays clear from bankruptcy. However, there is uncertainty about what is and what is not acceptable within a group. The issue has become more problematic with the increase of economic integration in the single market. Therefore, it is of great interest for Luxembourg and other EU countries which hosts many subsidiaries to have a doctrine about what is permitted under the interest of the group theory.

Several academics groups have proposed a coherent regulation of groups in the EU Member States. In the late 1990's, the "Forum Europaeum on Group Law", a group of leading company law academics, elaborated a draft directive for a European regulation of groups based on some standards and rules entitled "The Corporate Group Law Principles and Proposals" (1998).[4] More recently, in 2007, at the initiative of Professors Paul Krüger Andersen and Theodor Baums, a group of academics was

[2] See Trib. Corr. Paris, 16 May 1974, Soc. Saint-Frères, D. 1975, p. 37, Rev. soc. 1975, p. 657, n. B. Oppetit, JCP éd. E. 1075, II-11816, p; 381; Court of cassation, Criminal Chamber, 4 February 1985, Rozenblum and Allouche, D. 1985, p. 478, n. D. Ohl, I-639, JCP 1986, II-20585, n. W. Jeandidier, Rev. soc. 1985, p. 648, n. B. Bouloc.
[3] Article L. 242-6 French Commerce code; by analogy article 495 Luxembourg Commerce code.
[4] See. European Business Organization Law Review (EBOR), 2000, p.165; "Corporate Group Law for Europe", Forum Europaeum Konzernrecht, Stockholm (Corporate Governance Forum) 2000.

established to work on a European Model Companies Act (EMCA).[5] The EMCA is directed at Member States and includes a specific chapter on groups that was influenced by the Rozenblum approach. The chapter was published in October 2013. Another working group of academics led by Professor Marcus Lutter, the Forum Europaeum on Company Groups, which includes former members of the Forum Europaeum on Group Law, was established in 2009 and published in 2015 a proposal on the regulation of groups at the European level.[6] However, these proposals do not detail what type of transactions should be acceptable. A French Think-Tank also published in 2015 a report on the recognition of the interest of the group at the European level.[7]

At the European level, the problem of the recognition of the interest of the group was mentioned in the report of the Think Tank on the Future of EU Company Law of 2011. Following a positive consultation in 2012, the Commission mentioned in its December 2012 Action Plan that it would take an initiative in 2014 on « Improving the information available on groups and the recognition of the concept of 'group interest' »

Managers and directors of Luxembourg subsidiaries receive regularly instructions from the parent company on how to act. There is therefore a need for them to have clarity about whether they fulfil their duties by implementing instructions even if these are not legally binding.

To date no standard exists on how to address conflicts arisen between the conflicting interests within a group of companies. In addition there is little guidance on standards on subsidiary governance practices.

While it appears presumptuous to envisage a perfect system, possibly based on a "one-model-fits-all" approach, the analysis and description of the issues which decision-makers are on a day-to-day basis confronted with could serve as a useful tool for a better perception and problem solution of the issues that are at stake.

[5] See http://law.au.dk/emca/

[6] Forum Europaeum Company Groups, Proposal to facilitate the management of cross-border company groups in Europe European Company and Financial Law Review (ECFR), n°2/2015 (to be published)

[7] Report «Vers une reconnaissance de l'intérêt de groupe dans l'Union européenne ?», Club des Juristes, étude réalisée en liaison avec des experts (juristes de la CCI Paris Ile-de-France, représentants d'organisations patronales, directeurs juridiques, professeurs étrangers), 2015. (to be published)

01 THE IMPORTANCE OF ANTICIPATING AND MANAGING CONFLICTS OF INTEREST

The Sessions revealed a large consensus that in the day-to-day decision-making by directors sitting on subsidiary boards within larger groups of companies, the interests of the subsidiary and those of the group (notwithstanding the conflicts of individual/financial interests of members of these boards which are not dealt with in this report) conflict from time to time. The Sessions, however, also revealed that the corporate interest of the subsidiary is not in itself contradictory with the interest of the group. Both are even usually the same.

The situation of each group is also unique, due to differences in culture, integration or lesser integration and activities. This makes the sensitivity of decision-makers to conflict issues a very differing one.

The manner conflicting interest issues and possible resulting conflict situations are approached by boards largely differs.

i) Conflicting interest situations are, as a rule, rarely identified in a clear and specific manner in the board papers directors receive before board meetings; directors' attention is normally not drawn to the fact that a given agenda item requires their particular attention by reason of an identified or possible conflict of interest between the interests of the subsidiary and those of the parent/group and which would require specific attention, consideration and discussion by the board.

   Board papers, as a general rule, do not contain any specific guidance or narrative on corporate interest issues, leaving directors, especially independent directors, without adequate back-ground information to consider and analyze a possible conflict situation. The general practice appears to be rather one of a non-proactive initiative by the parent company/group vis-à-vis its subsidiary and one of a "watch-out-reaction" from the subsidiary board/directors.

   The limited feed-back the Sessions provided on how companies approach the matter leads to the recognition that there is no uniform approach on how to analyze and solve, in a practical manner, conflicting interest situations within a group of companies.

   One reason for this situation (lack of identification of conflicts and uniformity in handling these) could be the fact that the group decision-makers who are on the subsidiary board are in this position to make things happen from a group point of view and are not in this position to solve conflict of interests and therefore do not always identify the conflict of interest.

ii) The perception of the existence of conflicting interests within a group has to be differentiated depending on the director background:

- **Directors belonging to the group** of which the subsidiary forms part of consider conflict situations to arise rather rarely. Their general perception is that conflicts on the corporate interest actually do not or are unlikely to arise given that, by nature, the subsidiary corporate interest matches that of the group. Where a conflict between both interests arises, a solution is found at group/parent level and/or in discussions with decision makers taking responsibility for the subsidiary (business leaders) even before the proposal is tabled to the board of directors; potential conflicts are identified upstream and adequate solutions are found before boards are asked to pass resolutions; the solution solving appears though to rarely involve the directors of the subsidiary;

- **Independent directors** tend to consider that, by and large, corporate interest issues are not adequately solved before a matter that could materialize in a conflict situation is tabled to the board; conflict situations, or at least the extent of the conflict, of this kind are normally identified by means of discovery action by the independent directors (rather than by group directors), largely by their questionings on the proposals tabled to the board;

- **Professional directors** (e.g. officers employed by fiduciary or domiciliary agent companies) tend to consider that their role is essentially one of carrying out the instructions from their principal (the parent company) their duty being confined to check whether proposed resolutions do not conflict with mandatory provisions of the laws and the subsidiary's Articles; their role to address corporate interest situations is, in the opinion of some participants, of secondary relevance and limited to a compliance role that could be addressed internally within the group organization.

iii) The Sessions revealed that an important factor in how conflicts of corporate interest are to be approached largely depends on the culture of how groups are run. The culture of groups appears to differ largely throughout Europe where geographical origin plays a role even if this is not the only cultural ingredient. Some groups seem to concede a large autonomy and power to directors of subsidiaries to resist, while others appear to impose a stronger parent domination and subsidiary abidance. The difference in approach would be less inspired by a given economic or business model than be dictated by some human behavior or reacting. The culture of the group would be defined at parent level, yet seems unevenly adhered to at subsidiary level.

WORKING GROUP ASSESSMENT

The general rule contained in the 1915 Act that directors must act in the company's best interest is applied in practice not in a uniform manner when conflict of interest situations arise between a subsidiary and its parent or the group it forms part of. Large differences exist in the approach on how conflict of interest situations should be addressed and on the manner conflict situations should be solved.

The differences find their source largely in the different origin or back-ground of directors, though the differences in the cultural approaches play an important factor. This underlines the importance to constantly monitor the "right composition" of the Board both from a skills and cultural and a personality point of view. "Diversity" is the key word here. The importance of the multitude of different factors should not be underestimated. This adds to the complexity of approaching intra-group governance aspects.

However, it should be reminded to all directors that the corporate interests of the subsidiary, even if 100% owned, are not identical to those of the parent company. A factual analysis has to be undertaken by all members of the board of directors who share the same collective responsibility for their decisions. The 1915 Act does not distinguish between directors belonging to the group, independent and professional directors.

02 ONE MODEL DOES NOT FIT ALL

The 1915 Act rules on how the governance in the various types of Luxembourg companies is to be organized actually differ not materially. In line with the traditional liberal approach of the 1915 Act, governance rules are to be described in each company's Articles; these rules differ from case to case leading to non-uniform governance mechanics.

The Sessions revealed that, as a general rule, the manner conflict of interest situations are identified and addressed are not described in the subsidiary's constitutive documents or internal rule books. They appear, as a rule, not to be addressed either in the parent company Articles and are hardly ever addressed in the parent company or group governance rule books (in such cases where such rule books exist).

The Sessions also revealed that a clear distinction needs to be made between different types or categories of subsidiaries, such as between:

- regulated and non-regulated subsidiaries;
- publicly listed and privately held subsidiaries;
- fully controlled subsidiaries (100% owned) and subsidiaries with minority interests;
- fully operational subsidiaries and subsidiaries (usually 100% owned) only incorporated for a special or technical reason; and
- joint ventures in the sense they merge two different groups' interests.

Given this variety which generates different level of complexities a uniform approach on the identification and the proper addressing of interest conflicting situations within a group is hardly possible. However, the Sessions revealed a very large consensus on the identification of the following issues:

2.1 As a rule, the group has developed a valid reason to set up the subsidiary, instead of a branch, since the subsidiary deserves a justification and a need within the group. The strategic setup of a subsidiary generally serves a clear aim for a local presence, with a structural, industrial or service purpose. Hence, the subsidiary interests match those of the parent or the group. It is up to the parent to set the group strategy with which the subsidiary company and the subsidiary board as a rule are bound to comply with. Subsidiary directors have not the power nor is it their duty to determine the group strategy or, unless being allowed to so do, to set a subsidiary strategy different from that of the parent/group.

The directors' duty consists of combining the subsidiary's interests based on the group strategy determined at a higher level: subsidiary directors are bound to perform a permanent balancing act of these interests while ensuring to the largest extent possible coherence in their action.

Their duty consists in identifying and addressing interest conflicting situations in this context; the tasks would be less one of questioning the group strategy than one of identifying specific risks proper to the subsidiary considered on a stand-alone basis and react thereon in a proper manner.

Where the operational subsidiary is 100% controlled by the group the professional dimension of the board becomes more relevant, as is the presence of independent directors.

2.2 Where groups and their subsidiaries operate along business lines and the subsidiary takes the form of an operational entity managing a business line in a specified geographic area – with staff, equipment, etc. of its own whether in a regulated or non-regulated environment - the interests of the subsidiary are de facto identical to those of the parent/group. It is difficult to conceive that the subsidiary would have interests differing from those of the group; it is held that the economic and financial approach on the implementation by the subsidiary of business plans prevails over the corporate interests rules laid down by legal practice for as long as no law rule is breached.

Business lines being uniformly applied in a vertical manner throughout the entire group the subsidiary corporate interests do not differ from those of the group and conflicts between corporate and group interests are excluded, or to the very least are rather theoretical.

This perception is particularly felt where the subsidiary is 100% controlled by the group, though equally applies where the group holds a controlling stake in the subsidiary. In such case the alignment of the interest of the subsidiary and the interest of the group is almost perfect.

However, in situations where the operational subsidiary is not a fully controlled affiliate of the group, it is recognized that a differentiation has to be applied: the business line approach is not in each and every case the same for the majority and the minority shareholder of the subsidiary; conflicts of interest do exist and therefore require special attention by the subsidiary directors.

When the subsidiary does not have exclusive responsibility for a business line in its geographic area, the potential for a conflict of interest is much higher, regardless of whether the subsidiary is 100% controlled or not.

Finally, the interests of the creditors, potentially also the employees, further need to be taken into account by the subsidiary board in particular where the subsidiary, even 100% controlled, is in financial difficulties and could face bankruptcy.

2.3 The issue of conflict of interests is of lesser relevance where the subsidiary exists only for purely technical reasons, such as the need to locate a given activity, transaction or business in a company set up for that purpose. In such cases, the subsidiary is usually 100% owned by the parent company. Situations of this kind are rather frequent in Luxembourg given Luxembourg's position as a hub for structuring industrial groups, as well as asset management and related activities designed for investments in a variety of sectors such as ITC, real estate, private equity and venture capital.

Such structures are met within groups where the needs to shelter risks, to enhance group-internal management or to seek efficiencies in certain legal, tax or accounting treatments have been identified. In such case the subsidiary is, generally, set up in the form of a 100% controlled entity.

In situations of this kind the collision of interests leading to conflict situations would not exist. Even if the subsidiary does, by hypothesis, not operate like a branch but with separate independent corporate bodies (board of directors, managers, shareholders meeting) the issue of conflicting interest situations is not likely to arise given that the single or sole purpose of the subsidiary forms the legal basis of the company's corporate interest which equals that of the group/parent. This is the case precisely because the mere reason to set up the subsidiary (often a special purpose vehicle – SPV) is guided only by group reasons. No conflict of interest issues arise therefore by nature for such type of subsidiaries.

WORKING GROUP ASSESSMENT

The economic reality of how groups (especially multinationals operating worldwide/conglomerates with global cross-industry activities) operate should be taken into account when addressing the issue of conflicting interests between the parent/group and the subsidiary. The best antidote to conflicts of interest is the clarity of the group organizational structure and the strategic business reason for the group set-up. Where sufficient care is given to design a proper economically driven group organization model and to monitor the model over time, conflicts of interest should be minimized. On the contrary, where a subsidiary position in the group organization model is not natural or not economically sound, conflicts of all sorts (regulatory, strategic or operational) are more likely to arise.

Operating subsidiaries working in a vertical manner on the basis of economic matrixes or business lines laid down by the group, in practice, are less exposed to conflicting interest issues given that their own corporate issue matches that of the parent/group. Yet, it is the subsidiary board's duty to carefully monitor situations on a case by case basis to determine whether interests conflict. Investment plans, addressing human resources issues, local market constraints or specificities do sometimes lead to the necessity to question the logic and binding element of a group business model or plan which might fail to address in an appropriate manner the stand-alone corporate interests of the subsidiary incorporated in Luxembourg. The proper alignment of the subsidiary and its directors to the group's overall strategy and vision constitutes a valuable tool to avoid conflicts of interest.

Conflicting interest situations do in reality not, or very rarely arise, within subsidiaries set up essentially for purely technical reasons (SPVs). The very nature of their activity and rationale for their creation matches as a rule the group interests. Yet, subsidiary boards should not for the sole reason that the subsidiary takes the form of a technical SPV consider that they are not or less exposed to conflicting interest situations, in particular where the SPV is not 100% controlled by the group and even more when the subsidiary is a joint-venture (e.g. when minority interests play a part). The SPV status exempts not *per se* the directors' duty to carefully monitor situations on a case by case basis to determine whether interests collide between those of the SPV and those of the parent/group. However, the very nature of the SPV needs to be taken into account by the directors as the SPV's corporate interest cannot have the same degree of autonomy.

03 BEST PRACTICES IN BOARD GOVERNANCE

The Sessions revealed that board governance is an essential factor to address conflict issues of corporate and group interests. The following findings were identified.

3.1 Board composition

The Sessions largely revealed that the identification and the solving of collision of interests situations can be efficiently addressed by means of an adequately composed board of directors. The adequacy tests in this respect are multifold:

- **Diversity**: there should be an adequate equilibrium between group employed directors and directors not employed by the group;
- **Position**: the position of directors originating from the group should be well thought of also from the subsidiary's added value point of view and not only from a group career management perspective;
- **Skills**: the obvious added value a director originating from within the group should be the deep knowledge of the group operations and strategy. He or she will then also have the adequate background and professional/technical skills to fully play his or her role on the board of the subsidiary;
- **Independence**: the board presence of independent directors presents an added value; reality shows that independent directors are better placed to identify potential corporate interest situations likely conflicting with/group interests and to participate in the solving of conflicts arising in this respect. The participants to the Sessions underlined that to have only one independent director is not enough. Boards should, as a rule have at least 2 independent director given that it is unfair, or presumptuous, to leave on the shoulders of a single director the load to act as a whistleblower in the identification of conflict situations. The number of independent directors for this purpose though needs not to represent the majority of the board members. Independent directors need also be given the possibility to consult mutually/separately;
- **Culture**: the board culture needs to be adequate; all directors should have an in-depth knowledge of the group culture and be offered the possibility to acquaint themselves therewith. Direct access by directors to the decision-making hierarchy within the group constitutes an efficient tool;
- **Challenge**: directors should offer a combination of capacity to resist, to object and to enquire with respect to proposals tabled to the board; directors should at all times be alert and prepared to investigate interest conflicting situations;
- **Trust**: a proper degree of trust must exist among directors (group employed vs. non-employed/independent directors); only trust will permit open and controversial debates where a possible conflict of interest is identified.

WORKING GROUP ASSESSMENT

The adequate composition of boards is a key element for the identification and handling of conflict issues. Practice shows that a higher degree of care should be devoted to the composition of subsidiary boards. It should be accepted that the adequacy of board composition does not only apply to operational subsidiaries, but also to technical subsidiaries even, though likely to a lesser degree, to SPVs. While the technical skills and the practical experience are important director selection criteria, a prime element should be the human qualities of directors, both of non-executive directors originating from within the group and of independent directors.

The subsidiary should be involved in the director selection process; a top down selection, only at group level, of directors is no likely to enhance the better identification of conflicting interest situations and the handling of these situations.

The presence of independent directors in subsidiaries should be a norm. The number of independent directors should be determined by reference to the business of the subsidiary. The presence of independent directors could be larger in operational subsidiaries than in technical or SPV–type subsidiaries. A single independent director proves of limited benefit: the identification and handling of conflict situations should not and cannot vest upon the shoulders of a single person. It is recognized that bringing in independent directors comes with a cost which is considered adequate in view of the potential benefit.

3.2 Role of the chairman of the board

The Sessions have not revealed a clear-cut perception of the role of the chairman of the subsidiary board to address conflicts of interest.

Some participants in the Sessions consider the chairman's role to be the speaker of the parent, thus being the prime advocate of the interests of the group; in this situation the chairman also acts as the relay between the subsidiary board and the parent/group. This should especially be the case where the subsidiary is 100% controlled.

For other participants in the Sessions the chairman's role is perceived primarily as one of a technical or logistical nature: holding the pen of the agenda of board meetings, organizing and presiding over board meetings, liaising between directors (group directors/independent directors), acting as fronter on decisions leading to the board composition.

Session participants largely consider that the selection of the chairman among the independent directors does not enhance the addressing and solving of conflict of interest situations.

WORKING GROUP ASSESSMENT

The role of the chairman of the subsidiary board should not be limited to act as the technical chair of meetings besides that of the prime initiator of board agendas. The chairman should have a leadership role: he or she should be the initiator of the proper consideration of conflict of interest issues between the subsidiary and the group. A strong chair enhances a better perception and handling of interest issues and avoids or eases the handling process of resulting conflicts.

The feedback from the Sessions is that there are no compelling reasons for the chair of a fully owned subsidiary to be an independent director. The assumption (in this particular situation) of the chair by a parent group representative has as main advantage that the chair represents a strong link to the group and that the position is filled by an individual who has a good understanding of the group. This should however, on a case by case basis, be balanced with the well-known advantages of an independent chair.

3.3. Toolkit for directors

The Sessions largely revealed that subsidiary directors, as a rule, hold few tools to properly address conflict of interest issues and to handle resulting conflicts:

- participants to the Sessions were very attached to defending the interest of the subsidiary for which they act as a director, especially when they act as the CEO of the subsidiary;
- participants to the Sessions who were CEOs of a Luxembourg subsidiary often felt that independent directors were a very useful support to help them resist or at least improve the terms of transactions requested by the parent company;
- participants felt that, generally, they receive in a timely manner adequate and sufficient information in the form of board papers; they, however, considered that there is a lack of specific information on interest aspects and likely resulting conflict issues;
- the directors' degree of knowledge of the group and its culture are often not sufficient; there is a lack of director induction courses or group presentations;
- generally, no specific rules of conduct exist on how to address and solve conflict of interest aspects and the possibly resulting conflict of interest issues; in the very few cases where such rules exist at group level, the rules are not communicated to and/or replicated at subsidiary level.

WORKING GROUP ASSESSMENT

Directors' toolkits could be improved. Board papers should highlight conflict of interest issues. Directors should receive factual information on conflict of interest issues facing the subsidiary with a written explanation on how the issue is addressed by the parent/the group. Such explanation is eventually to be supported by an opinion letter or information on valuation prepared by the parent/group (where pricing aspects are of particular relevance).

Directors should be given larger opportunities to benefit of director induction courses on the group's business model, culture and ethical rules. Regular contacts between directors and executives at subsidiary and group level in general, and more in particular with the group business lines within which the subsidiary operates and improved or eased access by subsidiary directors to the decision-makers at business lines level within the group, should become the norm. The enhanced knowledge of the group culture will permit subsidiary directors to better address conflict of interest situations besides to benefit of a general better orientation of the group. Directors should not underestimate the time investment required on the identification and the proper addressing of conflict of interest issues.

The lack of policies and rules of conduct on the identification and handling of conflict of interest issues and the manner to address conflict situations needs to be resolved. The discovery by subsidiary directors of conflict of interest issues takes places at too late a stage and board decisions are often passed without due regard to director requests for additional information (legal opinion, external valuation, tax advice). Such information it seems is at times usually provided more easily in the board papers when the subsidiary management needs the support of the independent directors to resist or modify the terms of a transaction requested by the parent company. Board practices should be improved in terms of editing director rule books setting out the principles and the guidelines to address conflict of interest issues and the handling of resulting conflict of interest situations.

Where rule books exist within the group, these should be made available to and/or replicated at subsidiary level where such relevance makes sense.

The direct involvement of subsidiary directors in the business line decision-making process related to the subsidiary should be improved. Though subsidiary directors are not supposed to share in the decision-making at a higher level of the group, their early involvement in decisions involving the subsidiary's business, f. i. by means of direct contact with the executive decision-makers at subsidiary level or at parent-level should avoid possible conflict of interest issues or enable them to address these issues in an appropriate manner before formal board consideration.

04 ILLUSTRATIONS: CASH POOLING, FINANCIAL ASSISTANCE AND DISTRIBUTIONS

The Sessions considered the following specific situations in which conflict of interest issues are of particular relevance. The Sessions revealed also that each situation of conflict is solved through negotiations. Therefore, within the scope of what is acceptable and not acceptable within a group, there is a wide margin left for negotiation. This explains why it is not possible to set up too precise rules as each situation is different.

4.1 Cash pooling/financial assistance

The Sessions lead to the acknowledgement that group funding and financial assistance in the form of loans or guarantees extended by a subsidiary down-stream (for the benefit of direct or indirect affiliates) or on a cross-stream or up-stream basis are common practices within a group of companies (except in groups having adopted business models or a culture which command that each subsidiary operates on a stand-alone basis and where any support from within the group, primarily the parent, is generally denied). The perception of conflict of interest issues appears to vary (again) between on the one side group directors and on the other side professionals and independent directors.

Participants, generally, found that financial assistance by different means is a normal practice within a group; the provision of financial assistance generates per se risks of conflict of interests only where the subsidiary is not in a situation to determine independently that the assistance is provided on an at arms' length principle basis.

Equally, participants considered cash pooling systems to be of the essence of and to be normal practices within a group. However, arrangements of this type need to be properly documented in the form of binding contracts and subsidiary directors should carefully monitor the terms of pooling arrangements from a financial consideration and risk perspective, in particular under transfer pricing considerations.[8]

[8] Groups operating in the financial sector will in the short future be subject to Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms, more in particular article 19 thereof which offers the option to banking groups to "enter into an agreement to provide financial support to any other party to the agreement" under certain conditions. Such type of contractual agreements will have the likely benefit to supersede the corporate law issues relating to conflicts between corporate stand-alone and group interests of a banking group considered as a whole.

WORKING GROUP ASSESSMENT

Financial assistance in different forms and the combining of cash management tools between group companies involving various subsidiaries is justifiable by reason of the very nature of groups and is normal business practice. For as long as sound business practices based on the at arms' length principle and transfer pricing constraints can be warranted and are adequately addressed when put in place and are monitored over time by means of adequate risk management tools, the stand-alone corporate interest of the subsidiary becomes of secondary if not to say of no relevance in as much that the subsidiary's interest will match the much larger group interest.

4.2 Distributions

The Sessions revealed that it is up to the group, or the parent company to define the group strategy on income allocation and profit repatriation. Distributions by subsidiaries are dominated by the expectations defined at group level, the stand-alone interest of the subsidiary being of secondary relevance.

Some participants considered that on distributions the likely conflicts of the group interest with the stand-alone subsidiary interest is a purely theoretical issue: given that the subsidiary adopts business plans based on group business models, group planning, capital expenditure, income allocation and profit repatriation are dealt with therein after due consideration of the subsidiary's funding and capex needs. Hence, the subsidiary's interests being normally addressed in these models and plannings, it is legitimate that the parent disposes at its discretion of any surplus income or profit generated by the subsidiary; any subsidiary concerns of its stand-alone corporate interest actually no longer exists. This is specifically the case given the group or parent's function to meet the subsidiary's financial needs or demands should these arise following important distributions or profit repatriation.

The participants considered though that the subsidiary directors retain the right to resist non-justified demands to channel up any and all profit generated by the subsidiary.

WORKING GROUP ASSESSMENT

Profit repatriation within a group of companies is a legitimate management tool within groups of companies and should not give rise to corporate interest issues, provided the repatriation is based on properly documented and approved business plans. Distributions should only be approved if compatible with applicable laws and the subsidiary Articles. Subsidiary directors should though resist oversized requests for distributions in situations where there are insufficient assurances from within the group of continued financial support of the subsidiary where the need so arises.

05 POSSIBLE LEGAL DEVELOPMENTS AT EU AND NATIONAL LEVEL

The Sessions considered initiatives which could improve the addressing of conflict of interest issues within the group.

5.1 Incorporating the concept of "group interest" into Luxembourg law/ the Articles of the subsidiary

The Sessions considered the merit of amending the 1915 Act by inserting therein a rule that boards/ directors be permitted to take into account when passing decisions the group interest besides to or as an overriding rule of the corporate/stand-alone interest. The proposal would offer the merit of greater legal certainty and flexibility when addressing conflict of interest situations within a group. A law change could also offer greater protection to directors of the Luxembourg subsidiary in terms of their liability.[9]

The participants to the Sessions were, on a majority basis, reserved to such law change for a variety of reasons:

- the introduction of such rule would make it necessary to provide for a workable definition of "group"; this could prove to be a too ambitious goal;
- the rule could reveal to be difficult to implement in practice even if the rule would not imply an automatic shift of director liability from the subsidiary to the parent board/directors across jurisdictions;
- the option to include the concept of "group interest" in the Articles of a Luxembourg subsidiary, such as 100% controlled subsidiaries, could be a preferable more practical and workable option to a general change of law. This would not imply that the "interest of the group" would not be recognized when such provision would not be included in the Articles as such interest is in any case in principle recognized by Luxembourg case law. However, it would certainly reinforce the possibility for the directors of the subsidiary to rely with an enhanced comfort on the "interest of the group" compared to others.

[9] Refining of Article 53 of the Law of August 10, 1915 on commercial companies.

WORKING GROUP ASSESSMENT

The introduction in the 1915 Act of the concept of "group interest" besides the current "company/stand-alone" concept is worthwhile to further consider. It is recognized that changing the law on this point will trigger a number of complex legal issues, such as the need to provide for a rather clear definition of "group", which according to the members of the Working Group should be the accounting definition, to address the liability issue (possible or lack of shift liability from the subsidiary to the parent) and to determine the treatment of directors' liability when the parameters of their decision-making change. On balance, the proposed change of the 1915 Act appears not to be without merit and an in-depth study of the proposal appears recommended.

5.2 Recognition of the interest of the Group at the European level

Participants to the Sessions were generally more supportive of the idea of a recognition of the "interest of the group" at the European level (potentially as an option for companies), rather than at the Luxembourg level. The reason hereof is that it would allow a level playing field in Europe.

5.3 European single-member S.à r.l./European Commission Proposal for a Directive

The Sessions revealed a high degree of interest for the European Commission proposal of a directive to provide for board/managers of the European single-member private limited liability company (SUP – Societas Unius Personae) to receive and to act upon instructions from its single parent[10]. This provision does not imply as such the recognition of the interest of the group since "Instructions given by the single-member shall not be binding for any director insofar as they violate the articles of association or the applicable national law". However, since in Luxembourg the "interest of the group" is recognized, the directors of the SUP would be allowed to take such interest into account. In such case, the proposal would not shift the liability from the directors of the SUP to the single member. This would be left for each Member State to decide.

The simplification, easier access and eased operating within an EU based group is within the logic of the Single Market and the Commission initiative should be supported.

[10] Art. 23 of the proposal for a Directive of the European Parliament and of the Council on single-member private limited liability companies, Brussels, 9.4.2014 COM (2014) 212 final.

WORKING GROUP ASSESSMENT

The Commission proposal, it seems inspired from existing legislation in some EU Member States (Germany, Netherlands…) to permit the parent of a SUP to give instructions to the Luxembourg SUP managers/directors and such SUP managers/directors being authorized to act upon such instructions is a meaningful tool to facilitate the management of subsidiaries established in different jurisdictions within the EU. The quick and seamless implementation of decisions at parent level will increase efficiency, hence be beneficial to the group taken as a whole. In addition, subsidiary managers/directors will see their liability better protected. Their acting will still be subject to local judicial review, such as with respect to the overriding requirement for them to act in accordance with applicable laws and the subsidiary Articles. The concerns on due compliance of the subsidiary/stand-alone corporate interest would though become of secondary relevance.

The Working Group recommends that the Commission proposal is given due attention. In particular it should recommend that the Luxembourg wider business community assesses the impacts of such a proposal on its business environment.

RECOMMENDATIONS

The Working Group findings from the Sessions combined with its own assessment on how to address the issues on the conflicts between the subsidiary's and the group's interest lead the Working Group to make the following recommendations and to propose practices with a view of a better addressing of conflict issues between Luxembourg-based subsidiaries and the group of which they form part:

1. Group organizational structuring should primarily be driven by **economical and business considerations**;

2. Directors should benefit of **induction sessions and regular information sessions** with a view to achieve a clear understanding of the business and purpose of the subsidiary and of the culture of the group;

3. Boards should adopt a **rule book** or regulations possibly inspired by or imported from the group or the ultimate parent on how conflicts of interest issues are to be dealt with; the rule book or internal regulations should be made available to all directors and explanatory/training sessions relating thereto be organized for directors[11];

4. The **direct involvement** of subsidiary directors in the **business line decision making process** related to the subsidiary should be improved. While subsidiary directors are not supposed to share in the decision-making at a higher level of the group, their early involvement in decisions involving the subsidiary's business, would avoid possible conflict of interest issues, f. i. by means of direct regular contacts with executive decision-makers at parent or subsidiary level;

5. Boards should be staffed with a **reasonable proportion of directors originating from the group** (executive or non-executive) and **independent directors**; the number of independent directors should at least be two;

6. The **board composition** should be **adequate and diverse** in terms of personality, professional skills and technical background with regard both to group and independent directors, though exceptions are conceivable for 100% controlled subsidiaries being more of a technical than an operational nature (SPVs); directors should be acquainted with the group culture;

7. Conflict issues should be **disclosed** in an appropriate manner in the board papers and submitted to director consideration before the actual board meeting;

8. Resolutions addressing topics giving typically arise to conflict issues should be debated and actively discussed in plenary meeting and **should not be dealt through circular resolutions**;

9. Consideration should be given on the merit to make reference in the subsidiary **Articles** of the fact that the subsidiary is part of a group and that in certain cases the **interests of the group** are to prevail over those of the subsidiary.

[11] Article 64(3) of the law of 10 August 1915 as amended provides for S.A. type companies to adopt internal rules (réglement intérieur). In practice few boards appear to adopt internal rules; rules or regulations dealing with conflict issues could easily be enacted on the basis of article 64(3).

NOTES

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