Corporate Governance and company groups: considerations from the OECD Principles

Grant Kirkpatrick

This paper first reviews the corporate governance problems which can arise in corporate groups unless the corporate governance framework is appropriate and outlines how the OECD Principles of Corporate Governance proposes that the issue be dealt with. The Principles leave open, however, the instruments which might be used to deal with company groups although it does indicate the general regulatory and institutional issues that need to be dealt with. The third section therefore briefly outlines how several countries have chosen to deal with the issue and evaluates potential policy reactions against the criteria developed in Chapter I of the revised Principles regarding the adequacy of the regulatory system. A final section presents some preliminary conclusions.

Company groups are widespread

Outside of the US and the UK, corporate structures are based predominantly around company groups of different types. The reasons for these two exceptions are partly historical. In the US, Section 8 of the Clayton Act prohibits interlocking directorates, and has effectively prevented the creation of the kinds of corporate pyramids and cross shareholdings that are common in much of the rest of the world. The Glass Steagal Act has up till recently also prevented banks from ownership roles such as in Germany and Japan. In the UK and also the US, strong concepts of fiduciary loyalty, which have been developed by the courts, have also prevented the rise of typical company groups, although this has not prevented them from being important in some other common law countries such as Canada. A more limited tradition and acceptance of multiple class shares has also contributed to the relative lack of company groups in the US and the UK.

The essence of a company group is common control over companies, each with a different composition of shareholders. We therefore exclude from the definition of company groups cases whereby a company operates its divisions as fully owned subsidiaries. The typical device is the control pyramid where a family controls several listed companies, usually through a private holding company, each of which controls yet more listed companies, and so on. Companies lower down the pyramid might also own shares in each other thereby bolstering the control rights of the family company at the apex of the pyramid. Some of the listed firms in the pyramid are usually in the nature of holding companies owning operational companies lower down. The main feature of the control pyramid is that a family can control assets far out of proportion to their actual equity in the group: its voting rights

far exceed its cash flow rights. Such systems might also be underpinned by different classes of shares with superior voting rights, Sweden being an example. Voting caps in the publicly listed firms also serve the same purpose and were widely used in Germany until several years ago, and have also been extensively used in Switzerland although this is slowly changing with some firms recently abandoning these methods of internal control.[1] In some countries the apex might be itself a widely held firm such as an insurance company and in France, Canada and a number of emerging market economies (e.g. China) the apex might be a state-owned enterprise.

Another form of company group involves cross shareholding structures in which firms own blocks of each others stocks and vote these blocks of shares. Although there may not be an easily identified apex to such groups as in the Japanese Keiretsu or in German groups that are usually centred around one of the banks or insurance companies (Deustche Bank and Allianz Insurance being the two key players)[2], they act as groups in the sense that insiders are able to exercise control over a wide range of assets with very little equity. As noted below, corporate governance issues similar to those which arise in family control pyramids arise in such inter-locking company groups. There are also other issues. Since cross holdings are often a product of simple swaps, the key legal and economic concepts of enterprise "own capital" and that limited liability firms cannot be owned by themselves but ultimately by real persons, are threatened. Such gearing, which is typical of the relation between Japanese insurance companies and banks, can also lead to macroeconomic fragility.[3]

The scale of company groups and the concentration of control that they imply is impressive. One study of 1433 firms from 18 emerging market economies found that two thirds of insider controlled firms belong to control pyramids and insider voting rights are 2.7 times their cash flow rights.[4] Partly as a result, around the world firms usually have a significant controlling shareholder: the median largest shareholder votes a 52 per cent stake in Austria, 56% in Belgium, 57% in Germany, 35 % in Switzerland, 20 %, in France, 55 % in Italy 44 % in the Netherlands and 35 % in Sweden. The corresponding figure in the US and in the UK is 5-10 %.[5] Moreover, family control predominates, resulting in a high concentration of wealth. The value of corporate assets controlled by the 10 leading families as a fraction of market capitalisation ranges from between 20-30 per cent in Western Europe

[1] Deminor, Global corporate Ratings 2003, Brussels

[2] The power of Deutsche Bank is not only that it owns blocks of shares of around 10-15 per cent in a number of large companies, but that in its role as a custodian the bank can control up to 90 per cent of a company's shares. This formal power has declined in recent years since share owners now have to give their approval for Deutsche to exercise the voting rights. However, in practice not enough owners exercise this right so that the *de facto* power of the bank is still strong. See [reference to come]

[3] M. Fukao, "Financial sector profitability and double gearing", NBER Working Paper, 2000

[4] See K. Lins, "Equity ownership and firm value in emerging markets", Journal of Financial and Quantitative Analysis, 2003, 38:1

[5] F. Barca and M. Becht, eds, The Control of Corporate Europe, 2001. For a review of the evidence available see R. Morck, D. Wolfezon and B. Yeung, "Corporate governance, Economic entrenchment and Growth", NBER Working Paper 10692, 2004, Table 2

but is only 4 per cent in the UK. East Asian countries show much higher concentration rates, Claessens citing estimates of between 40-80 per cent for the top 15 family controlled pyramids.[6]

The potential problems with company groups

Many authors have argued that company groups are not a problem but a rational response to underdeveloped institutions, especially financial markets and contract enforcement. It has also been argued that group banks lead to longer term and more secure financing, leaving firms open to pursue long tern strategies and to avoid unproductive takeover defences. Moreover, it is argued that group banks do not suffer from the problems of asymmetric information characteristic of financial markets and other unaffiliated financial institutions. Firms in a group can cross-invest in each other and because of information symmetries, internal financial markets are more efficient than open capital markets. These arguments thus claim that company groups can lead to higher and more stable economic growth. In this regard, Japan is often cited as is Korea, and some argue this case for Indian groups. The argument could just as well be applied to most of Western Europe and is also cited as an issue to be considered in China as groups formed around a SOE are starting to emerge.[7] However, even though they may be a rational response to lack of institutions at some stage in the history of a country, it does not follow that it is a first best solution from the viewpoint of the society at large, and there are serious questions about what they ultimately imply for the dynamics of an economy and its society.[8]

There are several strong arguments against the positive line of reasoning. First, what we are dealing with is not the usual beneficial presence of an owner in a stand-alone company, but one whose interest is likely to diverge quite strongly from those of other shareholders: there is an agency cost (i.e. incentive effect) due to the fact that their cash flow rights are much less that their control rights. This incentive structure can lead to increased possibilities for reaping private benefits of control, such as through related party transactions and tunnelling, employment of family members etc. Moreover, the potential agency costs increase more than proportionately as the control and cash flow rights diverge.[9]

---

[6] S. Claessens, et al, "The separation of ownership and control in East Asian Corporations", Journal of Financial Economics, 2000, 58: 1-2

[7] The quite particular situation of Chinese groups is discussed in J. Huchet and X.Richet, "Between bureaucracy and market: Chinese industrial Groups in search of new forms of corporate governance", Post Communist Economies, 14, 2,2002

[8] For example F Kali has developed a model in which groups form in response to the lack of capital markets and might even expand in size once capital markets increase. However, at some point they are likely to decline since their inherent lack of transparency becomes unacceptable to markets. He also notes that political economy effects might lead to groups remaining dominant even after their economic rationale has disappeared at great cost to the country. See R. Kali,, "Business groups, the financial market and modernisation", Economics of Transition, Volume 11, 4, 2003

[9] For a proof of this potential see L. Bebchuk, R. Kraakman and G. Triantis, "Stock pyramids, cross ownership and dual class equity: The creation and agency costs of separating control from cash flow rights", NBER Working Paper, 6951, 1999

Second, there is the possibility of costs due to entrenchment in much the same manner as an entrenched management is usually associated with such costs: insiders are effectively isolated from threat of takeover while the price they demand to sell the company is excessive due to private benefits of control. The controllers are under no real threat to maintain and improve performance. Moreover, there is a strong likelihood that the controlling shareholder will choose to pursue investment projects which are not efficient from an economy wide perspective. Bebchuk shows that the controlling shareholder has an incentive to increase gearing (i.e. use debt instruments) to finance investment projects. This incentive might decrease the difference between private and social returns of an investment project, but only if creditor rights and the threat of bankruptcy are effective. It is hardly surprising that, as noted below, major agency cost issues and financial market fragility concerns have occurred in countries where creditor rights are weak.

Third, such systems might lead to the financial system remaining underdeveloped and therefore to less growth and reduced dynamism in the economy. Group firms might also remain more conservative in innovations not wanting to threaten others in the group. In any case, there are reasons to be sceptical about internal capital markets in company groups. Where resources are redistributed from the top of the pyramid or company group, there is still an incentive for lower level managers to subvert the workings of an internal capital market. Rent seeking is not just about compensation but may take the form of preferential capital budgeting allocations. Moreover, there might be a form of "socialism" in internal capital allocation, whereby weaker divisions are subsidised by stronger ones.[10]

Fourth, the idea that group banks or other companies might monitor each other closely in a group thereby overcoming information asymmetries is open to challenge. In German, Japan and in other countries, it often appears that cross shareholdings and interlocking directorates are more in the way of a mutually supporting club rather than a monitoring mechanism.[11]

Finally, concentrated control might lead, under some circumstances, to unfavourable political developments and institutions that serve to reduce the growth and stability of a country.[12] In particular, existing groups have a strong incentive to lobby against reforms which are desirable from the country

[10] For an example of the broad literature on internal capital markets see D. Scharfstein and J. Stein, "The dark side of internal capital markets: Divisional rent-seeking and inefficient investment", The Journal of Finance, Vol LV, 6, 2000

[11] For documentation for Germany of the more general point that banks have often not been arms length monitors but more in the way of club members see M. Hellwig, On the economics and politics of corporate finance and control, SSRN manuscript. For Japan, the recent change in the company law allowing a single tier board as an option appears to be reinforcing company groups as outside directors required by law are being drawn from within group companies thereby strengthening inter-locking directorates. See [give reference to Ramsmeyer et al, 2004]

[12] See Morck et al for a description of such political economy arguments. See also Amy Chou, *World on Fire*, 2003

perspective, and the defence of their existing rights might lead to undesirable rigidity of the political system.

As is often the case, the relative costs and benefits associated with company groups are, *a priori*, unclear so that empirical investigation is required.

There is strong evidence that, without an appropriate regulatory framework, the undesirable effects of company groups do in fact represent serious costs for an economy.[13] This is in line with Claessens et al who found some weak evidence that the effects of group membership depend importantly on the regulatory and institutional framework which can offset the agency problems which are clearly important.[14] Measuring performance by Tobins Q, one large cross section, time series, study that includes OECD countries indicates that shareholdings by banks were not shown to improve performance, and performance declined the lower down in a pyramid a firm was positioned.[15] This result is supported by a study by Claessesn et al of 1300 publicly traded corporations in 8 East Asian countries: Tobin's Q rises with the cash flow rights of the largest shareholder and falls as the control rights of the largest shareholder exceeds its cash flow rights, typical of a pyramid. Thus the entrenchment effect arising from the difference between cash flow and voting rights dominates the beneficial effects of having an owner is dominant in the east Asian companies examined.[16] Agency problems are evident in many ways including executive turnover unrelated to performance, and the employment of unqualified family members who are also less likely to be replaced as a result of poor performance.

Lack of performance by firms in company groups often takes the form of excessive rates of investment and sales growth. This result could point to a dynamic effect: in Japan, Korea and Germany favourable macroeconomic conditions and catch-up effects in the past might have served to conceal poor performance for a long period, but the negative effects of agency problems and entrenchment

[13] For general reviews of empirical studies see K. Gugler et al, "Corporate governance and globalisation", Oxford Review of Economic Policy, Vol 20, 1, 2004 and Morck op cit.

[14] S. Claessens, J.Fan and L.Lang, The benefits and costs of group affiliation: Evidence from East Asia, mimeo. In fact they did not test the proposition directly but made the conclusion on the basis of a marked difference of East Asia with Japan. The result could just as well be explained by the pattern of cross shareholding and concessionary lending by a keiretsu or other bank, especially during the period of "convoy banking supervision where if a keiretsu bank had difficulties it would be supported by other non-group banks with the encouragement at that time of the Ministry of Finance.

[15] See K. Gugler, D. Mueller and Yurtoglu. B, "Corporate governance and investment performance", ECGI Working Paper, 06/2003. For a review of this and other studies see Corporate governance, A survey of OECD countries, OECD, 2004, Box 1.3

[16] See S. Claessens et al, "Disentangling the incentive and entrenchment effects of large shareholdings", The Journal of Finance, Vol LVII, No 6, 2002. It should also be noted that in OECD countries empirical work has shown strong evidence of a non linear relationship between the controlling shareholders cash rights and agency costs. Up to a level, agency costs decrease as the owner internalises the costs of any poor decision. Above a certain level, however, the incentive to exploit minority shareholders increases. See OECD 2004 op cit for a review of some of the literature.

gradually became dominant – and in the case of Asia, even before the 1997 crisis. The Asian crisis and events in Russia the following year also showed the importance of effective creditor rights in underpinning good corporate governance and thereby reducing agency costs.

There is also evidence of tunnelling which goes beyond research looking at control premiums in European and other countries.[17] For example, one study for India shows that firms in which controlling shareholders cash flow rights are highest (i.e. the firm is located toward the top of the apex—benefit the most from a positive shock to firms elsewhere in the group. This suggests transfers from firms lowest in the group to higher level firms(i.e. tunnelling). There is also direct evidence of tunnelling in Korea and a number of European countries. For example, in the former, when one firm buys another in the same chaebol, the acquirers stock price falls but the stocks of other firms in the same chaebol rise. The acquirer thus seems to overpay, with resources shifted to firms where the controlling family has higher cash flow rights.

A number of studies reviewed in OECD 2004, indicate that the level of financial development is closely related to growth and the redistribution of resources to more productive sectors. Such developments are in turn closely related to institutions that control agency and entrenchment problems. Thus even if internal financial markets result in optimal investment by a group firm, by restricting the development of external capital markets they lead to less efficient overall resource allocation. Morck et al go further and hypothesise that company groups and the associated concentration of control has a direct effect on the evolution of policy indicating the potential for a low growth trap. There is compelling evidence that this effect has been important in a number of countries.

In addition to the empirical work based on statistical relations, the problems arising from company groups have been highlighted in all the OECD Regional Corporate Governance Roundtables which have been conducted in Russia, South East Europe, Asia, Latin America and Eurasia. Complaints about related party transactions, disguise of beneficial ownership in complex corporate structures, lack of protection of minority shareholder rights, exploitation of creditors, and poorly operating banks have all figured prominently in the associated Regional White Papers and now in the follow-up work of the roundtables.[18]

It needs to be stressed, however, that evidence of agency costs in some countries does not imply that corporate groups are a policy problem. Corporate groups can and do credibly commit themselves not to exploit the opportunities through, for example, high debt and special rights for minorities such as pre-emptive rights, tag along rights etc. In Germany, strong creditor rights and high gearing might

[17] Tunnelling is defined as the transfer of assets and profits out of firms for the benefit of their controlling shareholders and has been observed in the past in Belgium, France, the Czech Republic and Italy. S. Johnson et al, "Tunnelling", NBER Working Paper, 7523, 2000

[18] For a summary of the various White Papers see, *Experiences from the Regional Corporate Governance Roundtables*, OECD, 2003

have had this effect. There are also private contractual arrangements which can pre-commit the company. And if the industrial organisation gains of corporate groups are large enough, as is frequently maintained, it is possible for the controlling entity to fully compensate the individual unit and still be better-off (i.e. Pareto optimality). On the other hand, the possibility for the controlling shareholder to re-contract thereby stranding investors who had initially accepted the arrangements is also high. The course taken in company groups appears to depend on the institutional environment.

How do the revised Principles deal with the problem

With such strong evidence of problems in company groups in both a number of OECD and non-OECD countries, it is hardly surprising that the issue figured prominently in the review of the Principles which was completed in 2004. The approach has not been to directly deal with company groups and cross shareholdings per se, but to establish basic principles to deal with the primary source of general corporate governance weakness.

The most important features of the revised Principles with respect to company groups are the emphasis placed on disclosing and controlling related party transactions, disclosure of the capital structure of the firm including any special voting rights and relevant shareholder agreements, demanding that minority shareholders be protected from abusive actions by, or in the interest of controlling shareholders and that they should have effective means of redress. These are issues for the board to oversee and to this end the Principles list as a key function of boards: "Monitoring and managing potential conflicts of interest of managements, board members and shareholders, including misuse of corporate assets and abuse in related party transactions." The inclusion of shareholders was quite intentional.

The role of the board is underpinned by its fiduciary to the company and to its shareholders. On this point, the Principles are clear that the fiduciary duty is to all shareholders of the company and not to another group company or controlling shareholder. Reinforcing the fiduciary duty of the board, the Principles go on to argue that "The board should be able to exercise objective independent judgement on corporate affairs". More specifically, "Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent to tasks where there is a potential for conflict of interest. Examples of such key responsibilities include … related party transactions … and nomination of board members".

The manner in which board objectivity might be underpinned depends on the ownership structure of the company. A dominant shareholder in say a company group has considerable powers to appoint the board and the management. However, in this case, the board still has a fiduciary responsibility to the company and to all shareholders including minority shareholders. In others, independence from a controlling shareholder or another controlling body will need to be emphasised if the *ex-ante* rights of minority shareholders are weak and opportunities to obtain redress are limited. This has led to both codes and the law in these jurisdictions to call for some board members to be independent of the dominant shareholder, independence extending to not being their representative or having close

business ties with them. In other cases, parties such as particular creditors and banks in particular can also exercise significant influence. Where there is a party in a special position to influence the company, there should be stringent tests to ensure the objective judgement of the board.

Issues related to company groups are also taken up in the chapter on shareholder rights. The capital structure and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be fully disclosed. This covers the case of company groups which are rather opaque about their control structure. Another method for private gain in company groups has also been addressed: transfer or sale of assets. The Principles call for shareholders to be sufficiently informed on fundamental decisions such as the transfer of all or substantially all assets that, in effect, results in the sale of the company. In the Roundtables we have often heard of companies transferring assets to other group companies in turn for shares which might prove worthless to the original shareholders. There are also many such cases in the OECD area, even though it is often hard to determine whether this was due to a bad business decision or a conscious transfer of resources by a controlling shareholder.

The Principles also call for full disclosure of board member qualifications and about other boards on which they serve. Interlocking boards should therefore be known by the shareholders.

Thus, the Principles lay down fairly strict standards about the operation of group companies where other shareholders are involved. However, strong fiduciary duties do not by themselves rule out group strategies so long as there are sufficient safeguards to deal with the agency problems and self-dealing which represent strong downside risks.

Although the general principles are clear, implementation will depend on the overall context. To give some guide as to how to react to corporate groups and to other problems, the Principles now include a chapter covering the need to ensure the basis for an effective corporate governance framework (Box 1). This can be used as an initial guide in considering responses to the problems arising from group companies. For example, an efficient regulatory regime and corporate governance framework would open the possibilities for private parties to find contractual solutions (i.e. private ordering). The key elements also concern effective enforcement and whether the regulatory and legal framework addresses the relevant issues in a way that minimises side effects.

Box I. Chapter I of the OECD Principles of corporate governance

I. Ensuring the basis for an effective corporate governance framework

The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

A. The corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets.

B. The legal and regulatory requirements that affect corporate governance practices in a jurisdiction should be consistent with the rule of law, transparent and enforceable.

C. The division of responsibilities among different authorities in a jurisdiction should be clearly articulated and ensure that the public interest is served.

D. Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfil their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained.

How is the problem of company groups dealt with in practice

The potential problems associated with company groups are handled in many ways but only a few countries such as Germany have specific laws governing their structure and responsibilities. Professor Schneider has undoubtedly covered this topic but briefly, German law distinguishes factual and contractual groups, each with different responsibilities. Under factual control, a company owns stocks or voting rights in another company. In this case, the negative impact of any influence by the parent must be disclosed, audited and compensated. Each shareholder can request a special investigation by the financial market regulator if the board declares that the negative influence was not properly compensated. The parent and its directors are liable not only to the subsidiary for negative influence but also to the shareholders of the subsidiary if they suffered an additional loss such as through a fall in the share price of the company. The directors and members of the supervisory board of the subsidiary may be liable separately and jointly to the subsidiary if they “covered up” a negative influence of the parent without compensation.

The second method covers cases specific to Germany with staggered supervisory boards and with a half comprising employee representatives. A contractual group is created by a contract of control with the management board of a company binding it to follow directions of the parent and usually also transferring all profits from the subsidiary. Shareholder approval is required of both companies. Creditors and shareholders are protected against a loss of value by an obligation of the parent to compensate annually any loss. Shareholders in the subsidiary receive a fixed dividend and have the right to have their shares bought by the parent at a fair price. Compensation might be in shares of the parent or the grand parent company, or in cash. In practice, court cases concerning valuation have proven to be very long (i.e. up to 8 years).

Thus the German approach combines transparency and fiduciary duty to ameliorate agency costs although enforcement remains a weak link. Strong creditor rights also serve to reduce agency costs.

Given the importance of company groups in Europe, other countries have also been active in trying to deal with the relevant issues, although not always successfully. Most countries accept the legitimacy of groups as a useful economic reality. However, the creation and functioning of groups is complicated by the fact that management of the subsidiary may not take into consideration the common economic interests of the group of companies taken as a whole, unless this is in the particular interest of the subsidiary. Violations may make directors liable both under criminal and corporate law. As a result, the High Level Group of Company Law Experts (the Winters report) observed that EU member states have tried to resolve the conflict by providing that transactions beneficial to the group but not in the direct interest of the subsidiary can be considered as legitimate, provided that the interest of that company are safeguarded on balance.[19]

In practice though this approach has proved difficult in a number of countries such as France, Belgium and Italy. The courts have in practice given priority to the loyalty of directors to the group and not to the individual company.[20] This has opened the way for intra-group transfers, to the detriment of minority shareholders. Some recent reforms have sought to address the issue. A fiduciary style emphasis is taken by the new company law in Italy, a country also characterised by company groups and large control premiums. Directors of a subsidiary must adequately justify any decision that is affected by the influence of the controlling company and mention any such intra-group relations in their financial reporting. The financial reporting of companies with consolidated balance sheets will in any case have to report such transactions after international financial reporting and accounting standards (IFRS) are introduced in Europe in 2005. But individual companies will still report under national standards which are weaker with respect to intra-group transactions. The law provides that shareholders and creditors may sue the controlling company for losses due to its guidance unless they are offset by gains that the subsidiary receives from being part of the group. Shareholders also have *ex ante* protection in that they may withdraw whenever the company enters or exits a group.

In Italy lack of transparency up until the recent reform and poor creditor rights have all probable served to increase agency costs as indicated by high control premiums. As in Germany, the valuation exercise might prove difficult and it can be expected that ex ante protection will involve some kind of business judgement rule: ex ante the firm might appear to gain on balance but there may well be a loss ex post. To which standard should the directors be held responsible? On the other hand some private contractual solutions are also in use: some Italian groups offer minority shareholders board participation.

[19] Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, Brussels, 2002

[20] For observations on this see K. Hopt, "Modern capital and capital market problems in improving European Corporate governance after Enron", ECGI Law working Paper, 5,2002

The approach in Belgium, another country with company groups and documented problems with them, has been somewhat different. A new law subjects significant operations involving a possible conflict of interest between members of a group of companies to specific board approval procedures. To the extent that the interest of the dominated company and the potential harm to it are made transparent, there is a clear improvement over the status quo. However, as experience shows, shifting resources to other companies does not necessarily involve significant operations, but often simply day to day pricing and marketing decisions. The new Code of corporate governance in Belgium, which is to be implemented on a comply or explain basis, also calls for cross shareholdings above 5 per cent to be disclosed.

The Winters report in Europe took up the question of disclosure, an emphasis also taken by the Principles. In their recommendations, they argue that the parent company of each group should be made responsible for disclosing coherent and accurate information with regard to the group's structure and relations. Moreover, "especially with respect to non-financial disclosure, it should be ensured that -- especially where listed companies are involved – a clear picture of the group's governance structure, including cross holdings and material shareholders' agreements is given to the market and the public".[21] In addition, companies should be required to provide specific information when they enter and exit from a group.

The Winters report is thus along the lines of the Principles which call for full disclosure of the capital structure of a firm and about related party transactions The fact that the report had to take up the issue shows the extent of the problem in a number of EU countries. A major problem with the proposals of the High Level group is that the apex of a group or pyramid is often a private company where disclosure rules are usually much less stringent than for public companies. This is an issue that the OECD does not address directly in the Principles although the annotations do note that beneficial ownership information should be available to the enforcement authorities if required and refers to the OECD template, *Options for Obtaining Beneficial Ownership and Control Information* , which did address the issues surrounding private companies.

A key problem identified by the Winters Report is the existence of listed holding companies in a pyramid group. Unlike current practice in a number of EU countries, the Report considered that listed holding companies placed at lower levels of a pyramid whose sole or main asset consists of shares in another listed company in the group structure does not bring any added economic value, except to finance the control of the controlling shareholder. Given the weak position of minority shareholders in such companies, entrenchment and lack of transparency, they recommended that such companies be de-listed, with minority shareholders offered shares in the controlled company in exchange for share in the holding company.

[21] High Level ,op cit, page 100.

Simplification of corporate groups along theses lines appears to be underway in a number of countries such as in Canada and Sweden due it seems to the need to attract foreign investors who have been cautious about such corporate structures. Thus increased transparency may not be enough given the possibilities available to controlling shareholders to abuse their position.[22]

Along the lines of German law, the Report also advocated the introduction of special investigation rights, sell-out rights for minority shareholders and the adoption of concepts of wrongful trading and shadow directors. Such mechanisms address the more general problem of minority rights and not just those related to pyramids and groups of companies. This is important, for it avoids having to craft specific laws and regulations for company groups and pyramids with the accompanying need for definition. Shadow directors (i.e. those who are not formally directors but who are in a position to control a company's directors) are clearly an issue in a number of Roundtable countries and some countries such as Australia reinforce the liability of directors for their fiduciary responsibilities by making it possible to also bring a case against a shadow director.[23]

Seeing that the separation of control rights and cash flow rights is the main cause of agency costs in company groups, one policy option followed by Korea [and to some extent Japan?] is to restrict voting rights of one firm in another. A rationale is that a simple share swap by two companies does not constitute the establishment of an equity position in the same way that cash or in-kind contributions do. In the absence of strong pre-emption rights there is little to stop two companies cross exchanging shares to dilute non-controlling shareholders to what ever level they like. As noted above, other countries have made multiple voting shares, caps etc illegal.[24]

A particular issue in company groups concerns the membership of banks and other financial institutions which opens the way for particularly damaging related party transactions. Indeed, one study for Mexico indicated that related party loans were less likely to be repaid and were also granted at lower interest rates and on more favourable terms than other loans.[25] This led to extreme financial instability and involved serious questions of equity. In other countries, the possible need for some form of lender liability has been raised.

In modern financial markets many banks operate in holding companies. In these corporate groups, banks may exercise control, or be controlled, or simply be affiliated to other banks and companies within the holding company structure. The holding company structure of banks creates a particular

[22] A highly instructive example is in Morck et al, op cit, who cite the case of a Canadian group whose companies showed low capital productivity. After entry into force of NAFTA, the productivity has improved and the structure of the groups simplified. Sweden has a similar experience.

[23] A real life example of a shadow director concerned a person ruled ineligible to be a director replacing himself with his spouse. Being considered a shadow director left him open to liability for the actions of his spouse including the possibility to use assets in his name for compensation.

[24] Tax arrangements are also important in both encouraging and in controlling the formation of company groups.

[25] La Porta et al, "Related Lending". [complete]

principal agent tension that requires a different approach than what would be the case for individual banks. To tackle this issue, in the US the Federal Reserve has been granted broad authority to adopt regulations to govern the management of banking and financial holding companies. As noted by Alexander, these broad supervisory powers extend to considering and approving any proposals or transaction by a banking institution, or its affiliate, or the holding company which controls such banking institution, that would divert earnings, diminish capital, or otherwise impede such banking institutions progress in achieving its minimum capital level. Approval for particular transactions can be denied.[26] In general, the bank holding company should be a source of strength to the bank. The concept is clearly to separate banking and non-banking enterprises. Self dealing among holding company subsidiaries is also covered and any loans must have 100 per cent collateral. For a bank holding company to become a financial holding company, it must show that its subsidiaries are "well capitalised" and that affiliated or subsidiary institutions are well managed. Such a heavy regulatory approach may not be possible in many countries where regulators either lack power, resources, or indeed both.

Some Conclusions

There is general agreement that policy with respect to company law and corporate governance should allow maximum flexibility to discover new corporate forms and to structure corporate forms and financing according to the needs and wishes of the contracting parties. This is particularly true with respect to groups of companies where there is at least a *prima facie* case that company groups following group policy and strategy might be a productive corporate structure. Benefits include being able to separate operations into self-contained enterprises with perhaps different wage and salary structures, while at least nominally isolating the rest of the group from financial difficulties in one member through the limited liability principle.[27] Risks for minority investors might be controlled by contractual arrangements but without a broader guarantee of transparency and effective enforcement these might remain underdeveloped. There is certainly a darker side to "private ordering" when controlling shareholders can renege on previous commitments leaving investors as a group "stranded". Many of the advantages could also relate to the tax system which might not be optimal. The advantages might also be illusory. The reputational damage to a company using limited liability to protect itself from difficulties in a group firm, and the always present question of related party transactions leading to bankruptcy, may in practice limit its importance.

While the advantages of group firms might appear persuasive, and certainly give a *raison d'etre* for the widespread existence of corporate groups, they raise another set of fundamental issues related to

[26] K. Alexander, corporate governance and banking regulation: the regulator as stakeholder, Working Paper 17, Judge Institute of Management.

[27] It should be noted that holding companies have been banned in Japan until quite recently. The company form was reintroduced to facilitate corporate restructuring. The question however remains whether other laws and regulations of a complementary nature should have been changed at the same time.

fiduciary duty. The overriding need for the board to protect all shareholders frustrates group policy while moves to limit or reconfigure fiduciary duty have led in practice to many problems and unwanted side-effects. An obvious solution is to permit or even require some form of "squeeze out" of the non-controlling shareholders. This would in large part depend on the existence of legal and financial institutions to make any judgement about values valid. Swapping shares on the basis of valuation for shares in the controlling firm is one method and would in effect result in consolidation of fiduciary duty in the controlling firm and ameliorate the dangers of a straight buy out. Another method is to have quite different company laws covering group firms as in Germany, or to restrict voting rights of cross held shares in a group. Indirect methods are also important such as strong competition policy which reduces the possibility for rents to be captured by the controlling shareholders.[28] And of course capital market development, even in the face of strong vested interests, also has the potential to reduce the sometimes artificial advantages from internal capital markets which at the end of the day might be quite inefficient beyond a certain point of development. But allowing internal capital markets in the first place runs the risk of creating path dependency so that such liberalising policies might never be followed – or at least followed much too late.

Although different methods of controlling the agency problems inherent in groups are in use, the empirical work does not give much guide as to which are effective. Cross section time series studies, which are by far the best econometric methodology, will frequently result in any potentially positive effects being captured in the country dummy variable, which is not very informative since many other effects are also captured. One of these is the intensity of competition, which scarcely figures in existing studies. Part of the problem is that it is easier for empirical work to use variables such as the difference between cash and voting rights and position in a pyramid, with variables representing legal or institutional constraints to abusing the potential from control scarcely developed.[29]

Even though the principles which should govern good corporate governance in company groups are clear, the instruments which have been employed in different countries appear to have had very mixed effects from making the situation worse to being relatively successful. This reinforces the need for policy to clearly consider the context of the agency problem and the basic principles involved before embarking on policy initiatives which might make the matter worse. Such dangers are highlighted in the revised OECD Principles of corporate governance.

[28] While company groups were broken up in Germany after the war, they quickly reformed during the 50's. However, the external environment was quite different involving tough competition laws and a liberal policy on imports. In Japan, the zaibatsu returned in a looser form in the post war period as keiretsu, but in an environment of weak competition law and enforcement, and a restrictive import regime.

[29] For a view of this and other econometric problems see A. Börsch-Supan and J. Köke, "An applied econometrician's view of empirical corporate governance studies", German Economic Review, 3(3), 2002