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Justifications for Minority-Co-Owned Groups and Their Corporate Law Implications

Law Working Paper N° 693/2023
March 2023

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Abstract

Corporate groups with listed subsidiaries are common around the world, despite the risks they pose to minority shareholders. Shaping a firm as a web of formally independent, minority-co-owned legal entities facilitates controllers' diversion of corporate wealth (tunnelling) via intragroup transactions and other non-transactional techniques. This paper problematizes the conventional view of groups as tunnelling-facilitating infrastructures by arguing that organizing as a group with listed subsidiaries (a minority co-owned group) may create value for all shareholders. For instance, organizing as a minority co-owned group increases transparency, improves performance thanks to the possibility to use stock options for subsidiary managers, and allows to circumvent inefficient restrictions to dual class shares. We then analyse the policy implications of this finding in light of the choice, popular especially among European policymakers, to establish special corporate law rules for groups centred on a relaxation of directors' fiduciary duties, with a view to facilitating group management. We show that the existence of value-enhancement justifications for minority co-owned groups does not support the establishment of these special, lax regimes. Quite the opposite, the justifications we identify support the opposite claim that intragroup relations should be subject to stringent self-dealing rules (or at least to no less stringent rules than those established for other conflicted transactions).

Keywords: Conglomerates, Corporate Governance Corporate Groups, Corporate Law, Pyramidal Groups, Related Party Transactions

JEL Classifications: G3, G34, G38, K22

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Abstract

Corporate groups with listed subsidiaries are common around the world, despite the risks they pose to minority shareholders. Shaping a firm as a web of formally independent, minority-co-owned legal entities facilitates controllers' diversion of corporate wealth (tunnelling) via intragroup transactions and other non-transactional techniques. This paper problematizes the conventional view of groups as tunnelling-facilitating infrastructures by arguing that organizing as a group with listed subsidiaries (a minority co-owned group) may create value for all shareholders. For instance, organizing as a minority co-owned group increases transparency, improves performance thanks to the possibility to use stock options for subsidiary managers, and allows to circumvent inefficient restrictions to dual class shares. We then analyse the policy implications of this finding in light of the choice, popular especially among European policymakers, to establish special corporate law rules for groups centred on a relaxation of directors' fiduciary duties, with a view to facilitating group management. We show that the existence of value-enhancement justifications for minority co-owned groups does not support the establishment of these special, lax regimes. Quite the opposite, the justifications we identify support the opposite claim that intragroup relations should be subject to stringent self-dealing rules (or at least to no less stringent rules than those established for other conflicted transactions).

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Introduction

Corporate groups are an important reality of the modern corporate landscape. Virtually every large firm is organized as a group,[1] i.e., as a network of formally independent companies, each having formal legal personality[2] (and thus its own assets and liabilities, creditors and shareholders), under the common control of a "parent" company.[3]

A significant number of corporate groups around the world are minority co-owned groups (MCOGs),[4] namely groups with one or more listed subsidiaries. Some of them are long-lived, others are newly formed. A prominent example of the former is South Korea's Samsung Group, existing since before WWII[5] and comprising today numerous listed subsidiaries operating across several different businesses.[6] A very recent example of MCOG is the Volkswagen group after Porsche was listed on the German stock exchange as a subsidiary of Volkswagen, itself a listed company in turn controlled by a holding company.[7] Multiple layers of listed companies, also known as pyramids (of which figure 1 provides an extreme example), are not the only form of MCOGs.

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[1] *See, e.g.,* Luis Alfonso Dau, Randall Morck & Bernard Yeung, *Business Groups and the Study of International Business: A Coasean Synthesis and Extension*, 52 J. INT'L BUS. STUD. 161, 161 (2021) ("Business groups . . . are not only prevalent across much of the globe but, in many countries and regions, are the primary form of business organization."); Klaus J. Hopt, *Groups of Companies: A Comparative Study of the Economics, Law, and Regulation of Corporate Groups*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 603 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2017) ("Groups of companies rather than single independent companies are the modern reality of the corporation."). For a comprehensive study of business groups in western countries, also containing empirical data, see BUSINESS GROUPS IN THE WEST: ORIGINS, EVOLUTION, AND RESILIENCE (Asli M. Colpan & Takashi Hikino eds., 2018).

[2] The legal personhood is the legal "device" that allows to treat the company as a separate legal entity (as a fictional person), capable as such of owning assets and assuming liabilities.

[3] The most common technique to attain control over a company is via direct and indirect equity stakes in it. Throughout this analysis we refer to groups formed via this technique.

[4] *See, e.g.,* Luis Dau, Randall Morck & Bernard Yeung, *Corporate Governance, Business Group Governance and Economic Development Traps* (NBER Working Paper No. 28069, 2020), https://www.nber.org/papers/w28069 (last visited April 22, 2021), at 3 (observing that "[i]n many economies, most large listed companies came to belong to one of a handful of business groups."). This is rather the exception than the norm in the U.S., where subsidiaries are most often wholly owned. *See, e.g.,* Richard Squire, *Strategic Liability in the Corporate Group*, 78 UN. CHI. L. REV. 605, 611 (2011). For two examples of U.S. minority-co-owned groups, one involving Coca-Cola, see Vladimir Atanasov, Bernard Black & Conrad S. Ciccotello, *Law and Tunneling*, 37 J. CORP. L. 1, 29-33 (2011).

[5] https://en.wikipedia.org/wiki/Samsung.

[6] Among them, Samsung Electronics, Samsung Heavy Industries, Samsung Engineering, Samsung Life Insurance, Cheil Worldwide.

[7] *See, e.g.,* Alexandra White & Peter Campbell, *Investors Rush to Snap up Shares ahead of Porsche IPO*, FIN. TIMES (Sept. 26, 2022), https://www.ft.com/content/7e59d4a6-0c01-49b8-9cad-62da3b50fb14.

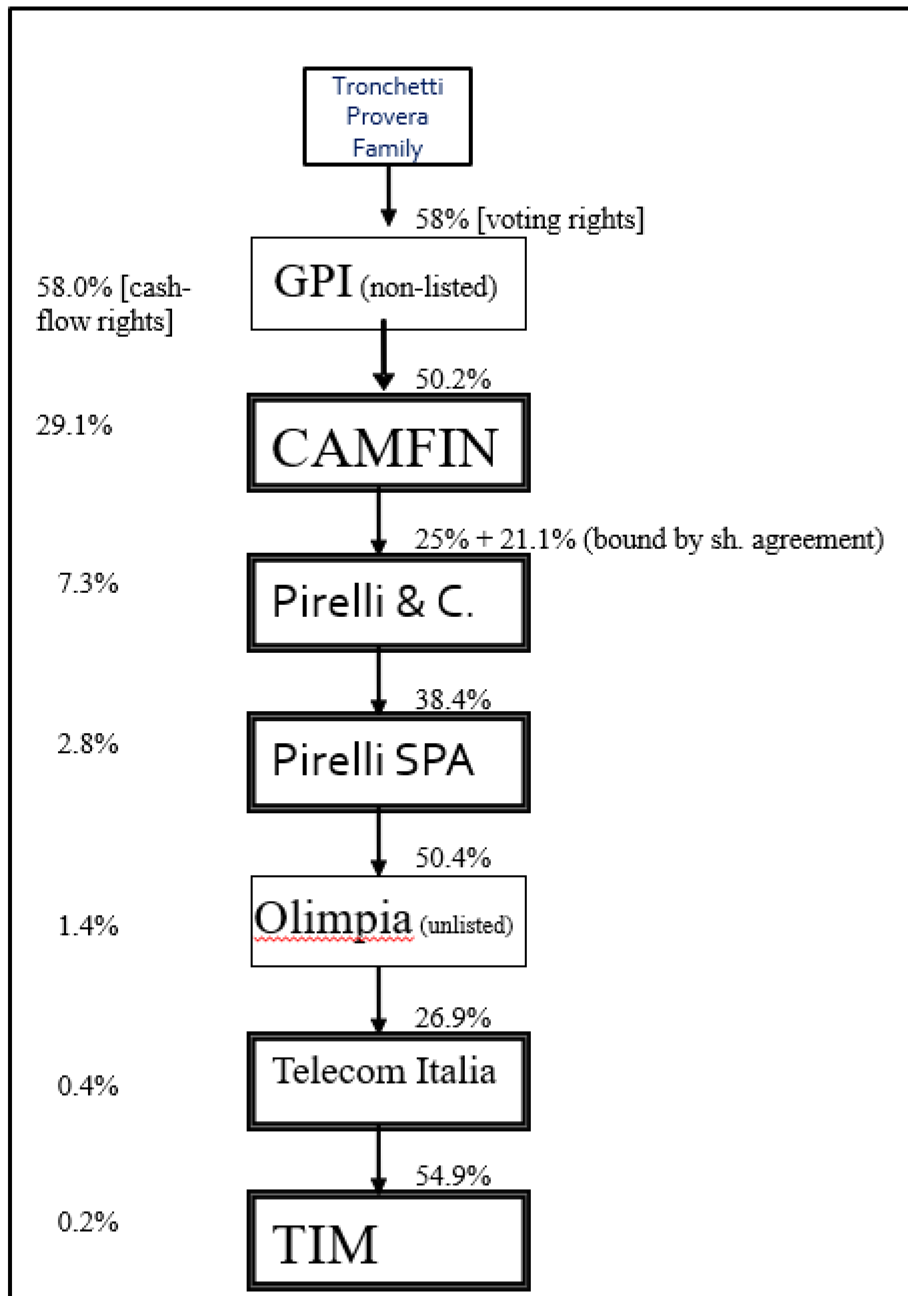

Figure 1: the Pirelli/Telecom Italia group in 2001 (source of the data: Consob website)

A simpler structure is one where a holding company directly controls both a listed company and some wholly owned subsidiaries, as in figure 2.

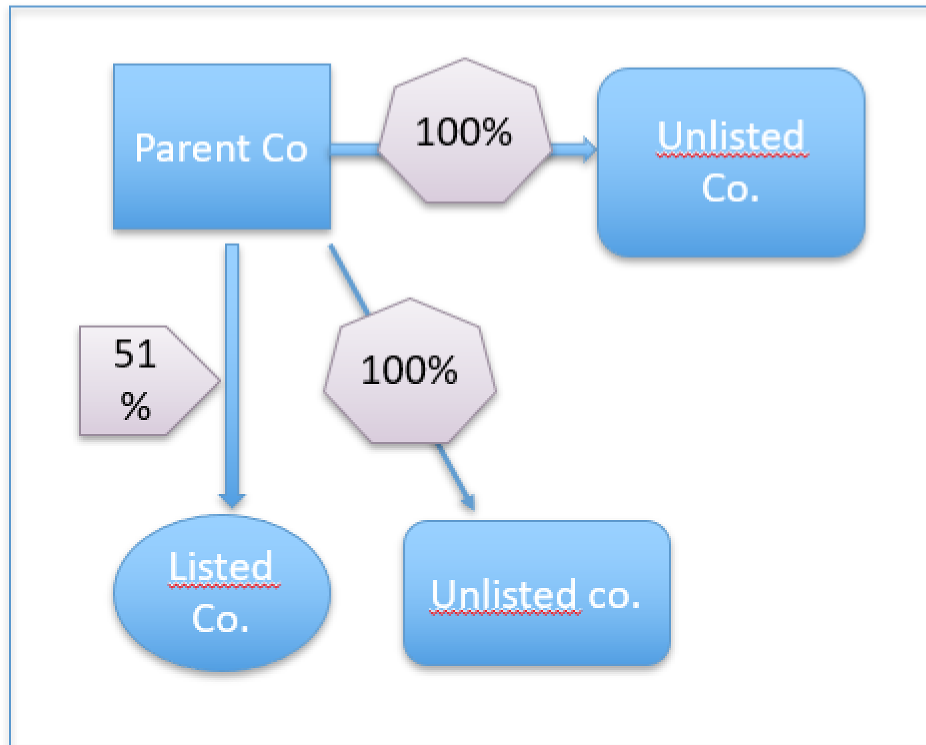

Figure 2: stylized non-pyramidal MCOG

A prominent real-world example combining the two stylized forms of MCOGs (pyramidal and non-pyramidal) is French media conglomerate Vivendi, a listed company which controls (or has a considerable block of shares in) a number of listed companies but also owns a 100% stake in many non-listed ones (figure 3).

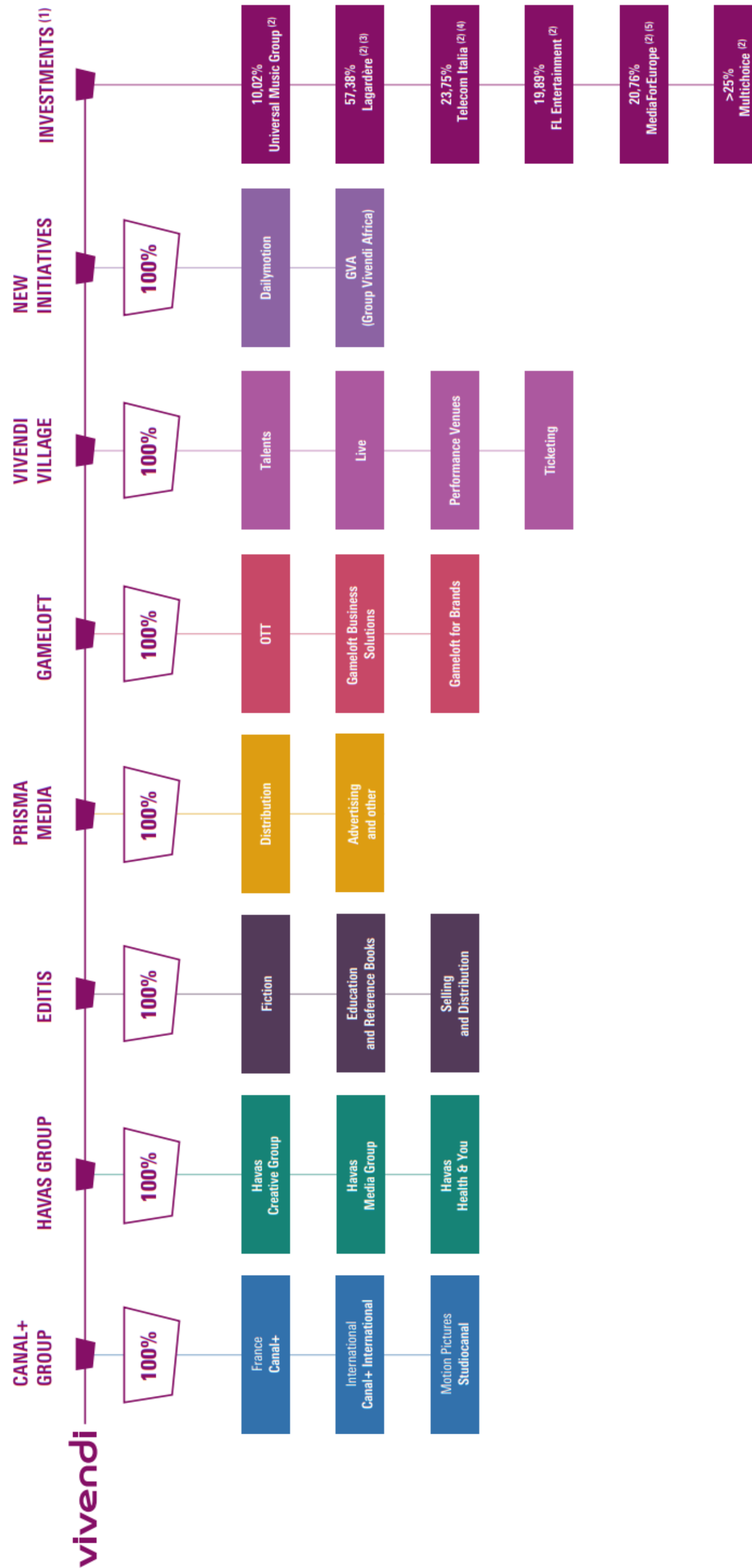

Figure 3: Vivendi group simplified organizational chart as of Sept. 30, 2022[8]

[8] https://www.vivendi.com/wp-content/uploads/2022/11/Vivendi-Simplified-organization-chart-as-of-September-30-2022-accessibility-version.pdf.

MCOGs are well-known to entail significant risks for minority shareholders. They facilitate controllers' tunneling[9] (and therefore increase agency costs[10]), relative to more straightforward corporate structures, such as wholly owned groups (that is, groups with minority shareholders present, if at all, only at the parent company level) and the multidivisional single-entity firm.[11]

By structuring their firms as MCOGs, controllers can engage in frequent intra-group transactions (IGTs)—the chief tunneling technique in groups—and obfuscate their negative effects on minority shareholders more easily, because conflicted transactions like IGTs tend to become routine business transactions.[12] This is especially the case for groups where minority-participated subsidiaries operate in related businesses and (perhaps even more so) for vertically integrated groups, namely groups where minority-participated subsidiaries operate along the production chain of the same product or class of products. There, IGTs, far from being episodic, are by their very nature part of the firm's day-to-day operations. So much so, that, for example, in France IGTs are regularly treated by companies as exempt from the rules on related party transactions following their qualification as entered into at normal conditions in the ordinary course of business.[13]

Yet, IGTs are often bilateral-monopoly transactions—a feature that makes it harder to assess whether they are value-diverting, since there is no readily-available market benchmark against which to measure their fairness.[14]

The MCOG structure also facilitates controllers who may engage in tunneling via elusive (and difficult-to-police) non-transactional techniques involving no exchange between group

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[9] *See generally* Atanasov et al, *supra* note 4 (for a taxonomy and a discussion of the various tunneling techniques). For empirical evidence of high tunnelling in Korean and Indian groups *see* Jae-Seung Baek, Jun-Koo Kang & Inmoo Lee, *Business Groups and Tunneling: Evidence from Private Securities Offerings by Korean Chaebols*, 66 J. FIN. 2415 (2006); Marianne Bertrand, Paras Metha & Sendhil Mullainathan, *Ferreting Out Tunneling: An Application to Indian Business Groups*, 117 QUART. J. ECON. 121 (2002).

[10] *See e.g.,* with specific reference to pyramids, Lucian A. Bebchuk, ___DRAFT pp. 7-11_______, in this volume.

[11] *See, e.g.,* Hopt, *supra* note 1, at 608 (highlighting how the risk of controlling shareholder opportunism may be higher in groups than in stand-alone companies with a controlling shareholder).

[12] *See, e.g.,* Luca Enriques, *Related Party Transactions*, in THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE, *supra* note 1, 506, at 508. *See also* Sang Yop Kang, *Rethinking Self-Dealing and the Fairness Standard: A Law and Economics Framework for Internal Transactions in Corporate Groups*, 11 VA. L. & BUS. REV. 95, 105 (2016) (for evidence that intra-group exchange amounts to a significant fraction of overall exchange in Korea's top five groups).

[13] For one example involving Vivendi, *see* AUTORITÉ DES MARCHÉS FINANCIERS, RAPPORT 2019 SUR LE GOUVERNEMENT D'ENTREPRISE ET LA RÉMUNÉRATION DES DIRIGEANTS DES SOCIÉTÉS COTÉES 42 (2019), https://www.amf-france.org/sites/institutionnel/files/2020-02/rapport-2019-sur-le-gouvernement-dentreprise-et-la-remuneration-des-dirigeants-des-societes-cotees.pdf (criticizing Vivendi for qualifying all transactions between itself and wholly owned subsidiary Havas, whose CEO was the son of Vivendi's founder and then CEO, Vincent Bolloré, as routine ones). On the exemption from RPT rules for routine transactions *see* Geneviève Helleringer, *Related Party Transactions in France. A Critical Assessment*, in THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS 400, 406-07 (Luca Enriques & Tobias Tröger eds., 2019).

[14] *See, e.g.,* Alessio M. Pacces, *Procedural and Substantive Review of Related Party Transactions: The Case for Non-Controlling Shareholder-Dependent Directors*, in THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS, *supra* note 13, 181, 196-199 (stressing the limitations of market-based criteria—such as the arm's length standard—in assessing the fairness of transactions with idiosyncratic features).

members.[15] For instance, a minority-participated subsidiary may be induced to forgo a profitable business opportunity or to invest in a loss-generating project with, respectively, negative or positive spillover effects on other group members. Controllers thus siphon off common corporate value without resorting to more visible (and easier-to-police) IGTs.[16]

To be sure, so long as minority shareholders correctly discount tunneling risks in the price they pay for minority shares,[17] controllers' choice in favor of the MCOG structure should not be expected to have distributive consequences.[18] Tunneling, however, has social costs as well. Because it is (usually) illegal also where it is ineffectively policed, it must be hidden or disguised,[19] which generates costs (both direct and indirect) that, from society's standpoint, are a pure deadweight loss.[20] Furthermore, widespread tunneling is likely to generate adverse selection in equity capital markets. The cost of capital will be unduly high for honest entrepreneurs who tap those markets to finance entrepreneurial projects but do not wish to steal from those who provided capital thereafter. At the margin, some firms may have to forgo positive net present value projects and/or a listing on the stock exchange.[21]

This essay problematizes the conventional view of MCOGs as tunneling infrastructures by showing that MCOGs may also have value-enhancement justifications, i.e., their existence may be explained not only by controllers' intention to extract larger amounts of pecuniary private benefits, but also by the goal of increasing value for all shareholders. To this end, we first recall the major

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[15] *See* Atanasov et al., *supra* note 4, at 9 (discussing tunnelling techniques, such as freezeouts or sales of controlling stakes, not involving a transaction between the firm and another party); Jens Dammann, *Corporate Ostracism: Freezing out Controlling Shareholders*, 33 J. CORP. L. 681, 693-4 (2008); Luca Enriques, *Related Party Transactions: Policy Options and Real-World Challenges (with a Critique of the European Commission Proposal)*, 16 EUR. BUS. ORG. L. REV. 1, 10-11 (2015). A thorough analysis of non-transactional tunnelling is provided by Lucian A. Bebchuk & Assaf Hamdani, *The Agency Costs of Controlling Shareholders* 21-40, https://www.lawfin.uni-frankfurt.de/fileadmin/user_upload/Hamdani_Tunneling_Draft.pdf (discussing "indirect tunneling" as a form of non-transactional value diversion typically occurring when a controlling shareholder owns other businesses in related industries).

[16] *See* Bebchuk & Hamdani, *supra* note 15, at 14 (observing that non-transactional tunneling cannot be eliminated "by simply expanding anti-self-dealing rules or improving the enforcement of existing rules"), 41-45 (where a discussion of the limits of anti-self-dealing regimes in policing non-transactional tunneling).

[17] *See, e.g.,* John C. Coffee Jr., *Future As History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 644 (1998-1999) (for the general observation that "[a]bsent [strong legal protection of minority shareholders], most investors will be reluctant to make equity investments, except to the extent they can . . . buy at sharply discounted prices"); Kang, *supra* note 12, at 144-5.

[18] *See, e.g.,* Kang, supra note 12, at 102-3, 144-5.

[19] To put it differently, controllers must still refrain from outright theft or looting also where minority shareholder protection is scant.

[20] In an important sense, the very choice in favor of the MCOG structure is itself a technique to hide and disguise illegal expropriation of minority shareholders. Indeed, as we pointed out above in the text, that choice often allows controllers to more easily (and effectively) conceal value-diverting actions. *See also* Kang, *supra* note 12, at 126-7 (showing, among other things, how groups and intragroup exchange help controllers minimize the risk of incurring the criminal sanctions associated with more primitive forms of wealth diversion, such as outright theft and embezzlement).

[21] *See* Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430, 431 (2008); Alessio M. Pacces, *Controlling the Corporate Controller's Misbehaviour*, 11 J. CORP. L. STUD. 177, 192 (2011).

efficiency reasons for organizing a firm as a group, rather than as a single entity, and show that they do *not* justify the choice of an MCOG structure. Next, we turn to the more specific question whether there are business rationales (other than controllers' intention to maximize private benefits of control) for structuring a single entity firm or a wholly owned group as an MCOG. We find five possible, non-mutually exclusive rationales: first, the MCOG structure may increase firm transparency, potentially decreasing the group's cost of capital. Second, it allows subsidiary managers to be compensated with stock options, which may lead to reduced managerial agency costs and a lower cost of capital. Third, the MCOG structure may be used to circumvent inefficient restrictions to dual class shares or, fourth, to facilitate acquisitions by foreign firms. Fifth, the MCOG structure may find a justification in path dependency and the high costs of switching to more efficient organizational structures. Other things equal, these rationales may make MCOGs a superior organizational form relative to both the single entity firm and the wholly owned group.

The fact that MCOGs may deliver unique benefits has significant implications. To begin with, it weakens the case in favor of radical policy choices, such as a ban on pyramids. Second, it may support the view that favors laxer corporate law constraints on self-dealing when it takes the form of intragroup transactions. As a matter of fact, some national corporate laws (mostly in continental Europe) already provide for a similar regime. These special rules on groups relax directors' fiduciary duties by allowing subsidiary directors (under certain conditions) to prioritize the "interest of the group" as a whole over that of the subsidiary. The chief goal of this special regime is to ease the management of firms organized as groups, removing the constraints that corporate law poses in this respect, for instance, by subjecting each intragroup transaction to supposedly onerous procedural requirements and/or heightening the legal risks attaching to those transactions. One may argue that the introduction of this special enabling regime is even more justified once it is demonstrated that MCOGs can be value-increasing organizational structures. Indeed, by decreasing group management costs the regime would maximize the benefits that the MCOG structure brings about, to the advantage of all the shareholders involved.

This essay debunks this idea, showing that none of the value-enhancement justifications we identify are consistent with the claim that corporate law's constraints against unfair self-dealing should be relaxed for firms organized as groups (including MCOGs) to ease their management. Quite the opposite, those justifications reinforce the proposition that rules on IGTs should be rigorous or, at the very least, not less rigorous than those established for other conflicted transactions.

I. Justifications for the existence of groups

MCOGs are a powerful tool for tunnelling. Does that mean that controllers' opportunism is the sole rationale behind organizing a firm as an MCOG?

For sure, MCOGs exist because controllers choose to structure the firms they control as such. Rational controllers can be expected to choose the organizational structure that allows them to maximize the sum of (1) their equity stake as valued in the public market and (2) the private benefits of control.

Yet, the fact that MCOGs can only be observed when they allow controllers to maximize the value of their controlling stake does not imply that they are always an inferior form of business organization. If an MCOG structure entails benefits for shareholders as such that are greater than the increase in agency costs that the structure entails, then MCGOs will be optimal from the perspective not only of the controllers but also of the other shareholders. And unless negative third-party effects can be envisaged, such as a higher cost of capital across the board,[22] these privately optimal MCOGs can be considered socially optimal as well. The goal of this section and section II is to show that MCOGs can serve functions that, other things equal, may positively affect the market value of the relevant publicly listed shares. To be clear, we do not claim that each and any existing MCOG is therefore in line with the interests of the relevant minority shareholders, let alone that any or all existing MCOGs are optimal organizational forms from society's perspective, and yet some of them may indeed be so.

MCOGs may in fact display properties that, depending on the circumstances, make them a superior organizational structure relative to both the wholly owned group and the single-entity firm. Importantly, however, the focus must be on MCOGs specifically, and not on groups per se. In other words, while we do not question that there are a number of good reasons why organizing a firm as a group rather than as a single entity may create value, what matters for our purposes are business rationales for MCOGs specifically. This part reviews the main business rationales for structuring a firm as a group and highlights how such rationales do not require the presence of minority shareholders at the level of one or more subsidiaries.

The vast economic and legal literature on corporate groups has provided several value-creation-based explanations for the existence of wholly owned groups. We do not aim here at providing a comprehensive account of these explanations—a task that would far exceed the more limited goals of this essay. Rather, we report here only the most common and widely accepted ones and, without engaging with the question of whether these explanations support the proposition that

[22] See *supra* note 21 and accompanying text.

organizing as a group creates value,[23] we highlight that they fail to answer the separate question of whether groups where minority shareholders are present at the subsidiary rather than exclusively at the top company level also create value for all the relevant shareholders, let alone whether they are efficient.

A. Risk management advantages. First of all, groups are frequently regarded as capable of providing better risk management than single-entity firms, thanks to the opportunities offered in this respect by the subsidiaries' limited liability.[24] Limited liability allows investors to control risk exposure when the firm expands into new businesses and markets. It isolates the firm's existing assets from the risks associated with the new venture, allowing the firm (its investors) to diversify[25] and exploit new business opportunities more cheaply. Yet, achieving these goals does not require the presence of minority shareholders in the group's subsidiaries.[26] More effective risk management via the exploitation of a company's legal personality and limited liability may be achieved in an equally effective manner through the establishment of wholly owned subsidiaries.

B. Managerial agency costs reduction. Second, scholars frequently point out that groups allow for better firm management. The "legal independence of group members facilitates the delegation of activities and decision-making"[27] and provides managers, employees and stakeholders of the subsidiary with improved incentives,[28] thus reducing the firm's overall agency costs of management. These benefits can be particularly valuable for firms displaying a high degree of internal complexity, such as those operating across multiple jurisdictions (multinational enterprises), unrelated businesses (diversified conglomerates), or different levels of the production chain (vertically integrated firms).

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[23] *See e.g.,* J. Ramachandran, K.S. Manikandan & Anirvan Pant, *Why Conglomerates Thrive (Outside the U.S.)*, 91 HARV. BUS. REV. 110 (2013) (offering a number of reasons why groups are more efficient than multi-divisional single firms).

[24] *See* Klaus J. Hopt & Katharina Pistor, *Company Groups in Transition Economies: A Case for Regulatory Intervention?*, 2 EUR BUS. L. REV. 1, 13 (2001); *but see* George G. Triantis, *Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 117 HARV. L. REV. 1102, 1131 (2004) (highlighting how single entities encompassing different business projects provide *creditors* with better protection, through the diversification of insolvency risk due to exogenous shocks).

[25] *See* Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 510 (1976) (explaining groups as the result of shareholder attempts to "reduce risk through diversification").

[26] At least in the absence of laws preventing companies from benefiting from limited liability when they own all of a subsidiary's shares. EU law has required those member states, like Italy, which used to provide for such a rule, to get rid of it. See Directive 89/667/EEC of 21 December 1989 on single-member private limited-liability companies (Twelfth Council Company Law Directive), now replaced by Directive 2009/102/EC of the European Parliament and of the Council of 16 September 2009, in the area of company law on single-member private limited liability companies.

[27] Hopt & Pistor, *supra* note 24, at 13.

[28] *See generally* Andreas Engert, The Corporate Group as an Organizational Form – Separating Control from Value Appropriation (2016) (unpublished manuscript) (on file with the authors) (arguing that the group structure can be viewed as a tool to align the incentives of a subsidiary's stakeholders).

If separate legal personality improves management compared to organizing as a multidivisional single-entity firm, again it does not follow that minority shareholders have to be present at the subsidiary level.

C. Reducing the cost of debt. Third, a group structure may help the firm to get external finance at a lower cost, especially when the firm operates across a number of unrelated businesses: the firm is partitioned into two or more legally distinct subsidiaries under common control, each running one of the firm's businesses, allowing creditors (especially trade creditors, like customers or suppliers, or industry-specialized lenders) to focus on the business they know best. This, in turn, reduces creditors' screening and monitoring costs, thus lowering the firm's cost of funding.[29] Once again, to achieve this goal a group does not have to be structured as an MCOG.[30]

D. Reducing funding costs more generally. Other value-creation-based justifications for groups point to their "gap-filling" role in economies that lack well-developed market-supporting institutions.[31] More precisely, groups represent, from this perspective, an adaptive response to the absence of well-developed key input markets, such as financial[32] or labor markets.[33] Consider financial markets. Where, due to their absence or underdevelopment, external finance is unavailable or excessively costly, a group's internal capital market can make up for it and provide the necessary funds. Thus, courtesy of the cash flows produced by other group affiliates, new profitable entrepreneurial projects (e.g., entry into an unrelated but promising new business) that would otherwise be forgone may be financed.

The gap-filling rationale has a number of variations. One is the following: in countries characterized by low-quality institutions, significant adverse selection in equity markets, and high levels of private benefits of control, a well-established family may develop a reputation as a trustworthy controller by showing self-restraint and predictability in the extraction of private

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[29] *See, e.g.,* Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 399-401 (2000). Note, however, that, in order to fully exploit such advantages, subsidiary-level financial data must be available to creditors and the subsidiary must not offer guarantees to other group members. *See* Henry Hansmann & Richard Squire, *External and Internal Asset Partitioning: Corporations and their Subsidiaries*, *in* OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE, *supra* note 1, 251, at 260-1.

[30] The group structure is also thought to facilitate the transfer of the firm's contractual rights or obligations. See generally Kenneth Ayotte & Henry Hansmann, *Legal Entities As Transferable Bundles of Contracts*, 111 MICH. L. REV. 715 (2013). Again, however, the presence of minority shareholders at the subsidiary level is not required to achieve this benefit.

[31] *See, e.g.,* Tarun Khanna & Krishna Palepu, *Is Group Affiliation Profitable in Emerging Markets? An Analysis of Diversified Indian Business Groups* 55 J. FIN. 867, 868 (2000) (for the observation that business groups in developing economies may "internally replicate the functions provided by stand-alone intermediary institutions in advanced economies", thus providing a solution to the external market failures caused by the absence (or underdevelopment) of such intermediaries).

[32] *See, e.g.,* Triantis, *supra* note 24, at 1112-3 ("Internal capital markets play a greater role in capital reallocation when external capital markets are less developed."); Tarun Khanna & Yishay Yafeh, *Business Groups in Emerging Markets: Paragons or Parasites?*, 45 J. ECON. LITER. 331, 336 (2007) (observing that incomplete capital markets make "the use of internal capital markets relatively efficient . . . .").

[33] Khanna & Yafeh, supra note 32, at 336.

benefits.[34] Once they have built this reputation, they can raise capital at a lower cost than an untested newcomer.

Another variation of the gap-filling rationale is the propping-up rationale for groups.[35] Where capital markets are underdeveloped, a group's internal capital market provides affiliate firms with a useful (and otherwise unavailable) safety net that may help them overcome temporary financial distress due to unforeseen external shocks. Here, group affiliation increases firm value by reducing the risk that unexpected financial difficulties disrupt viable businesses by forcing them into bankruptcy.

Yet another variation is the risk-reduction rationale:[36] expanding into unrelated businesses via the establishment of new divisions or subsidiaries is a technique to decrease the risk borne by shareholders. Where capital markets are underdeveloped, this firm-level diversification is valuable to the parent's shareholders, who may not attain a comparable level of risk reduction through portfolio-level diversification (i.e., via a direct diversification of their equity holdings).

When applied to MCOGs, the gap-filling rationale for groups is perhaps even weaker than the rationales previously discussed. It provides a second-best explanation for the presence of large conglomerates operating in a variety of businesses, but it does not indicate what their optimal organizational structure should be (i.e., whether such conglomerates should adopt a group structure rather than a single-entity structure to exploit their internal capital market). Put differently, the gap-filling rationale is about firms' optimal size and scope in economies with underdeveloped financial markets, not about whether they should be organized as multidivisional companies or corporate groups. As such, even in conglomerates operating in an economy with underdeveloped financial markets, this rationale does not explain why minority shareholders must be present at the subsidiary level.

Note that, if the gap-filling rationale is unable to provide a value-creation-based explanation for MCOGs in economies that lack well-developed financial markets, it is *a fortiori* even less likely to explain the presence and economic prominence of MCOGs where capital markets are well-developed.[37]

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[34] *See* Sang Yop Kang, *Generous Thieves: The Puzzle of Controlling Shareholder Arrangements in Bad-Law Jurisdictions*, 21 STAN. J.L. BUS. & FIN. 57 (2015).

[35] *See, e.g.,* Eric Friedman, Simon Johnson & Todd Mitton, *Propping and tunneling*, 31 J. COMP. ECON. 732 (2003) (providing a theory of propping in groups operating in weak legal environments, where financial markets are likely non-existing or underdeveloped).

[36] *See* Khanna & Yafeh, supra note 32, at 335-6.

[37] *But see also infra*, notes 62-65, for a discussion of path dependence. To be fair, one empirical article has found evidence that European pyramidal groups may have played a role similar to venture capital in the financing of new firms as recently as in the 2000s. *See* Jan Bena & Hernán Ortiz-Molina, *Pyramidal Ownership and the Creation of New Firms*, 108 J. FIN. ECON. 798 (2013).

E. Regulatory arbitrage. The choice in favor of a group structure might finally be driven (and perhaps in practice is often driven) by tax and, more generally, regulatory arbitrage considerations.[38] The underlying goal is to minimize a firm's tax burden or to choose the most favorable legal regime for the firm's shareholders (e.g., by locating labor-intensive productions in countries with poor labor protection). The tension between shareholder value creation and social welfare is particularly evident in this case: tax and/or regulatory arbitrage may well create value for the shareholders but does not imply net social benefits. More to the point here, though, minority shareholders usually need not be present at the subsidiary level when tax optimization is the justification. Common tax arbitrage techniques, such as the channeling of group profits where they are taxed less via IGTs (transfer pricing),[39] may take place with no minority shareholders at the subsidiary level. Indeed, what usually suffices to this end is that the transacting companies have separate legal personalities. With due exceptions, that is also the case for other regimes that a group structure enables avoidance of. In other words, regulatory arbitrage more generally is rarely a value-creation justification for MCOGs.[40]

II. Justifications for the existence of minority-co-owned groups

The previous section showed that the most commonly agreed-upon value-creation rationales for the existence of wholly owned groups are of no use when it comes to answering the question of why minority shareholders should be present at the subsidiary level. This is not to deny that, under specific circumstances, organizing as an MCOG may be value-increasing compared to operating as either a wholly owned group or a single-entity firm. In this section, we identify the benefits that can specifically attach to MCOG structures.

A. Enhanced transparency. One value-enhancement-based rationale for organizing as an MCOG is enhanced information production and disclosure. Large firms often display a high degree of internal complexity that makes them hard to understand for outside investors (if not for the

[38] *See, e.g.,* Maribel Sáez Lacave & María Gutiérrez Urtiaga, *Corporate Groups: Corporate Law, Private Contracting and Equal Ownership* 9 (ECGI Law Working Paper No. 581, 2021), https://ssrn.com/abstract=3826510 (claiming that "[t]he first reason why groups are valuable is that they offer the possibility to engage in regulatory arbitrage" and that "[r]egulatory arbitrage can explain why many group structures are so complex and legally intractable").

[39] *See, e.g.,* Prem Sikka & Hugh Willmott, *The Dark Side of Transfer Pricing: Its Role in Tax Avoidance and Wealth Retentiveness*, 21 CRIT. PERSP. ON ACC'T 342 (2010) (documenting that transfer pricing is used for tax minimization purposes).

[40] An exception might be when the choice in favour of the MCOG structure reduces the likelihood that remedies against creditor expropriation, such as veil piercing doctrines, will be applied. In this case, opting for an MCOG structure is valuable for the parent company's shareholders. See Lacave & Gutiérrez Urtiaga, *supra* note 38, at 9.

controllers themselves).[41] This is especially the case of "multi-business" firms, such as multinational enterprises, diversified conglomerates, or vertically integrated firms.

The lower transparency of these firms largely depends on the fact that their disclosures tend to be less informative than those of more focused firms. Indeed, financial statements tend to aggregate information about the different business areas in which the firm operates and therefore may not always offer a sufficiently fine-grained representation of performance.[42] Greater information asymmetry, in turn, may negatively affect the firm's cost of capital.[43]

Reducing the firm's size and scope by spinning off one or more divisions or wholly owned subsidiaries is an obvious way to alleviate this information asymmetry.[44] In fact, the sale or spinoff would enhance the selling company's focus. Increased focus, in turn, would make the firm's financial statements (and other disclosures) more informative. In addition, enhanced firm focus allows managers to specialize, improving performance.[45]

For firms operating in several *unrelated* businesses (and having access to efficient financial markets), this choice is usually an efficient one. In fact, where financial markets are well developed, risk reduction via business diversification is more efficiently achieved at the portfolio level (i.e., by shareholders via the diversification of their equity holdings) than at the firm level. Accordingly, investors value more "focused" firms that do not engage in this type of diversification.[46]
However, for firms operating in *related* businesses (such as vertically integrated firms or firms producing related products or services), the spinoff option may in fact destroy value. Here, firm integration (the fact that the divisions or wholly owned subsidiaries are kept under common control) usually yields significant advantages in terms of tighter coordination and reduced transaction costs.[47]

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[41] *See* Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 791 (2003).
[42] Financial accounting principles address this problem by requiring multi-business firms to provide disaggregated data about each single business in which the firm operates ("segment reporting"). However, segment reporting applies only to some information items, such as profits or assets and liabilities pertaining to the single business areas (*see, e.g.,* IFRS 8 (Operating Segments)), and therefore may not provide sufficient additional information.
[43] A higher information asymmetry should lead to an increase in the firm's cost of capital: *see, e.g.,* David Easley & Maureen O'Hara, *Information and the Cost of Capital*, 59 J. FIN. 1553 (2004); Christian Leuz & Robert E. Verrecchia, *The Economic Consequences of Increased Disclosure*, 38 J. ACCT. RES. 91 (2000).
[44] *See, e.g.,* Katherine Schipper & Abbie Smith, *A Comparison of Equity Carve-outs and Seasoned Equity Offerings*, 15 J. FIN. ECON. 153, at 154 & 174 (1985); Sudha Krishnaswami & Venkat Subramaniam, *Information asymmetry, valuation, and the corporate spin-off decision*, 53 J. FIN. ECON. 73 (1999) (for consistent empirical evidence). *See also* Ronald W. Masulis, Peter K. Pham & Jason Zein, *Family Business Group Expansion Through IPOs: The Role of Internal Capital Markets in Financing Growth While Preserving Control*, 66 MGMT SC. 5191, 5192 (2020) (for the general observation that improving transparency is a typical goal of divisional carve-outs in widely held companies).
[45] For consistent empirical evidence *see, e.g.,* Robert Comment & Gregg A. Jarrell, *Corporate Focus and Stock Returns*, 37 J. FIN. ECON. 67 (1995); Kose John & Eli Ofek, *Asset Sales and Increase in Focus*, 37 J. FIN. ECON. 105 (1995).
[46] *See, e.g.,* Philip G. Berger & Eli Ofek, *Diversification's Effect on Firm Value*, 37 J. FIN. ECON. 39 (1995). On the contrary, where capital markets are underdeveloped, firm-level diversification may be valuable to shareholders: see supra note 36 and accompanying text.
[47] This intuition goes back to Ronald Coase's seminal work on the nature of the firm (*see generally* R. H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937)) and has been subsequently developed and refined, among others, by

These benefits may well outweigh the transparency and other benefits that the mother company may obtain from the spinoff.

Carving out a subsidiary and listing it on a stock exchange—thereby transforming what was before a multidivisional single-entity firm or a wholly-owned group into an MCOG—allows controllers to capture the benefits, in the form of a lower cost of capital, of enhanced transparency and decreased information asymmetry[48] without forgoing the benefits of integration.

The carveout and subsequent listing will improve transparency by increasing the sheer size of the information produced and disseminated by the group. In fact, the subsidiary's listing will provide investors with a significant amount of additional information regarding the subsidiary's business, as a consequence of the application of securities regulation's numerous disclosure mandates.[49]

To be sure, if the goal is reducing information asymmetry and improving investor understanding of the firm's business, controllers always retain the option of *voluntarily* increasing the amount of information provided by the group. E.g., they may disclose more disaggregated (division- or subsidiary-level) data than what accounting principles and/or securities regulation requires them to provide to the public. Increased voluntary disclosure would allow controllers to improve group transparency without bearing the costs associated with a subsidiary's carveout and subsequent listing.

However, the carveout option (i.e., the choice to resort to the MCOG structure) offers controllers at least two advantages that voluntary disclosures do not provide. First, the subsidiary's listing allows controllers to credibly commit to enhanced transparency also for the future, thanks to the "lobster-trap" role played by securities regulation.[50] Second, listing may be used to attract (or

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Williamson (*see* OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS (Free Press, 1975), OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING (Free Press, 1985)), Klein, Crawford and Alchian (*see* Benjamin Klein, Robert J. Crawford & Armen A. Alchian, *Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J. L. & ECON. 297 (1978)), and Grossman and Hart (*see* Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986)).

[48] See *supra* note 43.

[49] *See, e.g.,* Schipper & Smith, supra note 44, at 174. Schipper and Smith identify an additional advantage of equity carveouts, namely that they alleviate the negative information effects of external equity financing described by Myers and Majluf (*see* Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have*, 13 J. FIN. ECON. 187 (1984)), "reducing the probability that positive net present value projects of the subsidiary are foregone" (Schipper & Smith, *supra* note 44, at 169 and 175). Yet, this advantage does not require the subsidiary to retain its listing for long *(id.* at 179-80). More generally, there is ample evidence that equity carveouts are a temporary phenomenon (in the U.S.): they are often followed by a third-party acquisition or a reacquisition within a few years. *See* B. Espen Eckbo & Karin S. Thorburn, *Corporate Restructuring*, 7.3 FOUND. TRENDS FINANCE 159, 198 (2013).

[50] On securities regulation as a commitment device see generally Edward B. Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 CARDOZO L. REV. 675 (2002). See also Schipper & Smith, *supra* note 44, at 174.

broaden) analyst coverage over the group's business, with the effect of a stronger reduction in information asymmetry.[51]

Improved transparency may also have indirect beneficial effects on capital allocation decisions within the group. Centralized (i.e., parent-level) capital allocation decisions may often be poorly informed due to information manipulation and other strategic behavior on the part of the potential beneficiaries of the funds (namely, the single subsidiaries' management teams competing for their allocation).[52] Having a listed subsidiary can reduce such biases, as market signals can be used to gauge the value of individual management teams' strategies and investment projects, thus allowing for a more efficient allocation of capital within the group. To put it differently, listing allows controllers to benefit from the market's evaluation and information-processing capabilities to improve the quality of controllers' own capital-allocation decisions, thereby enhancing the functioning of the group's internal capital market.

B. Lower managerial agency costs. Differently from the wholly-owned group and the multidivisional single-entity firm, only an MCOG allows subsidiaries' managers to be paid in stock options and other compensation schemes linked to the specific performance, as measured by stock prices, of their subsidiarised division rather than to the performance of the whole business or to accounting-based performance measures.[53] To the extent that stock-based compensation tailored to the performance of the individual subsidiary works better than incentive schemes based on different metrics in aligning managers' incentives to shareholder interests, managerial agency costs at the subsidiary level will be reduced.[54] That, of course, is more likely to be the case where the effort of subsidiaries' managers is little correlated to the performance of the whole group and therefore a stronger rationale for listed conglomerates than for integrated or multinational enterprises.

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[51] *See, e.g.,* Stuart C. Gilson, Paul M. Healy, Christopher F. Noe & Krishna G. Palepu, *Analyst Specialization and Conglomerate Stock Breakups*, 39 J. ACC'T RES. 565, 568-9, 575-6 (2001) (arguing that conglomerate stock breakups lead to an increase in the number of analysts following the firms resulting from the breakup and providing empirical evidence consistent with this hypothesis).

[52] *See* Paul Milgrom & John Roberts, *An Economic Approach to Influence Activities in Organizations*, 94 AM. J. SOC. S 154 (1988).

[53] *See, e.g.,* Debra J. Aron, *Using the Capital Market as a Monitor: Corporate Spinoffs in an Agency Framework*, 22 RAND J. ECON. 505 (1991).

[54] *See* Gilson & Gordon, *supra* note 41, at 791. Multidivisional single-entity firms may resort to tracking stock, namely stock whose payoffs are linked to the performance of a specific division, as a substitute for stock options. However, the efficiency of tracking stock in reflecting managerial performance is limited, because the value of tracking stock is highly correlated with that of the firm's common stock. That is because, first, tracking stock's dissolution rights are usually not linked (or poorly linked) with the tracked assets (Edward M. Iacobucci & George G. Triantis, *Economic and Legal Boundaries of Firms*, 93 VA. L. REV. 515, 536 (2007)). Second, tracking stocks are usually not allowed to pay dividends if the company's general performance has been negative, that is, if the company's financial statement reports a loss, notwithstanding the division's positive performance (*Id.*, at 538-9). Because of these limitations, tracking stock is a poor substitute of subsidiary's stock options as an incentive compensation device.

Compensating managers based on the performance of their subsidiary may be valuable also to attract the best talent. That may be the case of a conglomerate which also operates in an industry where listed firms paying managers generous stock-based compensation packages are dominant and an entrepreneurial culture prevails among key employees.[55]

C. An alternative to dual class shares where limits or bans on these exist. MCOGs may be an adaptive response in jurisdictions that restrict the use of dual-class shares but not of pyramidal groups. Both dual class shares and pyramids are techniques to deviate from the one-share-one-vote (OSOV) principle and therefore to achieve a wider separation of ownership and control.[56] The distortions and risks associated with (large) deviations from the OSOV principle are well-known.[57] However, sometimes these deviations may also create value. This is the case of newly listed, highly innovative firms for which a high and persistent information asymmetry exists between the founder-controller and outside investors. Letting the controller pursue her "idiosyncratic vision" of how the firm's business must be run free of market pressures may be valuable also to outside investors, who may enjoy superior returns thanks to the founder's comparatively deeper knowledge of the firm.[58] Resorting to a pyramidal MCOG is a way to achieve this outcome—insulating knowledgeable controllers from the influence of (less knowledgeable but highly powerful) outside investors—where dual-class shares are banned or restricted.

Another case in point is where control is highly valuable (e.g., because of the high non-pecuniary private benefits associated with it). Allowing controllers to deviate from the OSOV principle facilitates external growth via valuable acquisitions: they may acquire a mere majority of the listed target's shares or carve out a subsidiary and use the cash so raised to finance acquisitions. Where dual-class shares are restricted or prohibited, external growth may thus rely on setting up a pyramidal MCOG.

D. Solution to inefficient restrictions to acquisitions by foreign firms. Governments often raise barriers—either formal or informal—to foreign corporations intending to acquire domestic firms (especially large ones, or those otherwise considered "strategic"). However, they may sometimes be open to the idea of foreign takeovers (e.g., when the operation may help bail out troubled domestic firms), subject to an acquirer's commitment to preserve the target as a separate domestic legal entity

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[55] For evidence that carved-out subsidiaries tend to be high-growth firms see Eckbo & Thorburn, *supra* note 49, at 192.

[56] *See* Bebchuk, ___________, in this volume, where also evidence (draft p. 3) of pyramids as a substitute for dual-class shares (prohibited in Israel).

[57] *See generally* Bebchuk et al., *supra* note **Error! Bookmark not defined.**.

[58] *See generally* Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560 (2016).

with local minority shareholders and/or a listing on the national stock exchange.[59] The local shareholdings and listing may in fact help politicians to retain greater influence upon such firms, whether via the sweeping powers of a securities regulator or by inducing public pension funds to hold a large minority stake. Clearly, when national law or politics prevent foreign controllers from obtaining one-hundred-percent ownership of domestic firms, some valuable cross-border business combinations may be executed only via an MCOG.

E. Path dependence: switching to more efficient organizational structures may be too costly. Finally, what may justify MCOGs could be not some inherent feature of theirs, but the very simple fact that switching to a more efficient organizational structure may be too costly. If high enough, transition costs—namely the costs that must be borne to move from the MCOG to a more efficient structure—may outweigh the efficiency benefits brought about by the transition to a new organizational form, justifying MCOGs as a second-best organizational structure.[60]

In addition to providing a further justification of MCOGs, [61] (high) transition costs may help explain the persistence of this organizational structure, namely its existence and continued prominence in an economy also long after the economic preconditions that prompted its popularity ceased to exist.

In fact, path dependence[62] provides a plausible explanation for the continued prominence of groups in countries, such as South Korea (and possibly some EU countries as well), which have relatively recently attained a sufficient level of economic development.[63] There, MCOGs may persist notwithstanding their having ceased to perform their initial gap-filling function[64] because converting

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[59] *See* Sáez Lacave & Gutiérrez Urtiaga, *supra* note 38, at 9 (stating that "many developing countries impose ownership restrictions on the percentage of shares that a foreign firm may own in a local firm.").

[60] *See* Lucian A. Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127, 139-142 (1999) (identifying "sunk adaptive costs" and other factors that make the choice of keeping the existing corporate structures efficient). Still, path-dependent outcomes must display some "acceptable efficiency" (see Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641, 641 (1996)) in order to survive, i.e., they cannot be "too inefficient" (*id.*). Indeed, highly inefficient structures are worth changing also when transition costs are high. Even more intuitively, a MCOG may survive as a second-best form if the transaction costs of taking the subsidiary private are higher than the benefits of doing so. *See* Dammann, *supra* note 15, at 698.

[61] Notice that the path dependence efficiency justification of MCOGs is a peculiar one: Here the MCOG, differently from the other efficiency cases discussed above, is by hypothesis an inferior organizational form relative to both the wholly owned group and the single entity firm. What makes it value maximizing to keep it in place instead of moving to the more efficient structure are uniquely the high costs of such move.

[62] The theory of path dependence of corporate structures stipulates that "[t]he corporate structures that an economy has at any point in time depend in part on those that it had at earlier times". See Bebchuk & Roe, *supra* note 60, at 127.

[63] *See* Ramachandran et al., *supra* note 23, at 112 (pointing out that countries such as Korea, where groups have likely played in the past the gap-filling role discussed in section I.D, have now largely "caught up" in the development of market-supporting institutions, yet groups are still thriving there).

[64] *See supra* section I.D.

into a simpler organisational structure (like the standalone single-entity firm or the wholly owned group) may impose excessively high transition costs for shareholders as a whole.[65]

Note, though, that controlling shareholders' self-interest, rather than efficiency considerations, may drive the choice of keeping the MCOG structure in place: controlling shareholders may refuse to proceed to a group restructuring whereby minority-co-owned subsidiaries are done away with if the rents they extract through the existing MCOG structure make their shareholdings (and their shareholdings only) more valuable than under a streamlined non-MCOG structure. When that is the case, controlling shareholders may preserve the status quo even when the gains for the non-controlling shareholders from the group restructuring would be higher than the rents extracted by the controlling shareholders.[66]

III. Relaxing corporate law constraints against self-dealing to facilitate the integrated management of MCOGs?

Section II showed that MCOGs cannot be qualified as mere tunnelling-facilitating legal infrastructures: their existence may be justified as a source of value creation for both controllers and minority shareholders in the various MCOG entities.

This finding weakens the case for radical policy choices, such as a ban on MCOGs—if only in their pyramidal form. Unless the widespread use of pyramids causes serious adverse selection problems in the capital market, a solution of this type appears undesirable as it may prevent value maximization at those firms where the adoption of the MCOG structure would yield net benefits.

In addition, one may wonder whether the existence of MCOG-related benefits provides an argument in favor of special enabling regimes aimed at facilitating group management via a relaxation of directors' fiduciary duties and other corporate law constraints against controllers' unfair self-dealing. The argument would go as follows: for the reasons discussed in section II, MCOGs may lead to greater shareholder value than the single-entity firm and groups where minorities only own shares at the holding company level. MCOGs integrate the various entities into an individual firm via their *de facto* unitary management as a single group-level firm. The sheer number of intra-group interactions, mainly in the form of IGTs, needed for the various entities to act as an individual firm often make corporate law's ordinary protections against self-dealing impractical, if not incompatible with the group's efficient management altogether. Hence, special rules aimed at easing intragroup interactions should be devised for MCOGs.

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[65] *See generally* Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641 (1996) (noting that a path dependent solution may be the most efficient one if high transition costs are factored in).
[66] *See* Bebchuk & Roe, *supra* note 60, at 130.

This kind of reasoning underlies the choice of some continental European jurisdictions to establish special, more lenient regimes for MCOGs (and groups more generally).[67] The details of these special regimes vary across jurisdictions but what they have in common is that they provide for a relaxation of directors' fiduciary duties.[68] Their key principle is that directors of a group subsidiary may adopt decisions that are functional to the "interest of the group," even when they are disadvantageous for the subsidiary itself, such as unfairly priced IGTs, subject to the condition that the harm so inflicted to the subsidiary receives proper compensation *ex post* or, in an even more enabling version of the principle, compensation may reasonably be expected to occur in the future.[69]

In a companion paper we show that the benefits of these special regimes are much more limited than their supporters believe, at least wherever, like in continental Europe, litigation over director fiduciary duties is rare.[70] We also highlight that the risk of increased agency costs and adverse selection problems that these regimes entail is high.[71] Here, the point we make is that none of the benefits of MCOGs that we discussed in Section II support the policy choice in favour of such special regimes. Quite the opposite, for those benefits to materialize a certain degree of managerial independence of the minority-co-owned subsidiaries from other group entities is required, inconsistent with laxer rules on IGTs.

To see why, consider, first, the MCOG-specific benefits of enhancing transparency/reducing information asymmetry[72] and of better motivating managers to pursue shareholder interests.[73] For either of those benefits to play out the listed subsidiary must be granted a significant degree of independence from the rest of the group. Were that not the case and the listed subsidiary were to be managed just like any other division of the larger group (i.e., as a company engaging frequently in intragroup exchange and free from fair-price constraints), what could be gained thanks to the separate listing in terms of increased transparency and incentive alignment would in fact be lost. The high number of IGTs, coupled with the systematic deviation from fair price constraints in those transactions, would blur the separate picture that the subsidiary's financial reports would be meant to provide, making it much harder to gauge the financial performance of the subsidiary and hence of its

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[67] *See, e.g.,* Pierre-Henri Conac, *Director's Duties in Groups of Companies – Legalizing the Interest of the Group at the European Level*, 10 EUR. COM. & FIN. L. REV. 194, 195 (2013).
[68] For Germany *see* AktG, § 311; for France *see* the so called "Rozenblum docrine" articulated by the Cour the Cassation (Cour de Cassation, Chambre criminelle, feb. 4 1985, no 84-91.581, in Revue des Sociétés 648 (1985)); for Italy *see* Art. 2497, para 1, Civil Code.
[69] The latter is the version adopted by the European Model Companies Act, a recent model law crafted by a group of European academics. *See* Paul Krüger Andersen et al., European Model Companies Act (EMCA) (2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2929348.
[70] *See* Luca Enriques & Sergio Gilotta, *The Case Against a Special Regime for Intragroup Transactions*, EUR. BUS. ORG. L. REV. *passim* (forthcoming 2023), available at https://ssrn.com/abstract=4101546.
[71] *Id.*
[72] *See supra* section II.A.
[73] *See supra* section II.B.

management team. Hence, an enabling regime that were to facilitate intragroup exchange would undercut the specific functions of MCOGs as outlined above and therefore their benefits for the relevant shareholders.[74]

Let us now turn to the MCOG-related benefit of achieving the same result of dual class shares where the relevant jurisdiction prohibits or restricts such arrangements.

The intuition of some degree of policy aversion to special rules in favour of MCOGs should *in theory* be valid also where MCOGs are used to achieve the same outcome as dual class shares, i.e., for the purpose of allowing controllers to control listed firms with a small fraction of the cash-flow rights. The main rationale for restrictions against dual class shares is the risk of mismanagement and abuse (including tunnelling) that they entail.[75] If MCOGs are a way to avoid such restrictions,[76] why should policymakers treat them more benevolently? The presence of multiple different entities linked by a chain of controlling equity stakes, in addition to increasing incentives for value diversion much in the same way as dual class shares do,[77] makes tunnelling easier than in the case of a single-entity firm (or wholly owned group).[78] If the aversion against dual class shares is motivated by concerns over tunnelling and mismanagement, the same concerns should lead policymakers not to enact lenient rules for MCOGs when they are used as functional substitutes of dual class shares.

Rather, if policymakers tolerate MCOGs as a way to let controllers avoid the strictures of one-share-one-vote policies, the straightforward solution would be to abandon such policies. And, to deal with the stock of pyramidal groups present when such policies are reviewed, rather than relaxing self-dealing rules across the board, it would be best to provide for rules easing the transition from a pyramidal group to one where the controller retains stable control over the single listed entity arising out of the restructuring.[79]

Now consider the political justification for MCOGs as tools to enable foreign control of domestic firms in countries with mildly protectionist barriers to cross-border takeovers: its very logic

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[74] This intuition is in line with the finding by Apostolos Dasilas & Stergios Leventis, *The Performance of European Equity Carve-outs*, 34 J. FIN. STABILITY 121, 127 (2018), that the market reaction to equity carve-out announcements is more positive in European countries with a better record of minority shareholder protection.

[75] *See, e.g.,* Bebchuk et al., supra note **Error! Bookmark not defined.**, at 301-305. *See also*, more recently, Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585 (2017) (arguing that the efficiency of dual-class shares decreases over time and thus that perpetual dual-class shares are an undesirable corporate arrangement).

[76] *See supra* section II.C.

[77] Similarly to dual-class shares, pyramids increase the wedge between ownership and control, allowing controllers to control the firms at the bottom of the pyramid with an often negligible equity investment. See *supra* Figure 1 for an emblematic example.

[78] See *supra* text accompanying notes 9-16.

[79] To illustrate, suppose that a pyramidal group comprises three listed companies, with the dominant shareholder at the top directly or indirectly controlling 51 percent of the voting rights in each. To favour the transition from such a structure to one where the three merge into one listed company with dual-class shares, a regime could be introduced where minority shareholder protection (such as supermajority rules) is relaxed for corporate restructurings leading to the dominant

is at odds with a regime that grants greater discretion—and thus greater power—to controllers as a matter of corporate law. By increasing controllers' power over the company, such a regime would correspondingly decrease domestic policymakers' direct or indirect influence over it. While that might be good for the economy, it would clearly be a political non-starter.

Finally, consider the path dependence argument for MCOGs.[80] Again, a regime favoring the transition to more efficient ownership structures should be the best way to deal with MCOGs if path dependence explains (and justifies from an efficiency standpoint) their persistence. By hypothesis, these groups would be worth more themselves if they were not organised as MCOGs, transition costs being the only obstacle to their restructuring. Hence, for sure it would make no sense to provide for special enabling corporate law rules that, incidentally, would apply also to newly MCOGs. And if the reason why MCOGs persist is that controllers are able to extract high private benefits of control, then it stands to reason that policymakers should not adopt policies making the extraction of private benefits easier, as this would make controllers even more hostile toward the transition to more efficient structures.

To sum up, the idea that there may be specific rationales that may make MCOGs functional to the interests not only of controlling shareholders but also of the other shareholders within the group is far from sufficient to support the claim that standard self-dealing restrictions must be relaxed or removed in order to ease the operations of MCOGs. Quite to the contrary, we have seen that those specific rationales rather justify the opposite conclusion.

Conclusion

Minority co-owned groups are notoriously problematic: structuring an economically unitary firm as a constellation of minority-participated subsidiaries is a tremendously effective way for controllers to extract larger private benefits to the detriment of minority shareholders. This essay acknowledges

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shareholder holding no more than 51 percent of the voting rights in the surviving company (also a favorable tax regime and the provision of an adequate grace period may be used to ease the transition: see Bebchuk DRAFT p. 25-6____in this Volume). A more general, free-for-all reform of the law relating to deviations from one-share-one-vote that were to apply also to the stock of companies that are already listed when the reform enters into force may have undesirable distributional effects. Yet, minority shareholders could be granted appropriate governance rights (such as majority-of-minority approval) and remedies (such as appraisal rights) to reduce the risk of expropriation arising from the newly gained freedom for dominant shareholders to alter control rights in their favour. In any event, if the rationale for special group law rules is dealing with existing corporate pyramidal groups, any relaxation of self-dealing rules for corporate groups (or the decision to leave existing laxer regimes in place) should only apply to the MCOGs that exist when the special regime is introduced (or when the decision is made to leave existing laxer regimes in place). On regulatory dualism, see Ronald J. Gilson, Henry Hansmann & Mariana Pargendler, *Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the United States, and the European Union*, 63 STAN. L. REV. 475 (2011).

[80] *See supra* section II.E.

that such structures also have a bright side: they do display some value-enhancement features which, in some circumstances, may make them a superior organizational structure (relative to both the single-entity firm and the wholly owned group structure) capable of maximizing value for all the shareholders involved.

The existence of these benefits offers an argument against radical policy choices, such as a ban on minority co-owned groups. Importantly, however, this essay has shown that none of those value-enhancement features supports the claim—popular especially among European academics and policymakers—that subsidiary directors should be allowed to prioritize the group's interest over that of the subsidiary to ease group management. Quite the opposite, each of the value-enhancement features identified and discussed in this essay supports the view that directors' duty to always act in the company's best interest (and, more generally, standard corporate law rules against unfair self-dealing) should fully apply to these groups' subsidiaries.

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