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Abstract

This paper analyses some aspects of intra-group conflicts of interest in financial conglomerate groups.
General company law rules restrict management action of both parent en subsidiary following the Rozenblum test. The prudential directives - essential the financial conglomerates directive - contain rules specifically addressing intra-group conflicts, while the capital requirements directive allows supervision to waive solo supervision in exchange of consolidated supervision. Especially the latter rules may create tension with the general company law rules. Some of these possible risks can be mitigated by construing guarantees between the group entities. Other seem more difficult to avoid.

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CONFLICTS OF INTEREST IN FINANCIAL SERVICES GROUPS

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1. According to the financial conglomerates directive, conflicts of interest within groups should be the subject of special attention of the prudential supervisors. The directive remains however quite modest on identifying the type of conflicts it wants to address, on the management techniques to be used to review conflicts of interest, and the remedies or tools to redress where necessary.

2. This paper can be considered as an attempt to deal with some of these issues. There are two layers of reasoning: the first one would analyse the question of intra-group conflicts by extrapolating from general law on group of companies, the second one would deal with more typically prudential issues within the conglomerate context, dealing with the conglomerates directive (part II) and with the CRD (part III).

Part I. General law on groups of companies

3. Europe has no common law on groups of companies: an attempt to propose a so-called Ninth Directive was abandoned in the seventies, due to the strong opposition of several member states. Only Germany, since 1965 and Portugal have introduced formal group law into their companies act. However, there is more group law around than one would expect: many specific provisions have a group law aspect, and have their main application within a group context. Case law has been abundant in many jurisdictions, so that the general principles of group law have now been clearly outlined. Financial supervisors, especially within their function of supervising the securities markets, have in the past repeatedly taken position on issues of group law, in a sense that is comparable to the traditional case law.

4. Group law issues can be subdivided in two strands: some are dealing with creditors, and their protection within a group context. Others are dealing with shareholders at the different group layers: for the present purposes these are most directly calling our attention. They are directly linked to the issues of internal governance within the group context, a subject on which the Basel Committee has recently published a recommendation[2].

Usually, groups are subdivided in parents, subholdings, and subsidiaries: although one could state that all group relationships are individually unique[3], the general pattern is that of a holding company, usually a non-regulated entity, owner of all the shares in several subsidiaries, which in turn hold shares in sub-subsidiaries, etc. Usually, two main business lines can be distinguished in financial groups, i.e. one in banking, one in insurance. Sometimes a special treatment is deserved for the business line "investment management",

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2 Basel Committee on Banking Supervision, Enhancing corporate governance for banking organisations, February 2006, www.bis.org

3 G. Teubner, "Unitas Multiplex: problems of corporate governance in group enterprises" in D. Sugarman & G. Teubner (eds.), *Regulating Corporate Groups in Europe*, Baden-Baden, Nomos Verlagsgesellschaft, 1990, 67-104.

especially as independence and avoidance of conflicts of interest belong to the objectives of structuring this business line separately[4].

Subsidiaries are frequently wholly owned: this makes the present analysis somewhat easier, as no account has to be taken of the minority or outside shareholders. If there are external shareholders involved, the rules of group law require special attention to be paid to these[5].

5. One of the central issues in a group relates to the extent to which parent companies can instruct their subsidiaries to engage into transactions that are dictated by the interest of the parent, or other group companies, or of the group as a whole, and whether the subsidiary may validly consent to these transactions even when they are not directly in the interest of the subsidiary. These are the conflicts addressed in this paper.

There is an indefinite number of examples of these situations: cash pooling, royalties for non specific services to be paid to the parent, low interest loans, outright financial support to the parent, or to another group company; more complex cases relate to corporate opportunities, delimitation of business areas and so on. Many of these transactions are rarely discussed in public, except if they violate tax rules, especially on transfer pricing, or if the group entities get into financial difficulties.

The parent companies in general give instructions to their subsidiaries and prescribe the way these will be managed. Often subsidiaries are fully integrated in the group and enjoy little if any proper identity[6]. Although these are separate legal entities, often subject to other legal systems, the parent can as the owner of the shares determine policies, appoint directors of the subsidiary, prescribe management on an integrated basis and in general dispose of it as it fits into its overall policy, however respecting the rights of the local creditors and depositors, and the rules and regulations that are imposed by the local authorities. Local rules that reduce the parent in exercising its powers would be contrary to the EU rules on freedom of establishment[7].

The parent's or more generally the group's influence is transmitted not only through the election of the subsidiaries' board of directors, but through a wide range of more subtle instruments[8] that lead the subsidiary to be absorbed in the overall group policy, even if some autonomy will be maintained in specific areas such as marketing, HR policy, relations with the supervisors, etc.

6. There seem to be different answers to this question.

A first answer consists of declaring that all intra-group transactions should take place at arms' length, and that any damage that may be caused to a group company should be

[4] E. Wymeersch, "Conflicts of Interest, Especially in Asset Management" in L. Thévenoz en R. Bahar (eds.), *Conflicts of Interest: Corporate Governance and Financial Market*, Kluwer Law International, 2006, 261-275.

[5] E.g. mandatory bid rules or company law conflict of interest rules (see e.g. art 524 Belgian Companies' Code).

[6] These are the "qualifizierte faktische Konzerne", well known in German law.

[7] See the cases on golden shares: Case C-463/00, Commission of the European Communities v Kingdom of Spain, *ECR* 2003 I-04581, Case C-98/01, Commission of the European Communities v United Kingdom of Great Britain and Northern Ireland, *ECR* 2003 I-04641, Case C-174/04, Commission of the European Communities v Italian Republic, *ECR* 2005 I-04933, Joined cases C-282/04 and C-283/04, Commission of the European Communities v Kingdom of the Netherlands, not yet published.

[8] Such as the appointment of employees of the parent, the accounting and internal control system, the budget and development plans, etc.

compensated after due evaluation. Compensation should take place on an annual basis, under the personal liability of the board members. This very strict position is more or less the one applicable in general German company law. In practice it is difficult to uphold and companies often only formally comply with the requirement. Some companies will prefer to escape the regime altogether and therefore enter into an agreement with the parent whereby all profits will directly benefit the parent. This is the field of the German group contracts, among which the "Gewinnabführungsverträge" or profit transfer agreements should be mentioned along with "Beherrschungsverträge" or domination contracts

A second solution starts from the entirely opposite direction and declares the group influence a lawful objective, and allows group entities to make sacrifices for supporting group objectives. Group injunctions or similar measures are held valid and enforceable. Conversely, the subsidiaries can lawfully decide that decisions are taken, or not taken in the group interest. However, the group influence cannot go to the point that it would sacrifice the subsidiary's interest and those of its creditors to the group. Hence there are certain safeguards, to be discussed further, in the more detailed discussion of the French Rozenblum case. Strikingly the same formulation has been used not only in criminal law matters, but in many other fields, such as director's liability, validity of transactions in the pre-insolvency period, etc. Moreover there have been many subsequent decisions by the same French Supreme Court, but also by lower Belgian jurisdictions, and Italian law recently seems to be going in the same direction[9].

A third, intermediate solution is found in Dutch law, whereby "the articles of association may provide that the management should behave according to the instructions given by an organ of the company, giving general directions on subjects to be further defined in the articles"[10]. Dutch case law is not very clear on this point but seems to bend into the direction that the parent is not entitled to give binding instructions to the subsidiary unless the articles provide otherwise[11]. Also discussed is whether these instructions would be of a general nature, and not relating to specific transactions, although ex post the distinction seems rather theoretical. However, legal writing indicate that even the supreme court takes into account the de facto dependence of the subsidiary as a consequence of the parent's power to suspend or dismiss directors[12].

Although apparently very different, one seeming to be the opposite of the other, the three approaches are de facto quite similar. All three recognise that the parent is entitled to give instructions to the subsidiary and that the latter has to conform. All three admit that these instructions may be detrimental to the subsidiary, therefore there should be limits to the instructions of the parent. The French case law identifies the criteria against which these instructions will be measured and in that sense contains a more explicit message in terms of conduct. Violations of these criteria will lead to sanctions, of whatever nature. According to German or Dutch law, actions that would be harmful to the subsidiary will lead to an indemnification duty: the latter is defined in different terms as to periodicity, evaluation etc.

Beyond their detailed formulation the final outcome of the three approaches will be quite comparable. In each of these cases, group influence is accepted, but the consequences attached are different. In German group law, the question is approached from the angle of

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9 See following Italian Supreme Court cases: 11 March 1996, no. 2001, *Foro it.* 1996, I, p. 1222; 5 December 1998, no. 12325, *Giur. it.* 1999, p. 2317; 24 August 2004, no. 16707, *Giur. it.* 2005, p. 73.

10 Art 2: 129/239 § 4 Dutch Civil Code.

11 Sobi-Hurks decision, HR 21 December 2001, JOR, 2002-38, nt. Fabert-Bartman, see in general S. M. Bartman & A. F. M. Dorresteijn, *Van het Concern*, 6th edition, Deventer, Kluwer, 2006, Part IV.I.

12 P. Van Schilfgaarde & J. Winter, Van de BV en de NV, Deventer, Kluwer, 2003, nr. 43.

indemnification and possible personal liability, in Dutch law, it seems that the validity of the decision is at the core of the problem while in French law, the rule that has been formulated in case law is considered a general principle, the violation of which could lead to different sanctions. None of the compared systems however entirely refuses group influence. In most other states no statutory provision exists. Italian law goes into the direction of the German indemnification duty[13].

7. It is worthwhile to analyse in some more detail the French Cour de cassation case, known as the Rozenblum doctrine as its contains clear criteria about the limits set to the parent's or group's conduct. The case related to criminal conduct. As it has been used in several other even unrelated fields, legal writing considers it as "the yardstick" and at least a valuable alternative to the existing systems[14]. It also yields some interesting insight in the conduct to be adopted by the different parties involved in a group context.

The Rozenblum case relates to a criminal prosecution for "abus de biens sociaux". As the director of a number of unrelated companies, all of which were controlled by Mr. Rozenblum and his associate defendant, Rozenblum was prosecuted for having siphoned away assets between the different companies, to sustain those that were making losses. According to the Cour de cassation[15] whether these transfers were permissible should be judged by the following criterion:

> "the financial assistance given by the "de iure" of "de facto" directors of a company to other group companies in which they held a direct or indirect interest, should be supported by an economic social or financial common interest, to be evaluated in the light of a policy developed with regard to the group as a whole and should not be devoid of any return or disrupt the balance of the mutual obligations of the companies involved, nor exceed the financial capacity of the company that is supporting the burden".

The ruling clarifies that between companies belonging to the same group, transfers may take place at agreed conditions – hence without explicitly raising issues of transfer pricing – provided that a threefold test is met:

- there should be a policy with regard to the group as a whole
- financial assistance should not be devoid of any return nor disrupt the balance of mutual obligations
- the financial assistance should not exceed the capacity of the company that supports the burden.

The first of these three conditions is not always considered essential; in Belgium, where the same rule has been followed, this condition has not been retained.

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[13] Art. 2497, paragraph 1 Codice Civili; Vincenzo Cariello, "The "Compensation" of Damages with Advantages Deriving from Management and Co-ordination Activity (*Direzione e Coordinamento*) of the Parent Company (article 2497, paragraph 1, Italian Civil Code) – Italian Supreme Court 24 August 2004, no. 16707, *ECFR* 2006/3, 330-340.

[14] See Forum europaeum sur le droit des groupes de sociétés, "Un droit des groupes de société pour l'Europe", Part I, *Rev. Sociétés* (1) janv.-mars 1999, 70-80 (IV. Bonne gestion du groupe).

[15] Cass. crim., 4 February 1985, Dalloz, 1985, 478 nt. D. Ohl, Rev. Sociétés, 1985, 648, nt. Jeandidier; Gaz. Palais, 1985, I, 377, nt. Marchi; Cass., 13 February 1989, Rev. Sociétés, 1989, 692, nt. Bouloc, Cass. Crim., September 1996, Rev. Sociétés, 1997, 365, nt. Bouloc. There have been several other cases with the same holding: xxx

The two other conditions are crucial. They boil down to the idea that within a group there is a certain interdependency of the different group entities, and that a certain mutual support is allowed provided it does not take place on a unilateral basis, but that there is a sufficient “quid pro quo” to avoid one of the partners to be always on the losing side. Moreover, support cannot exceed what can reasonably be expected from the supporting partner: if it is beyond the latter’s financial capacity, it will be considered unlawful. This rule would forbid support being given in the light of insolvency or without necessary guarantees if the support could exceed the capacity of the creditor.

The rule is also important for what it does not say: it does not say that “assistance within a group cannot be given, and should necessarily be at arms’ length”. It requires some reciprocity but does not state the time period within which this “quid pro quo” should take place or be determined. A reasonable period will therefore be held to apply. It will be up to the board of directors to make a decision within which period of time the subsidiary will be expected to have received the just return. Also the ruling does not contain any information as to the balance between the two legs of the relationship: should there be a perfect “quid pro quo”, or only some balance? The answer is likely to be that there should not be a gross unbalance, but that the equilibrium between the two sides is left to the parties to evaluate. The judge will only check gross unbalance: this is often referred to as a “marginal” control. The last condition is of course very important: the board will have to decide whether group decisions, e.g. loans are not jeopardising the subsidiary’s solvency, even if they restrict some of its future development.

8. The Rozenblum holding will certainly be considered too lax to bank supervisors and to many bankers and businessmen as well. It allow massive transfers of substance between group entities at vague conditions, and against indemnities that are difficult to determine and even more difficult to implement. Until further notice however, it constitutes the clearest common denominator found in group law. Supervisors should do well to clarify their position on this point and may require from groups that their internal rules adopt a stricter attitude, and the necessary procedures to ensure that intra-group transactions take place at conditions that better reflect the arms’ length conditions. In the absence of any yardstick, one can fear that courts will adopt a ruling that follows the lines of Rozenblum.

To the extent that the rule recognises the parent’s right to impose certain decisions on the subsidiary, the rule would also allow the home supervisor to address essentially the parent, as the latter can then instruct the subsidiary’s management. This building block is of obvious importance in exercising consolidated supervision: if supervisory injunctions can lawfully be given in respect of a controlled regulated entity, it might suffice to address oneself to the ultimate decision centre, at the parent’s level, notwithstanding the necessary instructions to the subsidiary’s board. Continuing this line of reasoning, might it not seem that it allows to include subsidiaries in the group supervision, moving into the direction of assimilating subsidiaries to branches and considering that the parent’s supervisor is competent for the whole group. But this is a bold conclusion.

9. The rule that the subsidiary should follow up the instructions of the parent is rarely the result of an explicit order given by the parent but is in fact embedded in the entire functioning of the group. Often, several functions are common (audit, compliance, risk, etc) but the group management will coordinate and determine the limits within which the subsidiary can engage in the assigned business activities. Other indirect techniques to control the subsidiary consist of the common accounting, reporting and risk measurement platforms that are used

throughout the group. Increasingly the European directives will impose practices that are common to the group as a whole e.g. in terms of risk measurement or in terms of codes of conduct v.à.v. clients. All this results in a subsidiary being increasingly embedded in the overall group functioning, up to the point that in some cases one can ask oneself whether the subsidiary can still be considered a separate legal entity, and is not in fact running a business on behalf of the parent, although in the name of the subsidiary. If that were proved, there is a definite risk that all assets and liabilities be directly attributed to the parent[16].

10. In order to avoid this liability, it is important that the subsidiary retains a certain but sufficient degree of autonomous decision-making. Its board of directors should, within the limits posed by the group instructions, make its own determinations, decide itself on its operations, etc. Therefore it is important that the board has a real consistency, and be able to make decisions in cases that a strong conflict of interest would oppose the subsidiary to the parent.

In some jurisdictions, the supervisors have recommended to appoint independent directors, not only at the top holding company, but also at the level of the top subsidiaries within the group. Although it may seem odd to designate independent directors at a 100% subsidiary, the motivation for the recommendation flows from the differences of interest between the shareholder company and the creditors of the subsidiary, usually the depositors or policyholders of that subsidiary. In order to protect their interest and to ensure a built-in mechanism for guiding group conduct to that effect, these independent directors serve e.g. as objective monitors of the board's action, will take part in its audit committee, and in other advisory committees at board level, and if the worst came to the worst, might serve as some type of whistleblowers.

11. What should be the position of the directors of the subsidiary company, confronted with a conflict with the parent or with other group entities? If they too strongly or repeatedly refuse the parent's instructions, they will be fired, or even been held liable by the parent. If they merely obey the parent's orders and if these lead to the subsidiary's default, they might be held liable towards the latter's creditors. Here again, there are good reasons to apply the Rozenblum doctrine. On the one hand these directors are entitled to implement the group's policies, even if these have negative effects on the financial position of the subsidiary. But if they dutifully execute orders that are likely to exceed the subsidiary's financial capacity and lead to its default, they should refuse, and if needed, quit, lest they would be held liable. Furthermore, they could adopt a flexible attitude provided the safeguards of a quid pro quo, even in the longer term, have been attained. If both conditions have been met, they would be safe in liability terms. In practical terms this would mean that even implementing a parent instructions, policies and operational management, the directors of the subsidiary would in principle be safe against any claim in liability, including those of the subsidiary's creditors.

12. However, suppose that the subsidiary is urged to support the parent because the parent is in dire straits, and support may be needed to avoid the parent's collapse, then the board of the subsidiary has imperative reasons to refuse any support, unless robust or other techniques would eliminate its credit risk. If notwithstanding, the transaction would take place, this will result in the directors being liable, in this case for mismanagement, or a similar qualification under national law. Here again, before entering into these transactions, directors have to pay

[16] This is the hypothesis known in German law as the qualifizierte faktische Konzerne.

due diligence to the probability of default of the parent. If there is any doubt in terms of solvency, they should abstain.

The Rozenblum line of reasoning clarifies the outer limits of acceptable behaviour in a group context. In practice however, it would be preferable that stricter criteria be applied. Here self-regulatory instruments such as decisions by the board of directors, or even the general meeting might reinforce discipline of both of parent and the subsidiary. In any case, boards are well advised to follow formal procedures before entering into intra-group deals, such as a formal description of the transactions, evaluating the risks involved, etc. Whether the transaction is in the company's interest is a moot question taking into account that this evaluation belongs to the board in any case.

Regulators might usefully contribute to invite groups to adopt policies to that effect.

Part II. The directive on financial conglomerates

13. The directive aims at organising supplementary supervision on conglomerates being groups with regulated entities belonging to different financial sectors. The "Intra-group Transactions" (art. 8, referring to other articles) belong to the points of specific attention of this cross-sector supervision The following short description only deals with those aspects that directly relate to intra-group transactions, without analysing the related provisions of the directive, such as those concerning the definitions, the scope of the directive, the designation of the coordinator, the supervisory measures and so on.

The subject of intra-group transactions does not cover all situations where conflicts of interest may exist: there are conflict situation that do not result in intra-group transactions, e.g. if corporate opportunities are diverted from one subsidiary to another due to a group decision Conflicts may also be the consequence of conflicts between parallel interests, such as in case of cross default clauses. In case of common brands, a risk generated in one entity may reverberate on another. These are also cases of intra-group competition, whereby e.g. access to certain market segments is denied to some group entities within the overall strategy of the group. In some cases a subsidiary may unilaterally take decisions that are beneficial to the parent, without formal agreement, such as considerable transfers of profits to the parent (by way of dividends, reduction of legal capital, or share buy-backs). One can expect supervisors to be equally interested in these relations, to the extent that they may considerably affect the subsidiary's future.

14. As a directive on financial supervision, it does not introduce substantive criteria allowing the supervisor to approve or reject certain transactions. However, it requires within a conglomerate, internal control mechanisms and risk management processes in order to identify, monitor and control intra-group transactions and risk concentration. It introduces rules on reporting intra-group transactions and risk concentration, and allows the supervisors to "review" these transactions and to assess the adequacy of internal control mechanisms and risk management processes. This process is analysed in three steps:

a) Reporting of all significant intra-group transactions on a regular basis.

   a. The type of transactions and risks will be identified by the coordinator, after consultation with the other authorities involved (annex II). Specific group and risk management structures have to be set up for identifying these transactions.
   b. The significance threshold was established, on a default basis, at 5% of the total amount of the capital adequacy requirement at the level of the conglomerate.
   c. Internal procedures and reports should allow to identify, measure, monitor and control intra-group transactions (art 9 (3) (b).
   d. Reports have to be addressed to the coordinator

b) Intra-group transactions are subject to internal risk management processes. (art 9(2)

   a. This implies sound administrative and accounting processes, risks management and internal control procedures.
   b. Governance and management procedures including appropriate approval and periodical review procedures have to be adopted by the appropriate governing bodies
   c. Integration of the risk management systems throughout the organisation.
   d. Adequate capital adequacy policies to take into account the risk profile.

c) "Supervisory Overview"

   a. These transactions shall be subject to "supervisory overview" by the coordinator. Special attention is to be given to the contagion risk, the conflict of interest risk, the risk of circumvention of sectoral rules and the level or volume of risks (annex II)[17]
   b. Assessment of the conglomerate's structure, organisation and internal controls
   c. In addition national authorities may set quantitative or qualitative limits pending further coordination; these refer firstly to the reporting obligation, and probably extend to supervisory review
   d. The authorities have the right to impose additional measures if intra-group transactions introduce an additional risk.
   e. For the circumvention risk the Annex II provides that the states may allow the supervisor to apply the rules on intra-group transactions applicable in one sector to be applied to the conglomerate as a whole. Probably self regulation could be put to work here

15. This short overview of the relevant provisions of the directive indicates that henceforth the supervisors will have adequate tools to be informed about significant intra-group transactions, and about their conditions. Although the notions do not cover all intra-group relations, the supervisor's view would certainly encompass the bulk of the relevant transactions.

Supervisors will have to take a position on the effect these transactions may have on the overall solvency of the group. As to tools and remedies, the directive is less explicit. In assessing the organisation and internal controls, the supervisor could probably observe whether certain relationships create additional or excessive risks. Within its general competences, supervisors could recommend regulated entities to introduce adequate procedures to deal with intra-group conflicts of interest, avoiding these to result in contagion

[17] For the circumvention risk the Annex II provides that the states may allow the supervisor to apply the rules on intra-group transactions applicable in one sector to be applied to the conglomerate as a whole. Probably self regulation

risk cases. These procedures are commonly referred to as “firewalls”. Among these procedures, one could propose :

- special reporting obligations on the pros and cons of intra-group transactions, identifying the advantages to each of the group entities of the proposed transactions
- special reports analysing the contagion risk
- approval by the boards of transactions that might create risks above a certain level
- special guarantees for intra-group transactions that in exceptional cases might jeopardise the subsidiary’s future
- appointing independent directors, in charge of scrutinizing and evaluating intra-group transactions.

Apart from recommending changes to these relationships, the final sanction will be the requirement to put up additional capital.

Part III. The Capital Requirement Directive

16. In recent directives dealing with banking supervision one sees a further tendency to overcome the legal division that exist in groups between parent and subsidiaries, and to deal with group level only. There are several markers illustrating this tendency: several articles of the CRD point into that direction: art. 129 is a very well known one, but also art 69 should be mentioned as well, and there may be more where indirectly the same lines of reasoning are followed. Furthermore, it is worthwhile to remind that the ECJ, in its Caixa case has in fact also followed the same reasoning. Whether these points may be read as marking the road towards dealing with branches and subsidiaries as part of the same entity remains to be seen. In fact, dealing with the group on an integrated basis raises important questions in terms of home/host financial supervision, depositor protection, lender of last resort intervention and so on. This is not the issue to be dealt with here: rather the question to be brought up here relates to the relationship between the supervisory provisions and the general company law concepts as have been developed in case law. Are the two approaches significantly different and should supervisors pay additional attention to the underlying risks flowing from the company law analysis?

1° Article 69 CRD

17. The CRD states the principle that supervision is exercised on a solo basis (art 68) and on a consolidated basis where applicable (art 70). In a limited number of cases however, the directive allows member states to derogate from the solo principle, both for the parent credit institution and for the subsidiary, and allows supervision to be exercised on a consolidated basis only, provided several stringent conditions are met.

18. The CRD states the principle that supervision is exercised on a solo basis is waived under certain conditions, is applicable to both the parent credit institution and the subsidiary, and allows supervision to be exercised on a consolidated basis only:

A- Parent and subsidiary should be subject to authorisation and supervision by the same member state[18] : the rule would hence not apply to a cross border situation.

[18] These should necessarily be the same supervisor

B- The parent should be a credit institution, or a financial holding company provided it is subject to the same supervision.

C- But the subsidiary may obviously belong to another business line different from that of the parent, e.g. an asset management subsidiary. It seems unlikely that it would also apply to an insurance undertaking.

D- Own funds should be adequately distributed between parent and subsidiary. This is the essential guarantee for limiting supervision to consolidated supervision. The rule has been formulated as an objective, meaning that it is not considered to be a touchstone for allowing the subsidiary to be treated on a consolidated basis only. The conditions for obtaining this permission are detailed in the conditions put forward by the directive as follows:

1) There should be no material, practical or legal impediments to the prompt transfer of own funds from parent to subsidiary[19];
2) The parent guarantees the commitments of the subsidiary; or the subsidiary's risks are negligible.
3) The parent is running the subsidiary prudently and its risk evaluation, measurement and control procedures extend to the subsidiary;
4) The parent is legally controlling the subsidiary at the 50% + level allowing it to appoint the members of the board, in clear: it should be a fully controlled subsidiary.

Although only condition nr.2 refers to the consent of the competent authority, it is same to assume that the entire scheme ahs to be approved by the supervisor.

Article 69 (1) can be said to refer to the case where the parent has refrained from arming the subsidiary with sufficient own funds, and hence can transfer these in case of necessity.

19. Article 69(3) contains a similar flexibility with respect to the solo supervision on the parent: solo supervision can be waived if two conditions are met. In fact the abovementioned conditions 1 and 3 apply in an adapted wording:

(a) "there is no current or foreseen material practical or legal impediment to the prompt transfer of own funds or repayment of liabilities to the parent credit institution in a Member State; and

(b) the risk evaluation, measurement and control procedures relevant for consolidated supervision cover the parent credit institution in a Member State. "

The case is equally critical as the consolidated supervisor would be ultimately responsible in case the group as a whole is threatened, and resources have to called back from the subsidiary.

[19] The rule says nothing about the transfers in the opposite sense, as the exemption relates to waiving the solo supervision on the subsidiary. This is rather indirectly dealt with under article 69 (3).

The issue that needs to be further analysed relates to the relationship of these provisions with the principles of negligence or of company law as these have been analysed before. Is there a risk of contradiction between the two?

20. Articles 68 and 69 are rules relating to the prudential supervision but do not state any particular provision on the underlying liabilities that may occur in certain circumstances. Indirectly however, article 69 (1) allows the supervisor to make abstraction of the proper situation of the subsidiary provided that its liabilities are fully covered by the parent. This guarantee can be prejudicial to the parent's creditors, and will normally be beneficial to those of the subsidiary. Therefore the guarantee has to be disclosed, and will be part of the consolidated statement to be published. The directive is silent who has to take the decision to free the subsidiary from solo supervision: has it to be taken by one, or- what seems more acceptable- by both supervisors involved? In any case the supervisors would have to verify whether the conditions of art.69 (1) have been met, and hence whether the guarantee is valid.

21. Art 69 (1) is based on the hypothesis that the parent would come to the rescue of the subsidiary, in which case "own funds" will be transferred to the subsidiary. The question therefore arises to what extent can a parent support its subsidiary – per hypothesis – that is evolving towards insolvency.

Article 69(3) allows waiving parent solo supervision in the mirror conditions, that the parent is becoming insolvent and has to call on the funds of the subsidiary. It should be repeated that both articles merely refer to the waiving the solo supervision, and contain no provisions on the general legal effects of the waiver decision. It is only by second round effects that legal consequences may appear. These relate ex ante to whether the support may lawfully be granted to the ailing group entity, or whether, once the support has been granted, there may be liability on the part of the supporting entity.

22. In the hypothesis of article 69 (1), the parent may feel obliged to support the subsidiary. As this support may jeopardise the situation of the parent, its creditors could object. Whether their objection is to be upheld could than be measured by the Rozenblum-test, provided this test is held applicable in the parent's jurisdiction. According to the Rozenblum test, there will be little doubt about the "quid pro quo" element: the parent will necessarily be able to further benefit from its subsidiary, at least potentially. One could expect that the survival of the subsidiary will bring further benefits to the parent, under the form of dividends, business flows, market share and so on. However, the other test would lead the parent to refuse support in case the subsidiary would likely not be able to reimburse the parent. This means that the parent's support would fail in case it is most needed.

What kind of remedy is to be applied in this case will depend on the circumstances in which the case arises. It was mentioned supra that the Rozenblum test has been applied in radically different settings: to determine criminal liability, to annul pre-insolvency transactions, to determine director's liability and even the validity of the transaction. If the shareholders of the parent complain, there might be director's liability. If the parent is also close to insolvency, the guarantee might even be annulled on the basis of the second element of the Rozenblum test.

23. This conclusion has to be qualified in two important respects.

A first case relates to the commitment of the parent to further contribute to the own funds of the subsidiary: there can be no objection that a parent subscribes to additional capital of its subsidiary, or -what is equivalent - that it promises to deliver that capital if needed. The possible insolvency of the subsidiary should be assessed taking that commitment of the parent into account.

On the other hand, if the parent has guaranteed the liabilities of the subsidiary - which is the case to which article 69 (1) refers - the analysis is more complicated[20]. This guarantee should be granted at a moment at which the solvency of the subsidiary is not in doubt: valid guarantees have to be honoured even if the situation of the subsidiary has later deteriorated beyond remission. However, guarantees granted at a moment that the subsidiary was already virtually solvent might be subject to criticism as good money is thrown after bad. Criticism might be formulated by the subsidiary creditor's on the basis that the guarantee has further extended the life of an irremediably insolvent entity. Criticism might also be formulated by the shareholders of the parent on the basis of bad management. In both cases the decision will hinge on the finding that the subsidiary was irrevocably insolvent . In both cases however the basis for liability would be the negligence or tort committed by the management of the parent in granting a guarantee to a manifestly insolvent subsidiary. The legal doctrine underlying the first type liability would be the same as is being applied to banks granting unjustified credit to debtors that appear to be fully uncreditworthy: at least in some jurisdictions, banks has been held liable towards creditors of a borrower for having misled these creditors about the true creditworthiness of their debtor.

24. Supervisors have to give their consent to the guarantee, according to article 69 (1): "the parent… declares, with the consent of the competent authority, that it guarantees the commitments entered into by the subsidiary….". As the rule is formulated it indicates that the supervisor has to ensure that the subsidiary's liabilities are effectively guaranteed. Therefore the supervisor will have to check very thoroughly whether any objections could be raised that could jeopardize the effectiveness of the guarantee.

25. According to article 69(3)[21], the parent will be allowed to be exempted from solo supervision, but being dealt with according to the consolidated supervision, provided that there are no impediments to the prompt transfer of own funds from the subsidiary to the parent, or to the repayment of liabilities to the parent by the subsidiary. The absence of any pre-established guarantee agreement constitutes a significant difference with the 69 (1) hypothesis. It implies that the subsidiary will be supposed to come to the rescue of the parent and dispose of part of its own funds in favour of the parent, or repay its liabilities towards the parent, in both cases without a pre-established obligation to do so.

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[20] "either the parent undertaking satisfies the competent authority regarding the prudent management of the subsidiary and has declared, with the consent of the competent authority, that it guarantees the commitments entered into by the subsidiary, or the risks in the subsidiary are of negligible interest;"

[21] in order to ensure that own funds are distributed adequately among the parent undertaking and the subsidiaries:

(a) there is no current or foreseen material practical or legal impediment to the prompt transfer of own funds or repayment of liabilities to the parent credit institution in a Member State; and

(b) the risk evaluation, measurement and control procedures relevant for consolidated supervision cover the parent credit institution in a Member State.

The two cases mentioned in art. 69 (3) have to be distinguished. If the subsidiary would reimburse the capital – be it by way of dividends, share buybacks, formal capital reduction or any other equivalent technique, this transaction may be criticized if it takes place in circumstances in which its – the subsidiary's - creditors may be harmed. This may be the case if the subsidiary voluntarily restitutes so much of its own funds to the parent that the subsidiary would be unlikely to be able to honour its liabilities towards its creditors, or at least would put their position in serious danger. The liability of the directors deciding on these actions might exist in favor of both old and new creditors of the subsidiary: to the former for knowingly reducing the safeguards for the payment of the debts[22], to the latter for trading with a company that is not likely to be able to honour its liabilities. The latter case is comparable to the "wrongful trading" case, where the debtor is trading on the creditor's risk. But outside that case, there is no restriction for a company, even a subsidiary to dispose of its own funds. Of course, these liabilities would only apply to decisions taken by the board of directors and not by the shareholders.

26. The case where the subsidiary repays its debts to the parent is somewhat different, as in this case there is a pre-existent liability, so that the assessment of the subsidiary's conduct should distinguish whether upon payment the debt is due or not. To pay a debt that is due cannot be criticized: interestingly, ad. 69 (3) does not refer to whether the debt is due or not, and that differently from article 70, mentioned hereafter. Pre-paying a debt to a parent that is close to insolvency could be held objectionable, both under Rozenblum, and more generally under negligence rules. The mere fact that there are no "practical or legal impediments" would not suffice to allow the board of the subsidiary to safely restitute these funds to its parent. In practice one easily sees the conflicts that this matter may create: the parent demanding the "excessive funds" of its subsidiary to be upstreamed, while the subsidiary, supported by its supervisor, unwilling to risk its liability in case of later failure of the parent. One understands why the directive provides that the supervisors of the subsidiaries have to be informed (69 (3) al.2). It is also noteworthy that art 69 (3) does not explicitly restrict its ambit to intra-state matters, but obviously may also be applied on a cross border basis. Although this may relate to the fact that the paragraph only concerns the parent, there is a textual argument that information has to be given to supervisors in all other member states (art 69. 3. last paragraph).

27. The basic idea underlying both paragraphs of article 69 seems to be that in a group, there should be no concern about where the own funds are constituted, provided that they can be effectively transferred in case of need. To the extent however that this approach would lead to leaving some group entities undercapitalised, there is definite risk of liability for the directors of those entities that are trading from these undercapitalised entities. This liability is of the same nature as mentioned above and designated as "wrongful trading". In case of a last minute transfer, there might be a case of director's liability if the payment was made to a parent that was irretrievably lost.

2° Article 70 CRD

28. The directive[23] contains a comparable reasoning for the calculation of the own funds of a parent in the specific case in which it fully owns a subsidiary (at the 50% + threshold)

[22] Company law, e.g. on reimbursing the capital, would grant additional protection to shareholders

[23] Art70 Both hypotheses have been dealt with before: repaying the own funds could lead to liability of directors to the creditors of the subsidiary (n° 25). Repaying debts that are due would not trigger any liability (n° 26).

and includes it in its risk evaluation, measurement and control procedures - compare the conditions under article 69 (1) - but whose liabilities or exposures are essentially towards the parent. This is a subsidiary that can be described as the "incorporated department" of the parent. In this case the calculation of the parent's own funds may include those of the subsidiary, provided again that the transfer of the own funds or the repayment of liabilities to the parent can be effectuated without practical of legal impediments. Here the directive reasons as if the own funds, although technically held by the subsidiary, were the property of the parent. Here again the same question will be encountered about judging at what moment the own funds can be transferred to the parent in case the latter is close to insolvency. The directive also states that the same approach applies in case the subsidiary owes "material liabilities" to the parent: the conditions for integrating the own funds in those of the parent is conditioned upon the prompt repayment of the liabilities, "when due by the subsidiary". One will understand "when due" that the liability was due at maturity, or due according to any specific clause. Whether that would include the parent's likely insolvency should probably be answered as if the clause referred to a guarantee contract.

The provision of the directive is more liberal as it allows the calculation to take place by incorporating in the parent's own funds' statement, the subsidiaries' own funds - irrespective where they are located, even outside the EU.

As this provision merely relates to quantifying the amount of the own funds, it does not seem to create any strong tension with the civil law principles. However, there might be a problem in case the basis on which the calculation has been founded appear to give rise to doubt under general legal principles.

The rule would allow the parent to be undercapitalised, relying on the subsidiary's own funds, in the expectation that these could be repatriated in case of need. The situation is similar to the one analysed under article 69 (3). Differently from that provision, article 70 refers expressly to the "repayment of liabilities when due": this addition would protect the subsidiary against claims for paying undue debts. The rule as formulated in article 70 obviously refers to a conduct that can generally be referred to as less problematic than the one underlying art. 69.

3° Article 129, CRD

29. The other very conspicuous provision of the CRD dealing with parent- subsidiary relations is art.129. This article allows certain matters relating to internal model permission, as referred to in Articles 84(1), 87(9) and 105 and in Annex III, Part 6 respectively, to be granted by the parent company's supervisor, to the extent that these permissions will relate to both the parent and each of the subsidiaries[24], wherever located in the EU. The intention is to have uniform models applicable throughout the group and approved by all supervisors involved and if no agreement can be found, ultimately by the parent's supervisor.

The rule does not seem incompatible with the civil law doctrine, as it only relates to supervisory practices while it seems rather exceptional that the models, submitted for approval will affect the intra-group relationship, the models leaving parties free to decide on their business relations.

[24] "submitted by an EU parent credit institution and its subsidiaries, or jointly by the subsidiaries of an EU parent financial holding company,"

30. Although the foregoing analysis reveals that in both provisions, one may fear that there may, in certain circumstances, be a contradiction with the civil law principles as embodied in the Rozenblum doctrine, it can safely be put forward however, that in evaluating permissible conduct by a parent, the appreciation of the supervisor will play an important role. Moreover, if the supervisor considered that there was sufficient capital in the subsidiary, that element will usually not be contradicted by a civil law judge.

Conclusion

31. The European Directives on Credit institutions contain provisions relating to the parent-subsidiary relationship. These directives essentially deal with supervisory issues and aim at coordinating the action of supervisors at the different levels of the group structure. Functionally they constitute a significant progress in structuring supervision in Europe.

However, some of the provisions of the directives may result in tensions with the general principles of company law, especially those relating to groups of companies. The latter principles have not been harmonised, so that account has to betaken with the differences and nuances in national case law. Further issues may arise on the basis of general negligence law, as applied in a company law context.

A close analysis of the main relevant provisions in this field – articles 69 and 129 CRD – reveal that in some cases there may be conflicts between the two approaches. This should urge supervisors to be particularly careful in granting exemptions from regulatory requirements. Some simple guidelines might contribute to a balanced result: a close scrutiny of the risk evaluation, measurement and control procedures, as called for by the directives, and a fine analysis of the possible difficulties under national company law might avert some of the more unexpected pitfalls.

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