PART I

Setting the Scene

Part I explains the why, what, and how of the book. Furthermore, the term shadow business is explained and defined as a societal concern that necessitates further research. The remedy of the information asymmetry that shadow business represents is group transparency. If, however, transparency is a value that requires legal commitments, then it needs to be operationalized. This means that it should be possible to derive legal obligations and that this helps realize transparency as an objective. This can arguably only be achieved where the term "transparency" is precisely defined. In Part I, transparency is discussed in light of three aspects and whether and to what extent a disclosure regime facilitates accessible, high-quality, and processable information, where the underlying goal is the avoidance of information asymmetry.

1

Corporate Group Transparency

1.1 SETTING THE SCENE: IDENTIFYING "SHADOW BUSINESS"

1.1.1 *De Facto Control Undertheorized*

A former chief financial officer (CFO) of a large US company decided in 2004, when under investigation, to cooperate with the federal authorities in the prosecution of his former fellow executives in what has been called the largest accounting fraud in US history. The company was Enron, and the informant, who was also one of the creators of Enron's opaque group structure, was Andrew Fastow. Massive losses in Enron's quarterly balance sheets from derivatives trading and failed projects had been hidden in off-balance-sheet special-purpose entities controlled by Enron. Accounting loopholes, special-purpose entities,[1] and poor financial reporting had allowed Enron's contractual control of the special-purpose entities to fly under the regulatory radar.[2]

The size of the scandal highlighted the importance of corporate group transparency. It also triggered a wave of new research, which has formed

[1] A common feature of the range of activities that led to Enron's downfall was the use of nonconsolidated special-purpose entities (SPEs). See W. Powers, R. S. Troubh, H. S. Winokur, Enron Corp., Board of Directors, Special Investigative Committee, and C. & P. Wilmer, *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.* (Diane Pub., 2002).

[2] The Enron case served as the backdrop for implementing the Sarbanes–Oxley Act on July 30, 2002. See, e.g., John C. Coffee Jr., "What Caused Enron?: A Capsule Social and Economic History of the 1990s" (2004) 89 *Cornell Law Review* 269, especially at 302; Curtis J. Milhaupt and Katharina Pistor, *Law and Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World* (University of Chicago Press, 2008), pp. 47–67 (discussing the Enron scandal).

two literature streams. The first stream focuses on the implications of subsidiarization and the corporate strategy of splitting an economic activity of one legal entity into two or more legal entities,[3] which in the context of this book is referred to as "organizational decoupling."[4] The second stream focuses on the use of derivatives and financial engineering to avoid beneficial ownership transparency. This is commonly referred to as "security decoupling," and research in this field is being led by the pioneering work of Henry Hu and Bernhard Black.[5]

De facto control of affiliated entities outside of consolidated accounts has, despite the post-Enron extension of the scope of accounting law reform, not been comprehensively discussed in the literature. Hu and Black focused, in their celebrated series of papers, on pricing mechanisms in securities markets and corporate governance in listed companies. Others have also followed their lead.[6] The focus of this book, however, is on the potential of equity

[3] The significance of subsidiarization for corporate strategy has been discussed thoroughly by, for example, P. I. Blumberg and K. A. Strasser in their vast amount of scholarly papers on corporate groups. Subsidiarization has also led to new practices in directing corporate groups, due to the potential differences between the role of shareholders in separate entities and the role of a parent company as a shareholder in its affiliated entities. For references to scholarly work on formal and informal governance in groups, see, e.g., J. Dine, *The Governance of Corporate Groups* (Cambridge University Press, 2000). I refer to the corporate strategy of subsidiarization as "organizational decoupling" and to internal mechanisms of operating a corporate group in a more or less unified way as "governance decoupling."

[4] See Chapter 5.

[5] Security decoupling and its potential to distort the basic notion of shares as a "bundle of rights," are discussed thoroughly in the pioneering work of H. Hu and B. Black. See Hu and Black, "Debt, Equity and Hybrid Decoupling: Governance and Systemic Risk Implications" (2008) 14 *European Financial Management* 663–709; Hu and Black, "Equity and Debt Decoupling and Empty Voting II: Importance and Extensions" (2007) 156 *University of Pennsylvania Law Review* 625–740; Hu and Black, "Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms" (2006) 61 *The Business Lawyer* 1011–70; Hu and Black, "Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership" (2007) 13 *Journal of Corporate Finance* 343–67; Hu and Black, "The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership" (2006) 79 *Southern California Law Review* 811–908. Hu and Black coined the terms "empty voter" and "hidden ownership" as two positions that can be taken by an investor. An "empty voter" holds proportionally more voting rights than economic exposure, and a "hidden owner" holds a lower amount of voting rights in proportion to economic exposure.

[6] For instance, S. L. Schwarcz, "Information Asymmetry and Information Failure: Disclosure Problems in Complex Financial Markets," in W. Sun, J. Stewart, and D. Pollard (eds.), *Corporate Governance and the Global Financial Crisis* (Cambridge University Press, 2011), pp. 95–112; D. Awrey, "Complexity, Innovation and the Regulation of Modern Financial Markets" (2012) 2 *Harvard Business Law Review* 235–94, 245–58; W.-G. Ringe, *The Deconstruction of Equity: Activist Shareholders, Decoupled Risk, and Corporate Governance* (Oxford University Press, 2016). For further references, see Chapter 6.

decoupling as a control mechanism. Equity decoupling can be combined with nonequity modes of control and strategic and coordinative means of control. This book, however, examines equity decoupling in a corporate group context. I combine the discussions on subsidiarization and governance with the implications of equity decoupling in a corporate control framework and so focus on the underanalyzed "control decoupling" aspect within the broad scope of security decoupling.[7]

Banking groups applied this strategy many years later to circumvent raised mandatory capital requirements.[8] This practice has been termed "shadow banking,"[9] and might have contributed to the Global Financial Crisis of 2008. Shadow banking practices are implemented outside of banking regulation to give a false perception of a bank's solidity. However, it was the International Financial Reporting Standards (IFRS) that enabled the practice that brought about the collapse of a large number of major banks.[10] Shadow banking prompted regulatory amendments around the world after its use became known.[11] Closing a gap in one legal domain does not, however, mean that opportunities for hidden control practices cannot be found in other domains. This became evident when it was revealed that Porsche, due to its derivatives contracts with Merrill Lynch, had more in common with a hedge fund than a car manufacturer.[12] Porsche secretly controlled 30 percent of

[7] See Chapter 6.

[8] Basel Committee on Banking Supervision, "Report on Special Purpose Entities" (2009), www.bis.org/publ/joint23.pdf (accessed January 20, 2019).

[9] Paul McCulley coined the term "shadow banking" in 2007, referring to "the whole alphabet soup of levered up nonbank investment conduits, vehicles, and structures." See P. McCulley, "Teton Reflections" (2007) *Global Central Bank Focus Series, PIMCO*, GCB Focus Sept 07 SGP-HK.pdf (pimco-global.com) (accessed October 16, 2021); P. Lysandrou and A. Nesvetailova, "The Role of Shadow Banking Entities in the Financial Crisis: A Disaggregated View" (2015) 22 *Review of International Political Economy* 257–79; M. Thiemann, "'Out of the Shadows?' Accounting for Special Purpose Entities in European Banking Systems" (2012) 16 *Competition & Change* 37–55.

[10] Thiemann, "Out of the Shadows?"

[11] Dodd–Frank Wall Street Reform and Consumer Protection Act (2010), discussed, for example, by S. L. Schwarcz, "Regulating Shadow Banking" (2011) 31 *Review of Banking & Financial Law* 619–42; European Commission, "COM(2013)614 Final: COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT Shadow Banking – Addressing New Sources of Risk in the Financial Sector" (2013), which discusses various legislative initiatives as a response to "shadow banking," including amendments to international accounting standards; M. Chui and C. Upper, "Recent Developments in Chinese Shadow Banking" (2017) *SUERF Policy Note. The European Money and Finance Forum.*

[12] See R. S. Chang, "Porsche: A 'Hedge Fund with a Carmaker Attached'," *New York Times*, January 23, 2009, nytimes.com (accessed October 16, 2021).

Volkswagen shares through prepaid options, because the notification regime did not require the holding of financial instruments to be disclosed. The use of derivatives has almost become "good corporate acquisition practice."[13] The discovery of these hidden control practices therefore triggered new regulatory amendments, this time (among others) in the Transparency Directive in the European Union.

1.1.2 *EU Law Falls Short of Capturing Certain Modes of Control*

Structure optimization is the common denominator in the examples given so far in this chapter. Legal entities, affiliation linkages, and internal governance structure are selected to optimize the regulatory applicability of, for example, taxation regimes and labor conditions. This practice does, however, also affect securities market stability, the transparency of shareholdings, and the beneficial owners. The key questions that therefore remain are "Can corporate groups choose alternative means of control to effectively control affiliated entities outside of the consolidated accounts?" And "Which forms of control are effectively included in disclosure obligations?" These comprise the topic of this book.

This book examines the discrepancy between the perception of corporate groups in law and what takes place in practice. Groups are perceived in corporate law as nothing more than a collection of separate entities in which shareholding is the primary mode of control.[14] Corporate groups are, however, in practice, interconnected economic systems of entities that are tied together by internal governance mechanisms. This book therefore aims to fill the gap in corporate law literature by analyzing how multinational groups can apply different modes of control, and it goes far beyond the simplistic understanding of corporate groups as a collection of separate entities tied together by shareholding.[15] This book also showcases the importance of an upgraded perception of groups in corporate law and how this influences the scope of secondary

[13] See, for example, the acquisition of Continental by Schaeffler. D. A. Zetzsche, "Hidden Ownership in Europe: BaFin's Decision in Schaeffler v. Continental" (2009) 10(1) *European Business Organization Law Review (EBOR)* 114.

[14] K. A. Strasser and P. I. Blumberg, "Legal Models and Business Realities of Enterprise Groups – Mismatch and Change" (2009) *CLPE Research Paper No. 18/2009* at pp. 1–26; K. A. Strasser and P. I. Blumberg, "Legal Form and Economic Substance of Enterprise Groups: Implications for Legal Policy" (2011) 1 *Accounting, Economics, and Law* 1–28.

[15] P. I. Blumberg, *The Multinational Challenge to Corporation Law: The Search for a New Corporate Personality* (Oxford University Press, 1993), pp. 304–06, 343–44; K. Vanderkerckhove, *Piercing the Corporate Veil: A Transnational Approach* (Kluwer Law International, 2008), p. 17 (noting the jurisdictional differences in this regard).

legislation in other legal domains that rely on corporate law definitions. I discuss, as examples of this, beneficial owners in securities law and control as a prerequisite for consolidated accounts in accounting law. This book analyzes the interrelation between a company, securities, and accounting law at the EU level by questioning whether the legislative aims addressed in secondary legislation can, without a harmonized concept of corporate groups, encapsulate de facto corporate control.

A comparison of corporate structuring practice with the definitions and assumptions on which the law is based sheds light on the extent to which business realities are encapsulated in the scope of corporate, securities, and accounting law. I assign the term "shadow business" to the phenomenon of corporate structuring practice that provides corporate groups with an opportunity to carefully select control linkages that allow the group to select the regulations it will be subject to. This makes legislation voluntary. The business strategy therefore allows a group to opt in or opt out of regulations. Shadow business centers on de facto affiliated entities. Legal definitions of corporate control, however, may allow these to fall outside the scope of group definitions.

The hypothesis examined in this book is that the current EU disclosure rules on corporate groups fall short in their capacity to penetrate the corporate opacity of shadow business practices.[16] Even the amended notification regime for major holdings of listed companies, which was implemented through the reformed Transparency Directive, can, for some means of de facto control, still fail to penetrate this veil. This potentially undermines regulatory objectives. If the EU disclosure rules are unable to capture relevant modes of control, then information asymmetry between those engaging in corporate engineering and third parties may affect important aspects such as negotiations between business partners and the calculation of cash flow, profits, dividends, and ultimately taxation.[17]

An explanation for this deficiency can be found in the divergence between the formalistic and functional perception of the multifaceted corporate group

[16] The EU legislator has amended a number of directives and regulations in the aftermath of the financial crisis. These amendments limit the scope of corporate and financial engineering, which is situated on the outskirts of the law. The legislative initiatives include increased disclosure of securities that have the same economic effect as shares, via amendments to the Transparency Directive (2013/50/EU); to the Accounting Directive to harmonize definitions of parent, subsidiaries, affiliates, and control (2013/34/EU); to the Accounting Regulation to make mandatory the application of IFRS to listed groups (Regulation (EC) No. 1606/2002); to the Market Abuse Regulation for additional disclosure of group structure (Regulation (EU) No. 596/2014); to the Anti-Tax Avoidance Directive (2016/1164/EU); and to the Shareholder Rights Directive for the increased disclosure of beneficial owners of intermediated shares (2017/828/EU).

[17] For details, see Section 1.2.

and the development of creative and innovative modes of control outside of regulation. The main thesis of this book is therefore that a definition of a corporate group that relies on a formal representation of separate entities through shareholdings is insufficient. I argue that this gap should be bridged by a theoretical framework that supports a definition of a corporate group as an integrated "going concern," following a natural science approach herein referred to as Systems Thinking.

1.1.3 *Toward Systems Thinking*

In this book, I analyze the potential deficiencies of current secondary legislation in the encapsulation of de facto corporate control in a corporate, securities, accounting, and tax law perspective. I then show that a Systems Thinking theoretical framework could provide the basis for the recognition of corporate groups by revealing economic substance for the objective of defining what constitutes a group as opposed to the current legal form-based approach. I do this in three steps.

First, this book argues that corporate control must be understood through both an organizational and a governance lens, and it provides the building blocks of the theoretical framework that are necessary to fully capture corporate groups. Recognizing de facto control furthermore requires a theoretical framework that encapsulates the affiliation linkages that are available. These include shares, shareholder agreements, derivatives, and nonequity modes of control that operate, for instance, through lending agreements, smart contracts on a private blockchain, and combinations of these. The selected affiliation linkages must then be merged with the chosen internal governance mechanisms. De facto control comes to light only when the combined outcome of affiliation linkages and internal governance mechanisms is assessed.

Second, this book uses Systems Thinking from science to shed light on the connection among organizational architecture, corporate structuring, and internal governance. This approach shows that Systems Thinking facilitates assessment of the functionality of the connection between organizational architecture and internal governance. Systems Thinking is therefore developed as an analytical tool for analyzing corporate groups, based on the recognition that the inner logic and management of a specific group connect with the formal corporate structure, and vice versa.[18]

[18] F. Manfrin, "The Firm as an Entity and the Law: The Economic Substance, the Legal Forms," in A. Canziani, T. Kirat, and Y. Biondi (eds.), *The Firm as an Entity: Implications for Economics, Accounting and the Law* (Routledge, 2007), pp. 292–316.

In groups, Systems Thinking may challenge predominant group definitions that are based on majority holdings or control, operationalized through a mix of contracts and shareholding. Perceiving groups as systems therefore focuses on the outcome of the interconnection between organizational architecture and internal governance that creates a group's distinctiveness and competitive advantage, and it implies the recognition that the sum of the parts of a given system exceeds the qualities or representation of the system's components.[19] The anthill is a vivid example of this. The anthill as an ecosystem is more than the sum of all the ants and pine needles. It comprises a number of pine needles and an internal system of operations among the participating ants. Hence, the inner logic and operations of the anthill are what distinguish it from a random pile of pine needles. Similar to the representation of an anthill is the recognition of groups being more than the sum of their parts, or separate entities, due to the inner logic of groups. Systems Thinking therefore can lead to the enterprise recognition of groups in some legal domains and under specific circumstances.[20]

Systems Thinking allows a corporate group to be perceived as being more than the sum of its parts, which is due to the internal economic and governance effects created within a group. Systems Thinking has been selected because of the analytical framework it can contribute to the analysis of complex subjects composed of a number of variables. Furthermore, Systems Thinking focuses on understanding the phenomena that emerge from interactions between identified components. This contrasts with the application of the legal dogmatic method, which can define the components of a group structure but is limited to the recognition of formalities in determining the formation of legal entities and the formal representation of parent companies that are affiliated entity shareholders.

Third, I analyze how Systems Thinking can be used when interpreting existing EU accounting, securities, and corporate law. Systems Thinking can allow judges, in cases where courts have been granted a discretionary power, to consider the factual structure of groups and its ability to fulfill a legal purpose, and, through this, merge the gap between formal group structures

[19] S. Johnson, *Emergence: The Connected Lives of Ants, Brains, Cities and Software* (Penguin Allen Lane, 2001), p. 120.

[20] The importance of recognizing enterprises as groups in various legal domains and under specific circumstances has been stressed before by P. I. Blumberg, *The Law of Corporate Groups: Procedural Problems in the Law of Parent and Subsidiary Corporations* (Little, Brown, 1983), pp. 23–25.

and their functional nature. To what extent corporations can engage in shadow business practices will therefore be determined by the extent to which Systems Thinking is applied to groups. In the European Union, the teleological interpretative method allows the court to focus on the legislative purposes at hand, which may in turn provide room for the application of Systems Thinking. The application of Systems Thinking to groups will enable legal reasoning based on a group's functional structure and will not tie this reasoning to legal form in veil-piercing cases when attempting to hold a group responsible for the actions of its affiliates.[21]

1.1.4 *Contribution to Scholarship*

This book therefore contributes in three ways to the current strand of research. First, the book contributes to existing research by systematizing the available variables in group structuring and by defining how the selection of legal forms, the quality of affiliation linkages, and internal strategic and coordinative means create a group's structural distinctiveness. Second, this book presents an enhanced perception of corporate control and proves its significance in the regulatory effectiveness of disclosure regimes. Third, the book provides, through embedding Systems Thinking, the enhanced methodological foundation that is necessary to construe existing legislation in light of de facto rather than formal means of control.

1.2 TRANSPARENCY AS AN OBJECTIVE AND DISCLOSURE AS A MEANS

The relationship between transparency and disclosure is crucial to closing the gaps identified and meeting the perceived need to apply Systems Thinking. The particularities of corporate groups that result in their distinctiveness render submitting them to disclosure rules challenging.

[21] Y. Biondi, "Accounting and the Economic Nature of the Firm as an Entity," in Y. Biondi, A. Canziani, and T. Kirat (eds.), *The Firm as an Entity: Implications for Economics, Accounting and the Law* (Routledge, 2007), pp. 237–65, noting on p. 242 that "the economic nature of the firm is grounded on the fundamental relationship between the *actual economic coordination* provided by (a) the firm as a whole, as a *managed* system, as an entity, and (b) the inner organisation of (c) its *going economic process*. This coordination is especially seen as a potential generator of (d) emerging business incomes and results for (e) all the undertakers (stakeholders)" (italics in original).