

CORPORATE GROUPS AND SHADOW BUSINESS PRACTICES

The uniqueness of this book is its conceptualization of a corporate group as a system of interaction, comprised of nodes, links, and internal governance tools. This framework can be used to understand what constitutes a group, based on affiliation linkages. By increasing our perception of group structuring we can assess the extent to which existing laws address all variables. If the law does not consider certain variables to be used for identifying groups, a case of shadow business may be identified. Group transparency is a recurring topic on the regulatory agenda. In this book, three legal domains are analyzed questioning whether specific amendments have led to increased group transparency: the control definition for consolidated accounts, shareholder transparency in company law, and major holding disclosure in listed companies. This book identifies deficiencies of the law in obtaining its regulatory objective of group transparency and proposes an interpretative solution based on Systems Thinking.

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To my dear father – who educated me in embracing complexity and triggered curiosity in me to understand all factors that inform a certain status quo.
Forever grateful.

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Foreword

Corporate groups play an important role in our global financial and economic system. For a host of legal, tax, accounting, financial, and other reasons, businesses often operate through a multitude of affiliated entities. As corporate groups become more complex, firms within a group can become more interactively dependent, transactions among those entities can diverge from the arm's length principle, and the group itself can become more opaque to investors and other outsiders. Adequate insight into the financial performance of a group, however, requires transparency.

This book focuses, among other things, on achieving that transparency, taking into account three core components of corporate groups: their legal forms, their affiliation linkages, and their internal governance mechanisms. In analyzing these components, the book considers accounting, corporate law, and securities law.

Shareholders must understand the corporate group's assets, liabilities, and operations if, from a governance standpoint, they are to monitor and hold management accountable and overcome the agency costs that drive conflicts between owners and managers. Creditors and other parties contracting with group entities must understand the financial circumstances of the group, and of their counterparties within the group, when assessing the impact, value, and relevance of their credit exposures. Among other things, they need to understand the group's central cash management and intercompany liabilities, and whether there are (or could be) any claims against a group member for which other group members might become liable.

The public also has an interest in corporate group transparency. Taxation, antitrust and competition law, and pension and retirement-income security, for example, depend on transparency. Without proper delineation of the group, taxable income might become shifted to nontaxable entities, market power might become obscured, and retirement funds might become

underfunded or otherwise at risk. The book also discusses the public interest in financial-conglomerate group transparency.

The book examines these concerns under EU law. Its analysis reveals, for example, that only certain elements of a corporate group are covered by the EU disclosure rules that aim to secure group transparency. The book challenges individual regulations, such as the EU Accounting Directive (2013/34/EU) and Accounting Regulation (Regulation (EC) No 1606/2002), IFRS, the EU Shareholder Rights Directive (2017/828/EU), and the EU Transparency Directive (2013/50/EU).

This book also is valuable because it builds on the literature pioneered by scholars, such as Philip I. Blumberg, Kurt A. Strasser, Janet Dine, Tom Hadden, James C. Bonbright, and Gardiner C. Means. Moreover, the book supplements other work on corporate group structures. German scholars, for example, have reflected on a codified law for corporate groups, resulting in a sophisticated system of stipulations and differentiations known as Konzernrecht. Literature on hidden corporate group control mechanisms includes Henry Hu and Bernard Black's series of articles on equity decoupling. A literature on internal group governance mechanisms harks back to the work of Reinier Kraakman and others and to long-standing scholarship on management theory. This writer also has contributed relevant articles on collapsing corporate group structures and on ring-fencing firms within corporate groups.¹

Steven L. Schwarcz

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¹ *Collapsing Corporate Structures: Resolving the Tension Between Form and Substance*, 60 THE BUSINESS LAWYER 109 (Nov. 2004); *Ring-Fencing*, 87 SOUTHERN CALIFORNIA LAW REVIEW 69 (2013).

Preface

This book recounts a story of the most common ways of structuring a business that have emerged over time, and this structuring occasionally represents a “too big/too complex to regulate” phenomenon. “Shadow business practices” embody the migration of group activities from regulated parts of a group structure to the unregulated; unregulated practices sometimes stem from innovation and the inherent regulatory game of catchup with new societal developments, and sometimes from legal engineering combined with partly transparent group structures.

The backdrop of this book is the research I carried out as part of the Oslo-led Sustainable Companies project. My contribution was a comparative analysis of the regulation of parent company liability for subsidiary externalities in twenty-eight jurisdictions. A key takeaway from this research is that there is an evolving legal trend, which is referred to as foreign direct liability, that is forming a new international legal basis in tort law that aims to pin parent companies to the mast for actions taken by their foreign subsidiaries. This is therefore a legal foundation that challenges the limited liability of parent companies, an insight that has spurred interest in researching how multinational groups will, in response to this loss of protection, structure their business. Are there alternative modes of control that they could use to allow them to hold authority over factories and production units without being held responsible for misconduct in those entities? This research question not only harks back to the shadow banking discussions of 2007–08 but also triggers an understanding of the sheer number of selections and choices available to managers in group structures to mitigate the applicability of regulations. This is the entry point from which the research described in this book emerges.

Lawyers are trained to understand the connections between legal interpretation and understanding the factual aspects of a case. When the factual side is

complex, legal interpretation may, however, still follow a rule of thumb, thus resulting in a gap between business reality and the law.

One example of factual complexity may be multinational corporate groups. The art of unraveling this complexity may, however, be to carefully revisit established depictions of groups and to assess the extent to which business realities still match or fit legal interpretation and legislative expectations. This is what this book is about – decomposing the complex corporate group as a legal construct, assessing the extent to which groups of the twenty-first century are subject to current legislation, and providing the reader with a possible solution. The art is to make this simple, simplicity being said to be “the ultimate sophistication.” I aim for nothing less.

This book is an amended version of my PhD dissertation from the University of Oslo. I am forever grateful for the guidance, advice, questions, comments, laughter, and conversations about life with my supervisor, Professor Beate Sjøfjell. Without her, my journey into research would not have taken place. I am also grateful to my co-supervisors, Professor Jay Cullen and Professor Yuri Biondi, for their valuable feedback, and not least to Professor Jukka Mähönen. I would also like to thank Professor Dirk Zetsche for providing valuable inputs in the transformation of my PhD dissertation into a book manuscript and my dissertation’s evaluation committee, comprising Professor Ola Mestad, Professor Dirk Zetsche, and Dr. Georgina Tsagas, for their positive assessment. My thanks go furthermore to anonymous reviewers of Cambridge University Press for their valuable inputs to the amended manuscript, and my sincere gratitude goes to Alasdair Graham-Brown, who has thoroughly reviewed and revised the English of the manuscript and made valuable suggestions for improvement, and to Miko Yeboah-Smith who diligently put the index together.

Finally, there is one more person – someone who knows that this book is dedicated to him but did not come to experience its fruition. That is my father. In 2015, he was diagnosed with atypical dementia and passed away at the age of 66. The change in his appearance as a CEO from the age of 28 and the last years of his life had been unbelievable. He held master’s degrees in both economics and law, and I grew up discussing with him many political and social concerns in our society from a very young age. My interest is not in understanding the obvious concerns in our society but the underlying factors that create a certain outcome, stemming from my early years and discussions. This is why I dedicate this book to him: for all the inspiration he gave me to see things as they truly are. As a small token of my appreciation and looking forward, not back, the royalties from this book will be given to research into dementia and Alzheimer’s disease. By purchasing this book, you, too, are

therefore contributing to the higher goal of finding successful cures to these debilitating conditions.

All trees start as a tiny seed. A book starts, however, with an inspiration. I am forever grateful for the inspiration I received from an early age and onward from my family, friends, and colleagues. And I would finally like to express my sincere gratitude to you for your interest in this book and for sharing with me the journey of exploring the universe of corporate engineering in light of regulatory effectiveness. I hope you enjoy it as much as I have.

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