DLA CLIFFE DEKKER HOFMEYR

CORPORATE GOVERNANCE ALERT

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IN THIS ISSUE

- **Managing the governance relationship in group structures**
- **Common law and the Companies Act**
- **Governance of group structure in terms of King III**

MANAGING THE GOVERNANCE RELATIONSHIP IN GROUP STRUCTURES

There is always a potential for cross contamination of risk between a group and its subsidiaries simply by virtue of the holding-subsidiary relationship.

A recent example of this is the relationship between Barclays, a major shareholder of Absa, which was in the spotlight when the reputation of Barclays plummeted globally following the London Interbank Offered Rate (Libor) scandal. Absa had to work hard to not be drawn into the fray.

Maria Ramos, CEO of Absa, confirmed on 16 July in a media interview on www.bdlive.co.za that the relationship between a group and its subsidiary was a complex one.

"You wouldn't expect anyone with a controlling interest in any organisation, particularly a bank, to say: 'Here's a big chunk of my capital, and I will see you twice a year.' That is not how it works," she said.

The problem with managing the governance of a group structure starts with the lack of recognition of the concept of a group in that at common law, the concept of a group as a single economic unit with its own interest is not recognised.

This is borne by a series of common law cases, in which the relationship between the holding company and its subsidiaries seems to be viewed with caution and as holding a potential for abuse.

In a precedent setting decision in *Rex v Milne and Erleigh (7) [1951] 2 All SA 113(A)*, it was crisply decided that the common law not only recognises but protects the distinct and separate *persona* of each company within a group, such that the law recognises only the interests of the company and its controllers, to the exclusion of the other group entities and the group itself.

COMMON LAW AND THE COMPANIES ACT

The key legal concept of separate ***personae*** turns on the practices of core financial practices and central control within groups and has described the anomalous manner in which groups tend to organise themselves as a network of **'subservient subsidiary'** or associated companies anchored by the authority of a central controlling or holding company.

This is often the case, to the extent that such subsidiaries are regarded as mere agents of the holding company, and this is seen as being undesirable, dangerous and liable to abuse.

At common law, there were prohibitions placed on subsidiaries from financially assisting the acquisition of membership and/or holding membership in their holding companies, and this was seen as being integral to protecting the subsidiary company's own financial interests and benefits. In particular, each company alone is to benefit from the availability of its distributable profits to the exclusion of all other entities in the group.

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The judgment of Coetzee J in *The Unisec Group Ltd and Others v Sage Holdings Ltd [1986] 3 All SA 1 (T)* dealt with the separable interests of each company in a group, and held that when a company is both shareholder and subsidiary of a holding company, any distribution payment received by that company cannot be treated by the holding company as additional profit available to it for distribution, and a recordal of such additional profit on the holding company's books will reflect a false and misleading state of affairs.

Coetzee J described the scheme devised by the parties as one *in fraudem legis* and held that schemes to 'desubsidiarise' a company so as to legitimise the flow of a beneficial interest are devised for the purpose of camouflaging the activity of share-trafficking.

While there is a legal rationale for the common law position as well as the caution by the courts, this view may well not be in keeping with the way the business world has evolved the last century, which has seen the rise and fall of conglomerates, global expansion and consolidation of companies to gain new markets.

In this regard, there are certain tell-tale, but significant, signs that the tendency, affirmed by Nicholas JA in *Ritz Hotel Ltd v Charles of the Ritz 1998 (3) SA 290 (A)*, towards ignoring, in appropriate cases, the common law rule of separating the legal personalities and looking at the group as an economic entity has gained legislative recognition.

The new Companies Act, No 71 of 2008 (Act) now includes a definition of a 'group of companies' in s1, and expressly provides for ways in which companies and persons are able to establish a nexus between holding companies and their subsidiaries.

In the same section, the definition of 'financial statement' includes group financial statements and the consolidated financial statements of a group, and pursuant to that definition s30(3), (5) and (6) require that such financial statements disclose the remuneration of the prescribed officers and directors of all the companies in the group and includes the services they render, their remuneration, benefits, loans and securities provided for the acquisition of shares in the group (or loans and securities to related persons), rate of interest payable and the amount by which such interest is 'discounted', options' value (as well as those held by related persons) and details of the securities they or related persons hold within the group.

The extent to which disclosure is required under this section, means that shareholders are given a consolidated picture of the economic state of the group's affairs and are wise to potentially weak areas that may be susceptible to abuse.

In s95, the definitions relating to offers made to the public include the securities and rights of the entities in a particular group.

Section 76 states a director of a holding company may not to use any information he acquires by virtue of his position to gain advantage for anyone other than the company on which he serves or its wholly owned subsidiary.

Section 93 allows a holding company's auditor access to the financial statements of any of its subsidiaries and also compels the cooperation of the prescribed officers and directors of the particular subsidiary with such auditor and any of his requests for information.

In the quest to create continuity and integration, the Chairman or CEO of a subsidiary company can be appointed as a director of the holding company board, leading to potentially conflicting duties.

Where a holding company and its subsidiaries are required to appoint an audit committee in accordance with s94, the subsidiary is exempted from having to do so, provided its holding company's audit committee performs its functions on behalf of the subsidiary, in this way the subsidiary is once again just an extension of its holding company.

Similarly, the subsidiary company may be exempt from appointing a social and ethics committee where it can be shown that the group will perform such function.

A further illustration of the Act confirming a recognition of the group as an economic entity, is evidenced in the excluded application of s112 and s115 in instances where there are disposals of the whole or greater part of the assets or undertaking of companies taking place amongst wholly-owned entities within a group.

Also, where a subsidiary makes such a disposal and, on a consolidated basis, it amounts to a disposal of the whole or greater part of the assets or undertaking of its holding company, that holding company must in addition get the approvals under s112 and s115, even though technically in law the disposal is by the subsidiary, not the holding company. Through these provisions, the economic reality of group ownership structure as has evolved has been balanced with the necessary protections.

GOVERNANCE OF GROUP STRUCTURE IN TERMS OF KING III

Most CEOs would agree that being part of a larger group has its own benefits, such as having access to additional intellectual capital, expertise, technology and, at times, access to capital.

The governance challenge comes in seeking to reconcile these benefits with what seems to be a natural inclination of the holding company to seek to direct, control and influence the business of the subsidiary, a position not enjoyed by ordinary shareholders. At times, this may happen in ways that may be perceived as usurping the role of the subsidiary board's legal responsibility to direct the business of the subsidiary.

As we have seen, apart from this issue of who is in control of the direction of the company, the reach of the holding company's executives in determining certain financial decisions, like dividends, on behalf of the subsidiary, holds a potential conflict of interest that may be viewed as an expropriation of shareholder value especially where the executive remuneration is linked to the performance of the subsidiary.

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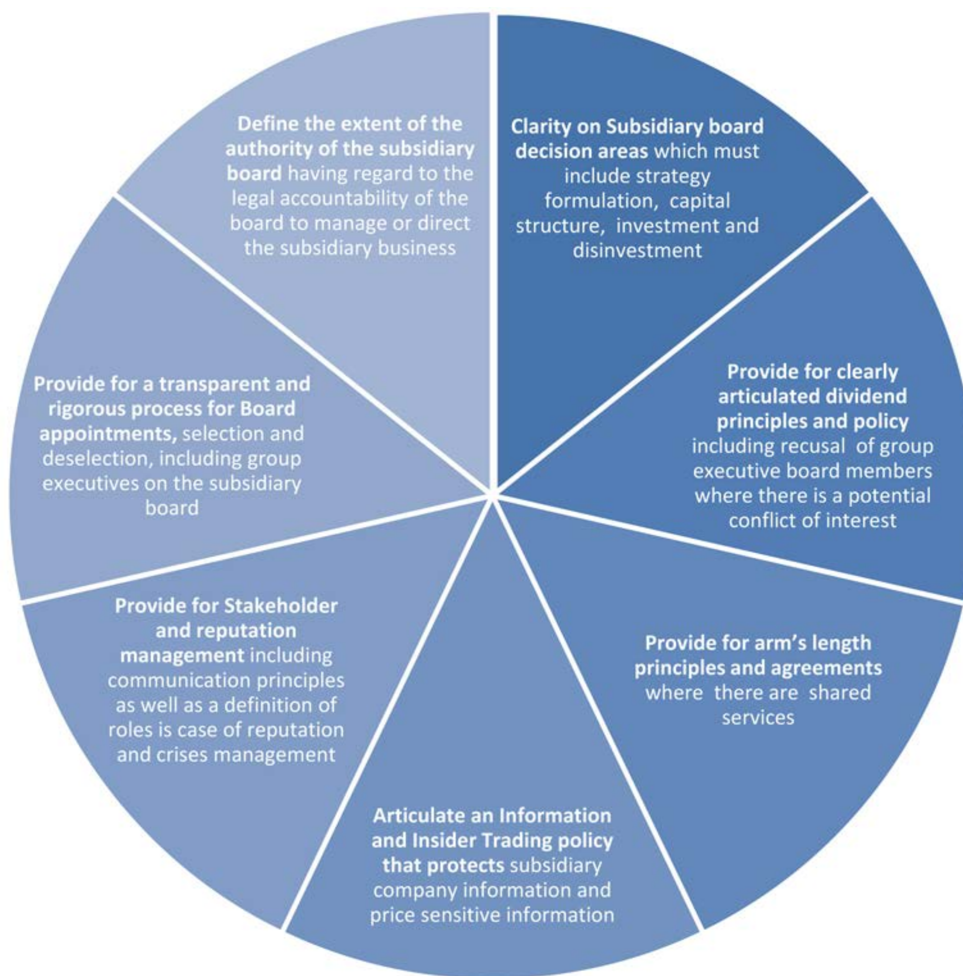
Apart from above, the flow of information between the holding company through its executives may potentially render them either to be 'insiders' or to a perception of an unequal treatment of shareholders and or a perception of a potentially prejudicial treatment of minorities.

In an attempt to regulate the relationship between the holding company and its subsidiary, King III recommends that companies in a holding-subsidiary relationship develop a corporate governance framework that outlines the relationship between a group and its subsidiaries.

While the provisions of the governance framework may differ from company to company, its minimum principles are shown in the diagram below and are to be based on the respect of the fiduciary responsibility of the subsidiary board.

The main point of departure for the development of such a framework is that the relationship between the holding company and the subsidiary is first and foremost subject to legal requirements applicable to the subsidiary. The challenge for holding companies is to reconcile competing legal requirements where the holding and subsidiary companies are listed in different jurisdictions. Notwithstanding, the fiduciary duties of the subsidiary directors to the subsidiary company takes precedence over any group policies.

GROUP GOVERNANCE FRAMEWORK MODEL



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