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Company Groups in Transition Economies: A Case for Regulatory Intervention?

Klaus J. Hopt[*] and Katharina Pistor[**]

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Company groups are an important factor in transition economies. For some, the origins can be traced to the socialist period. Others are a product of the transition process. This paper discusses the likely impact of company groups on transition economies both in the short and in the long term. It suggests that while in the short term company groups may well be transaction enabling, in the long term they could create substantial costs by impeding competition and undermining the adaptability of companies to changing economic conditions. Regulatory intervention should balance the short-term benefits of company groups with their potential long-term costs. In the short term, the primary goal of regulatory intervention should be to prevent the development of structures that may be difficult to reverse and to ensure minimum protection of shareholder and creditor rights primarily through disclosure requirements and exit options. The regulation of intra-group relations based on complex legal doctrines that rely heavily on judicial evaluations as currently suggested for the

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European Union do not seem appropriate for transition economies, given the weakness of legal institutions in these countries.

1. Introduction

The field of comparative corporate governance is currently undergoing what may amount to a paradigm shift. Since the seminal analysis of the modern corporation by Berle and Means in 1932,[1] the large publicly held corporation with dispersed shareholders as owners unable to effectively control management has dominated the field not only in the United States, the origin country of the Berle & Means corporation, but also elsewhere. Recent empirical analyses, however, document that the corporation with dispersed owners is much less common than typically assumed.[2] As a result, many of the assumptions that have driven the analysis of the corporate sector in the past are currently undergoing review.[3] To a large extent, the fresh look at the corporation, its ownership structure and performance, and the legal framework in which it operates can be attributed to the recent experience of the transition economies. Reform strategies that were implemented in these countries over the past decade included the reorganization of state owned enterprises into marketable share companies and their subsequent privatization. Corporatization and privatization were expected to lead to enterprise restructuring and improved performance.[4] In fact, these expectations materialized only slowly, if at all, and, as will be further discussed below, the emerging enterprise structures in these countries looks quite different from earlier predictions. Cynics may say that these countries became the testing ground for empirically unfounded corporate finance theories. In fact, many privatization programs in transition economies were designed and advised by US trained financial economists who have now taken the lead in challenging the very same assumptions on which their advice had been based.[5] While they earlier predicted that institutions will follow the market,[6] they now argue that institutions, in particular legal institutions, are determinants of the ownership structure of firms and the development of capital markets.[7] In any event, the process of transforming centrally planned economies into market economies has revealed how little is understood about markets and firms or the role of law and legal institutions for their functioning.

Against this background, the Max Planck Institute for Foreign Private and Private International Law in Hamburg hosted a symposium on company groups in transition economies in June 2000. The choice of topic was motivated by the observation that the company structure that is currently emerging in transition economies is characterized more by concentrated ownership, the formation of company groups and network relations among firms, than by independent firms with dispersed shares. The symposium brought together experts from various transition economies, including Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, Russia, and Slovenia, as well as from Western Europe.[8] The goal of the symposium was to take stock of the importance of company groups in these countries, the legal problems that arise from the existence or even dominance of groups, and to discuss possible approaches to legal and institutional reforms.

In this paper, we summarize available data on company groups and discuss legal issues that arise with company groups. In particular, we assess legal solutions that are currently practiced in developed market economies in light of

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[1] Berle and Means, *The Modern Corporation and Private Property* (New York 1932).

[2] La Porta, Lopez-de-Silanes and Shleifer, "Corporate Ownership Around the World", 54 *Journal of Finance* (1999) 471; for the United States, see also Holderness, Kroszner and Sheehan, "Were the Good Old Days that Good? Changes in Managerial Stock Ownership Since the Great Depression", 54 *Journal of Finance* (1999) 435.

[3] There has been a flood of analysis by economists of ownership structures both theoretically and empirically. See only the contributions in Morck (ed.), *Concentrated Corporate Ownership* (Chicago, 2000). For a different perspective, which claims convergence on the Berle & Means corporation as a result of international financial market competition, see however Hansmann and Kraakman, "The End of History for Corporate Law", 89 *Georgetown Law Journal* (2001) 439.

[4] There is a huge amount of literature on the pros and cons on privatization and the best approach in transition economies. For the early debate, see Lipton and Sachs, *Privatization in Eastern Europe: The Case of Poland*, Brookings Papers on Economic Activity (1990) 293 and Frydman and Rapaczynski, "Markets and Institutions in Large Scale Privatization: An Approach to Economic and Social Transformation in Eastern Europe", in: Corbo, Coricelli, and Bossak (eds.), *Reforming Central and Eastern European Economies: Initial Results and Challenges* (Washington, D.C. 1992) 253. For a review of mass privatization and the results, see Pistor and Spicer, "Investment Funds in Mass Privatization and Beyond", in: Lieberman, Nestor, and Desai (eds.), *Between State and Market: Mass Privatization in Transition Economies* (Washington, D.C. 1997) as well as other contributions in this volume. See also Pistor, "Company Law and Corporate Governance in Russia", in: Sachs and Pistor (eds.), *The Rule of Law and Economic Reform in Russia* (Boulder, Col. 1997) 165.

[5] This is true in particular for the design of the Russian privatization program. The leading advisors were Professors Andrei Shleifer of Harvard and Robert Vishny of Chicago University. See Boycko, Shleifer and Vishny, *Privatizing Russia*, Brookings Papers for Economic Activity (1993) 139 and more recently La Porta, Lopez-de-Silanes, Shleifer and Vishny, "Law and Finance", 106 *Journal of Political Economy* (1998) 1113; La Porta, Lopez-de-Silanes, Shleifer and Vishny, "Legal Determinants of External Finance", 52 *Journal of Finance* (1997) 1131 and La Porta et al. (1999), *supra* n. 2.

[6] Boycko, Shleifer and Vishny, *Privatizing Russia* (Cambridge, Mass. 1995).

[7] See La Porta et al. (1997) and (1998), *supra* n. 5.

[8] The contributions by all participants will be published in book form (Hopt, Jessel-Holst and Pistor (eds.), *Emergence, Behavior, and Regulation of Company Groups in Transition Economies in Legal and Economic Perspective* (forthcoming). We are grateful to the editors of *EBOR* for having accepted a selection of these contributions and for translating several into English to make them accessible to a broader audience.

the institutional infrastructure of transition economies. This paper will be followed by several articles that highlight specific aspects of company groups in transition economies published in this issue and in issue 2 of EBOR 2001.[9] They are only a sub-sample of the contributions made at the Symposium, but they are representative of the scope of issues that were addressed. We hope that their publication in EBOR will make the problems currently faced by transition economies accessible to a broader audience.

This paper is organized as follows. Section 2 presents a typology of company groups in transition economies as well as available empirical data. Section 3 reviews some economic explanations for the emergence of company groups and assesses their relevance for transition economies. In section 4 we discuss the key legal issues that arise with company groups, including competition law and the protection of shareholder and creditor rights. Section 5 gives an overview of issues that arise when financial institutions, in particular banks, are part of company groups. Section 7 concludes with our propositions for regulating company groups in transition economies.

2. TYPOLOGY AND EMPIRICAL EVIDENCE

Company groups are not a new phenomenon in transition economies. Conglomerates or associations of firms were a key characteristic of centrally planned economies. As plan fulfillment remained an unresolved problem, companies increasingly produced their own supplies, or established close ties with companies in the same production chain through enterprise associations. Moreover, the central administration found it easier to manage fewer large conglomerates or associations than a larger number of freestanding firms.[10]

New conglomerates joined these remnants of the classic socialist system during the period of reform socialism. In an attempt to revive their faltering planned economies, many countries decentralized economic decision-making to the company level. This process was most pronounced in Hungary, where it started already in the late 1960s.[11] During the period of *perestroika* it also affected companies in the former Soviet Union. Other countries, however, remained unaffected. This is true in particular for the Czech Republic and Eastern Germany, where central economic administration prevailed until the collapse of the regime.[12] The effect of decentralization was that company management took over control of assets, while trying to shift liabilities to the state as the still *de jure* owner. This process has been termed "spontaneous privatization". When management created subsidiaries or joint ventures with foreign parties and shifted valuable resources and production lines to these new entities, this resulted in the formation of a company group. The regime change did not halt the process of spontaneous privatization, but in many cases accelerated it, as the new policies created a run for assets.[13] The creation of an official and legally regulated privatization process thus did not mark the beginning of privatization, but an attempt to base it on orderly procedures.

Many observers noted the concentration of economic power in the former socialist countries at the outset of the reform process. Some suggested that these structures needed to be unbundled before privatization could proceed,[14] while others argued that the integration of these economies into the world market would diminish the influence of domestic conglomerates especially in the smaller countries of Central and Eastern Europe.[15] In some countries, privatization led to spin-offs of individual firms from larger conglomerates, and thus resulted in some unbundling. Given the speed with which privatization strategies were implemented, however, this process remained incomplete. In fact, proponents of rapid privatization strategies did not view favorably interventions

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[9] See the contributions by Jessel-Holst, Hommelhoff and Wymeersch in this issue and the contributions by Petrović, Sołtysiński/ Szumanski, Sándor/ Sárközy, Dreher and Fornalczyk in 2 *EBOR* (2001) No. 2 (forthcoming).

[10] For a discussion of conglomerates (*obyedineniye*) in the Soviet Union, compare Nove, *The Soviet Economic System* (London 1986), especially p. 75; and Kornai, *The Socialist System: The Political Economy of Communism* (Princeton, N.J. 1992) 399. Note that the policies towards concentration changed over time. In the Soviet Union, the 1960s in particular witnessed some decentralization. Nevertheless, large fully or partially integrated company groups remained a feature of the socialist system.

[11] For an analysis of this and comparable reform strategies in other socialist countries, which went under the rubric of "market socialism", compare Kornai, *The Road to a Free Economy – Shifting from a Socialist System* (New York/London 1990) 57 with further references; and Kornai (1992), *supra* n. 10, at p. 383.

[12] For a comparison of pre-reform strategies and their affinity with post socialist reform agendas, compare Stark and Brusz, *Postsocialist Pathways: Transforming Politics and Property in East Central Europe* (Cambridge, UK, 1998) p. 80. See also Elster, Offe and Preuss, *Institutional Design in Post-communist Societies: Rebuilding the Ship at Sea* (Cambridge, UK 1998) 35.

[13] Johnson and Kroll, "Managerial Strategies for Spontaneous Privatization", 7 *Soviet Economy* (1991) 281; Voszka, "Spontaneous Privatization in Hungary", in: Earle, Frydman and Rapaczynski (eds.), *Privatization in the Transition to a Market Economy* (London 1993) 89.

[14] Brzezinski, "Competition and Antitrust Law in Central Europe: Poland, the Czech Republic, Slovakia, and Hungary", *Michigan Journal of International Law* (1994) 1129 and Mastalir, "Regulation of Competition in the New Free Markets of Eastern Europe: A Comparative Study of Antitrust Law in Poland, Hungary, Czech and Slovak Republics, and their Models", 19 *North Carolina Journal of International Law and Commercial Regulation* (1993) 61.

[15] Lipton and Sachs, *Creating a Market Economy in Eastern Europe: The Case of Poland*, Brookings Papers on Economic Activity (1990) p. 75. This economic advice notwithstanding, it was Poland that established the strongest antitrust agency in the region. See Fornalczyk in 2 *EBOR* (2001) No. 2 (forthcoming) for details.

by antitrust agencies in the privatization process.[16]

Whatever the merits of restructuring prior to privatization, it soon became apparent that company groups were not only a legacy of the past. The transition process also led to the creation of new company groups, or business networks. They can be classified as "privatization groups" in case privatization strategies led to the creation of company groups; as "oligarch groups", when company groups were formed around influential individuals closely involved in the political and economic power battles; or as "restructuring networks". The latter term, which is borrowed from David Stark,[17] refers to the process of the emergence of company groups with privatized or newly private firms as their members in response to the economic and institutional environment they faced. Finally, as foreign strategic investors participated in privatization or acquired private or privatized firms, companies in transition economies became part of what we call transnational company groups – a well-known phenomenon within the European Union, and a growing phenomenon internationally.[18]

The purpose of our typology of company groups is to remind us that the existence of company groups in transition economies can be traced to different factors. Any theory that attempts to explain company groups in these countries must address the different legacies of these groups. Even more importantly, suggestions for regulatory intervention should be critically assessed as to whether they can possibly provide effective remedies in light of the causes that gave rise to the emergence of these groups.

Empirical evidence on company groups in transition economies remains scant and for the most part anecdotal.[19] The different types of company groups

[16] For a discussion of the tensions between decentralization on the one hand, and depoliticization, which was thought to be achievable through privatization on the other, see Joskow, Schmalensee and Tsukanova, *Competition in Russia During and After Privatization*, Brookings Papers: Microeconomics (1994) p. 335, and especially p. 343. They argue that privatization has ultimately benefited decentralization. This judgment, however, at least with hindsight appears to be premature. Certainly the privatization of the large natural resource companies in 1995, i.e., after the article had been published, resulted in a substantial concentration of economic power. See Johnson, "Russia's Emerging Financial-Industrial Groups", 13 *Post-Soviet Affairs* (1997) 333.

[17] Stark and Brusz, *supra* n. 12, ch. 5 at p. 137. See also Stark, "Networks of Assets, Chains of Debt – Recombinant Property in Hungary", in: Frydman, Gray and Rapaczynski (eds.), *Corporate Governance in Eastern Europe and Russia*, Vol. 2 (London/Budapest/New York 1996) 109.

[18] Transnational or multinational enterprises (MNEs) have been around for a while. There is a vast amount of literature on them. However, the scale of transnational mergers, including mergers of which neither party is a firm from the United States is of more recent origin. Compare Black, "The First International Merger Wave (and the Fifth and Last U.S. Wave)", 54 *University of Miami Law Review* (2000) 799. A prominent example is the takeover of Mannesmann by Vodafone in 2000.

[19] Many of the contributions at the symposium presented evidence of company groups from court cases or antitrust proceedings, but nobody had access to systematic data. Perhaps, this is not so surprising. Recall that it took a special effort by the European Corporate Governance Network (ECGN) to produce systematic data on ownership concentration in Western Europe. See Becht and Roell, "Blockholdings in Europe: An International Comparison", 43 *European Economic Review* (1999) 1049.

identified above, can be found in every transition economy, but incidence of particular types of groups (i.e., socialist groups, *perestroika* groups, privatization, oligarch, network restructuring, or transnational groups) differs from country to country.[20]

In an attempt to base our analysis on more systematic data, we have assembled data on the ownership structure and the identity of owners of the largest companies in several transition economies. Ownership concentration is not identical with company groups.[21] Ownership concentration can, however, be taken as a first approximation of the existence of company groups, as large equity stakes held by other corporations are suggestive of a strong formal tie between at least two companies. The identity of owners reveals whether blockholders are primarily domestic or foreign firms, or whether they are strategic or financial investors – a distinction that is relevant for our discussion of financial institutions as part of company groups.[22] Given the higher disclosure requirements for publicly traded companies, data for these firms are best accessible.[23] Data are available only for three of the transition economies represented at the symposium, namely the Czech Republic, Hungary and Poland. We include the largest non-financial firms among the largest fifteen companies in the database and classify their owners as domestic financial and non-financial companies, foreign financial and non-financial companies, or the state.

The results presented in Appendix 1 are striking. The data reveal substantial levels of ownership concentration. For the ten Czech firms, the largest single shareholder holds on average 56.3% of voting stock, and the largest three shareholders together close to 80%. For Hungary and Poland, the levels are much lower and close to average in worldwide comparison.[24] In Hungary, the largest single shareholder holds on average 27.25% (data for seven firms), while the three largest shareholders hold 42.33%. In Poland, the respective data for six firms is 27.76% for the largest owner and 48.77% for the three largest shareholders together.

[20] For evidence on the persistence of socialist and *perestoika* groups in Russia compare Broadman, "Reducing Structural Dominance and Entry Barriers in Russian Industry", 17 *Review of Industrial Organization* (2000) 155.

[21] For a more detailed analysis of the relationship between these two concepts, see *infra* 3.1.

[22] See *infra* 5.

[23] Data were obtained from Bloomberg L.P. (Princeton, NJ 1992) (series).

[24] See La Porta et al. (1998) *supra* n. 2, Table 7. The sample average is 46% for the stock held by the largest three shareholders based on the largest ten non-financial firms listed on the stock exchange.

Even more striking is the identity of the owners. In the Czech Republic, in seven out of ten firms, the state is still the largest shareholder;[25] in two cases it is a foreign non-financial investor, and in one a domestic non-financial investor. In Hungary, the state is the largest owner in two out of seven companies, in three it is a foreign investor, and in two a domestic company. In Poland, the state appears only in one case as the largest owner, foreign investors in three cases, of which one is a financial investors, and domestic in two.

Obviously, the data have to be evaluated with great caution. They may not be representative for the country as a whole, as the incidence of company groups among closely held companies may differ from publicly traded ones. Moreover, the strong presence of the state as an owner in the Czech Republic may overstate the extent of continuous state ownership in this country in comparison with the other two. It may simply reflect the fact that in the Czech Republic all companies that went through mass privatization were automatically listed on the Prague Stock Exchange and thus found their way into the database we used.[26] By contrast, many of the firms with large state ownership in the other two countries may simply not be listed. In fact, the EBRD estimates that by the end of 1999 the total share of GDP in the private sector had reached 80% in the Czech Republic and Hungary but was still at 65% in Poland.[27]

Despite these qualifications, the data should caution against the assumption that company groups continue to be and therefore should be treated primarily as a domestic phenomenon. If we exclude the companies that are predominantly owned by the state,[28] foreign strategic investors followed by foreign financial investors are the most important blockholders of the largest firms in these countries. Whatever the effects of transnational company groups on the

[25] In part this can be attributed to the fact that utilities companies belong to the largest publicly traded companies in the Czech Republic.

[26] See Pistor, "Law as a Determinant for Stockmarket Development in Eastern Europe", in: Murrell (ed.), *Assessing the Value of Law in Transition Economies* (Ann Arbor 2001) ch. 8, for a comparative analysis of the development of capital markets and the relevant institutional framework in these three countries.

[27] EBRD, *Transition Report – Employment, Skills and Transition* (London 2000), country assessments, 124 at pp. 156, 172, and 196.

[28] The state continues to be the most important parent of companies that have been privatized only partially. It may, however, be an exaggeration to label companies that are owned largely by the state and managed by an entity such as the National Property Fund in the Czech Republic, or State Holding Company (AVRt – Hungarian acronym for Hungarian State Property Management Agency) in Hungary as members of a company group. Having a single state management agency does not necessarily imply that firms are subjected to a single group management strategy. In fact, available evidence suggests that the state has by and large been a rather passive owner. See Pistor and Turkewitz, "Coping with Hydra – State Ownership After Privatization", in: Frydman et al. (eds.) Vol. 2, *supra* n. 17, at pp. 192 et seq. for an early assessment of the state as an owner in partly privatized companies.

domestic economy, the leading company of the group will be located outside the domestic jurisdiction. This is true at least for the Visegrad countries, which received over 70% of total flows of foreign direct investments into the former socialist countries.[29] Even though the incidence of transnational groups may be lower in other transition economies, the experience of the Visegrad countries may repeat itself there, as investment in the region can be explained best by multinationals pursuing global strategies in a changing world, not by specifics of these countries.[30]

3. Theoretical explanations for the emergence of company groups

3.1 General observations

The analysis of company groups is a difficult task, mostly because there is no consistent body of literature about, and no common understanding of, the definition of a company group across existing literature.[31] There is extensive literature on the costs and benefits of firm concentration from a macroeconomic perspective. Similarly, there is a large volume of literature on cartels as well as on mergers, and their impact on the competitiveness of nations. By contrast, new institutional economics, including theories of the firm, have struggled to define the boundaries of the firm, but have hardly addressed the phenomenon of company groups.[32] Similarly, the corporate governance debate hardly mentions the concept, but instead focuses primarily on concentrated ownership. The two concepts are related, but do not overlap completely.

Concentrated ownership is the simpler concept. It means that a firm is owned by relatively few large blockholders. The relevant threshold for concentrated ownership may be debatable, and in fact may vary from country to country. Where on average shareholders hold hardly more than 5% of a company's shares, a 20% shareholder may be deemed a blockholder. By contrast, where

[29] Krifa and Vermeire, "L'intégration des Pays d'Europe Centrale dans les Réseaux de Production des Multinationales et ses Conséquences", 29 *Revue d'Études Comparatives Est-Ouest* (1998) 77. They attracted more than 24 billion US dollars.

[30] Ibid., at p. 106.

[31] See also Khanna, "Business Groups and Social Welfare in Emerging Markets: Existing Evidence and Unanswered Questions", 44 *European Economic Review* (2000) 748.

[32] The theory that is most closely associated with explaining the boundaries of the firm is the property rights theory. For a good overview of this theory and its comparison with other theories of the firm, compare Hart, "An Economist's Perspective on the Theory of the Firm", 89 *Columbia Law Review* (1989) 1757. For a more recent overview compare Hart, *Firms, Contracts, and Financial Structure* (Oxford 1995) 228.

majority owners are common, a 20% shareholder might not have much influence, as a stake of this size would not even give him a veto right for decisions with qualified majority.

The real debate in economics literature concerns the costs and benefits of concentrated ownership. Substantial literature has pointed to the benefits of relatively concentrated ownership, as this reduces agency costs and thus enhances corporate monitoring.[33] Until the early 1990s, the Japanese and German corporate governance systems were viewed with envy by many American commentators. Firms seemed to benefit from concentrated ownership, which typically implied few changes in the ownership structure and thus lengthened the time horizon of management. The major cost of concentrated ownership is self-dealing by management and/or blockholders at the expense of minority shareholders.[34] The optimal ownership structure thus seems to lie somewhere between excessive agency costs in the case of highly dispersed ownership, and the lack of market disciplining in the case of highly concentrated managerial or blockholder ownership.

With the changing economic cycles between Germany and Japan on the one hand, and the United States and United Kingdom on the other, the assessment of corporate governance systems has shifted. Countries with relatively dispersed ownership structures and liquid markets now have taken the lead, and thus dispersed ownership structures and shareholder value are hailed as the panacea for enterprise growth and development.[35] Whether this is indeed the "end of history", as some authors claim,[36] remains to be seen. The extreme swings in the recent debate suggest that not even for developed market economies a consensus has emerged as to the superiority of alternative corporate governance systems. Therefore, caution is in order when applying these concepts to

[33] See Jensen and Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", 3 *Journal of Financial Economics* (1976) 305 on the nature of agency costs in firms. On the benefits of concentrated ownership see Roe, "A Political Theory of American Corporate Finance", 91 *Columbia Law Review* (1991) 10 and Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (Princeton, N.J. 1994). For an analysis of the tradeoffs between liquidity and control compare Coffee, "Liquidity Versus Control: The Institutional Investor as Corporate Monitor", 91 *Columbia Law Review* (1991) 1277. Empirical data on management ownership in the United States also suggest that there may be some benefits to ownership concentration in the hands of management. Compare Morck, Shleifer and Vishny, "Management Ownership and Market Valuation: An Empirical Analysis", 20 *Journal of Financial Economics* (1988) 293.

[34] See Daniels and Iacobucci, "Some of the Causes and Consequences of Corporate Ownership Concentration in Canada", in: Morck (ed.), *Concentrated Corporate Ownership* (Chicago 2000) 81 at p. 83 for a useful summary of this argument.

[35] See in particular Shleifer and Vishny, "A Survey of Corporate Governance", 52 *The Journal of Finance* (1997) 737 and the studies by La Porta et al., *supra* n. 5.

[36] Hansmann and Kraakman, *supra* n. 3.

transition economies or emerging markets. Indeed, empirical analysis shows that the benefits of equity markets vary across industries and across countries at different stages in their economic development. Capital-intensive industries, which characterize countries in their earlier development stages, benefit more from credit financing, which typically goes hand in hand with concentrated ownership.[37] Industries in research and development, by contrast, correlate with well-developed capital markets. It is therefore possible that given their current state of economic development, transition economies may benefit from a relatively concentrated ownership structure. Indeed, data for the Czech Republic lend support for this proposition.[38]

Company groups differ from ownership concentration in several respects. It is meaningful to talk about a company group only for "a cluster of several, typically legally independent firms".[39] Moreover, whereas ownership concentration clearly refers to equity ties between companies, company groups may consist of equity as well as contractual relations.[40] For our purposes, we define a company group as a cluster of legally independent companies that are linked by formal ties, be they contract or equity, and that are subject to the same management strategy set typically by the leading company in the group. Using this definition as a basis, the following sections review theories from an institutional economics perspective on the rationale for company groups. Economic theories were long preoccupied with exchange relations on markets. Only with Ronald Coase's famous article published in 1937[41] has the firm received greater attention. Coase posed the crucial question why firms exist, i.e., why not all transactions that make up the production process are conducted on markets through contracts rather than through property rights and the internal organization of a firm. His answer was that the market mechanism has its own costs. The suppression of the price mechanism within the firm and its substitution with

[37] See Carlin and Mayer, "Finance, Investment and Growth", available on <www.ssrn.com> (viewed 2000).

[38] Claessens and Djankov, "Ownership Concentration and Corporate Performance in the Czech Republic", 27 *Journal of Comparative Economics* (1999) 498. The analysis is based on 1,782 firms listed on the Prague stock exchange. Performance indicators used are accounting data, including profitability and labor productivity. Note that this result may be driven by the fact that many blockholders are foreign strategic investors. Thus, firms may benefit not only from better corporate governance, but also greater access to capital and managerial expertise. See also id. at p. 507.

[39] See Granovetter, "Business Groups", in: Smelser and Swedberg (eds.), *The Handbook of Economic Sociology* (Princeton, N.J. 1994) 453 for this definition.

[40] Some authors would also include informal ties, such as kinship relations. See ibid.

[41] Coase, "The Nature of the Firm", *Economica* (1937) 386.

central administration may substantially reduce transaction costs.[42]

Roughly sixty years later, Granovetter has extended this question and has asked why company groups exist, how they evolve, and what function they perform in different economies.[43] He reviews studies of company groups around the world, which show that in many countries it is not the individual firm that dominates, but a group of more or less formally organized company groups of various sizes. Examples include the *keiretsu* in Japan, the *chaebol* in Korea, the various family groups, such as the *Tata,* in India, or the *grupos économicos* in Latin America. In Western countries, apart from the German concern structures, the family based company groups in Sweden (Wallenberg family), but also the company groups in France and Belgium, whose emergence at least in part can be traced to state intervention, deserve special mention.[44]

Institutional economics and its sub-specialty, transaction cost economics, view company groups primarily as a response to imperfect markets and weak institutions. Underdeveloped capital markets, insufficient information transparency or a weak legal framework create incentives for firms to either form new or join existing groups.[45] The causes for their emergence also explain their function: they buffer financial problems and liquidity crises of individual firms and improve access by firms to capital markets by, for example, the reciprocal provision of securities and guarantees among group members. Government intervention is an alternative explanation for company groups. Tax considerations weigh heavily not only in the choice of legal forms, but also on the design of intra-firm relations. To avoid such distorting effects, legislatures should be weary of creating market-distorting incentives.[46]

Membership in company groups can be advantageous both *vis-à-vis* an isolated firm as well as *vis-à-vis* a fully integrated firm.[47] Company groups offer

[42] See also Williamson, *Markets and Hierarchies, Analysis and Antitrust Implications: A Study in the Economics of Internal Organization* (New York 1975); for a summary of the key arguments relevant for the theory of the firm see Williamson, "Transaction-Cost Economics: The Governance of Contractual Relations", 22 *Journal of Law and Economics* (1979) 233.

[43] See Granovetter, *supra* n. 39.

[44] Wymeersch, *Groups of Companies in the EEC* (Berlin/New York 1993).

[45] See in particular Kali, "Endogenous Business Groups", 15 *The Journal of Law, Economics and Organization* (1999) 615 for this view of company groups.

[46] The expected sell off of large equity stakes by German banks and other companies in response to the expected change in tax law is ample evidence of the impact of tax considerations on the ownership structure of enterprises. See "Germany's Quiet Tax Reform", *The Wall Street Journal*, 28 December 1999, A 18:1.

[47] For a detailed analysis of the economic rational of company groups see Kalfass, "Ökonomische Analyse der Konzernbildung", in: Mestmäcker and Behrens (eds.), *Das Gesellschaftsrecht der Konzerne im internationalen Vergleich* (Baden-Baden 1991). The subsequent analysis draws heavily on his work.

advantages over independent firms, if the transaction costs of market relations exceed the costs of co-ordinating activities among members of the group. Groups may also be superior to full integration, because legal independence of group members facilitates the delegation of activities and decision-making. This is relevant in particular for heterogeneous activities or highly independent stages of the production process. The establishment of company groups may lead to financial advantages for the leading company in the group, but also for other members. One reason is that the formation of a group may result in the concentration of economic power, thus reducing competition and allowing the group to reap the benefits of monopoly rents. Another is that companies may participate in the profits generated by other member firms either through equity stakes or contractual arrangements that transfer part of the profits to the leading firm. At the same time, they may reduce their own liability arising out of tort (including product liability) or contract, as formally each group member remains legally responsible for its own obligations.[48] The diversification of risks and liability means that the group functions as a buffer against negative economic externalities, although this may come at the expense of an individual member. Another source of financial benefits is that members may benefit from lower costs of external finance that is provided by other group members. A classic example is the establishment of pyramid structures. An alternative to this structure is the inclusion of an external financier (for example a bank) that holds a minority stake in the parent company, or co-owns a joint company and facilitates access to funds in the form of long-term credits, leasing or rent arrangements. Finally, group members can provide each other with securities and guarantees in order to obtain credits from external sources.

As this summary reveals, the field of institutional economics is primarily concerned with market distortions as determinants for the formation of company groups. Absent high information and other transaction costs, there should be no reason for the emergence of groups. From this analysis follows that the primary purpose of regulatory intervention should be the reduction of transaction costs, i.e., by improving access to information through disclosure requirements, strengthening institutions like courts that facilitate contract enforcement, and antitrust measures that enhance the competitiveness of markets.[49]

[48] Legal systems have found solutions to deal with this problem of shifting liability. See *infra* 3.2 (protection of shareholders rights).

[49] This is the policy implication that Kali draws from his analysis of company groups. See Kali, *supra* n. 45.

3.2 Application to transition economies

In the context of transition economies, these remedies appear to be most appropriate for company groups that emerged in the post-socialist period, especially the network restructuring groups.[50] These groups emerged in response to transaction cost problems faced by individual firms. It is therefore plausible that improvements in law and legal institutions, i.e., a reduction in transaction costs, would lead to a reversal of this process. The same remedies may work in the case of groups that resulted from a particular privatization strategy (privatization groups). They may dissolve themselves in light of potential efficiency gains. In contrast to network restructuring as well as privatization groups, oligarch groups are not as likely to respond to incentives, as their primary benefit results from the political benefits of economic power. With respect to company groups that are a legacy either of the classic socialist regime or the socialist reform period, the implications are also less certain. Classic socialist groups were created by political fiat. Their organizational and management structure was not designed according to economic efficiency criteria. Those who control these groups, in particular top management and their affiliates in the state bureaucracy (including in the post-socialist privatization or state property management agencies), may have little interest in undermining their own future by dissolving these groups.

The choice of reform strategies should therefore be informed by the legacy of company groups and the political economy in different transition economies. Changing the incentive structures of firms may not be sufficient, if the formation of groups is motivated by either political factors or is a defense mechanism against market based reforms.

Even where these reform strategies may work in principle (i.e., for network restructuring or privatization groups), it should be noted that this process will take time. Institutions for a market economy are not created over night, as the experience of the past ten years of transition amply demonstrates. In the meantime, the existence of company groups may be a desirable alternative. Absent adequate market institutions they can be viewed as transaction enabling.[51] The longer this process lasts, the less likely it is that it can be easily reversed. Path dependence theory suggests that even if alternative strategies become more efficient over time, switching costs may be too high to implement change.[52]

[50] Compare the typology of company groups we developed *supra* 2.

[51] See also Khanna, *supra* n. 31.

[52] North, *Institutions, Institutional Change, and Economic Performance* (Cambridge/New York 1990) for a basic exposition of the path dependency theory and Roe, "Chaos and Evolution in Law and Economics", 109 *Harvard Law Review* (1996) 641 for its application to legal evolution.

Where this is the case, more proactive policies, for example in the form of competition policy, may be necessary.

To justify such an intervention we must return to the question of the costs and benefits of company groups. To the extent they are transaction enabling, because they substitute for underdeveloped markets and weak legal institutions, the benefits seem to outweigh the costs. Company groups may, however, have a negative impact on the competitiveness of an economy. The greater security group membership affords firms may also make them less responsive to changing market conditions. The struggle of the Korean *chaebol* since the 1997/98 Asian financial crisis gives ample evidence of the adaptation costs of enterprise structures that relied too long on group protection.[53] In addition, they create conflicts of interest between investors of individual members and the group at large.[54] The irony is that group membership may be a *conditio sine qua non* for the survival of many companies during the transition process, but continuing dependence on group membership under changing market conditions may undermine the competitiveness of the same firms in the long term. The challenge for policy-makers is therefore to balance the short-term benefits with the potential long-term costs of company groups.

4. LEGAL REGULATION OF COMPANY GROUPS

Company groups have received much greater attention in legal literature as well as in legislation, in particular in Continental European legislation.[55] Within the EU, a comprehensive regulation of company groups exists in Germany since 1965 as well as in Portugal. Many other countries have legislation on company

[53] On the fall-out of the Asian financial crisis on the enterprise sector in Asia compare Rajan and Zingales, *Which Capitalism? Lessons from the East Asian Crisis*, Working Paper, Chicago University (1998).

[54] See also Khanna and Palepu, "Is Group Affiliation Profitable in Emerging Markets? An Analysis of Diversified Indian Business Groups", 55 *Journal of Finance* (2000) 867. Based on their analysis of company groups in India, however, they conclude that overall affiliation with highly diversified groups has a positive impact on affiliates.

[55] There is a huge amount of literature on company groups (concerns) in Germany. See the references in Emmerich and Sonnenschein, *Konzernrecht*, 6th ed. (Munich 1997). We focus here only on comparative studies. See, for example, Mestmäcker and Behrens (eds.), *supra* n. 47; Schmitthoff and Wooldridge (eds.), *Groups of Companies* (London 1991); Wymeersch (ed.), *supra* n. 44; Lutter (ed.), *Konzernrecht im Ausland* (Berlin 1994), and most recently Forum Europaeum Konzernrecht, "Konzernrecht für Europa" [Corporate Group Law for Europe], *Zeitschrift für Unternehmens- und Gesellschaftsrecht* (1998) 672. For the English language version of the principles developed by the Forum Europaeum see 1 *EBOR* (2000) 165.

groups in specific areas of the law, e.g., in tax law, banking supervision, and group accounting law. There is also a substantial body of case law on groups in most jurisdictions, reflecting the fact that company groups are an important real world phenomenon. Furthermore, attempts to develop principles for common group law (beyond the already existing European group accounting law) in the EU are currently under way.[56]

Transition economies have followed different strategies in developing a legal framework for company groups. Some have imported the German *Konzernrecht* wholesale. This is the case in Croatia, the Czech Republic, Macedonia and Slovenia. Others, such as Hungary, have been more selective, and have adopted only a few provisions, in particular those that appeared relevant for dealing with the phenomenon of transnational groups. Yet others, foremost among them Poland, have been reluctant to enact specific legislation on company groups and have instead adopted a policy of "wait and see and pick and choose".[57]

Even where a comprehensive group law does not exist, there are many other ways for a legal system to address the phenomenon of company groups. One approach is to treat the relation among group members as parent-subsidiary relations and deal with liability issues and shareholder rights under the rubric of blockholders. Creditor protection is achieved by way of piercing the corporate veil, the doctrine of equitable subordination and fraudulent conveyance law. This approach has been taken by the United States.[58] Another approach, used often cumulatively, is to deal with company groups from the perspective of antitrust law. It deals with behavior of economic actors (and economic structures) that may adversely affect competition. A wide interpretation of such behavior may imply that strong ties between legally independent firms may be

[56] Detailed propositions have already been developed by a group of legal experts from different European countries. See Forum Europaeum, *supra* n. 55. For a critical assessment of these propositions, see Fleischer, "Neue Entwicklungen im englischen Konzernrecht, Vergleichende Notizen im Lichte der Empfehlungen des Forum Europaeum Konzernrecht", *Die Aktiengesellschaft* (1999) 350; Kluver, "European and Australian proposals for corporate group law: a comparative analysis", 1 *EBOR* (2000) 287; Schoen, "Das Bild des Gesellschafters im Europäischen Gesellschaftsrecht" [The Concept of the Shareholder in European Law], *Rabels Zeitung* (1999) 1, English language version: 1 *EBOR* (2000) 3 ; Windbichler, "Corporate Group Law for Europe: Comments on the Forum Europaeum's Principles and Proposals for a European Corporate Group Law", 1 *EBOR* (2000) 265.

[57] For details see Jessel-Holst in *EBOR* 2 (2001) 45.

[58] Clark, *Corporate Law* (Boston/Toronto, 1986) ch. 2 (duties to creditors), ch. 7.8 (parents and subsidiaries), ch. 10 et seq.; Brudney and Clark, "A New Look at Corporate Opportunities", 94 *Harvard Law Review* (1981) 1044. Blumberg has made substantial efforts to develop principles of group law for American law, but they have not found widespread acceptance. Blumberg, *The Law of Corporate Groups* (Boston 1987). Cf. the survey by Blumberg, "The Increasing Recognition of Enterprise Principles", 28 *Connecticut Law Review* (1996) 296.

deemed anti-competitive and thus illegal. In particular the early development of antitrust law in the United States can be described as a process that forced firms to choose between full vertical integration on the one hand, or arms length relationships on the other.[59] To put it simply, antitrust law may be characterized as the law that establishes the limits of firm co-operation, while group law deals with the protection of stakeholder interests within groups. In the following sections we sketch out important control mechanisms for company groups in both areas of the law with emphasis on those mechanisms that may be relevant for transition economies. We do not attempt to offer a comprehensive analysis of either body of law.

4.1 Competition law

The function of competition law is to ensure the competitiveness of markets, this being an important goal of the transition process. The initial conditions as well as the circumstances of the transition process have demonstrated that this is a difficult and long-term process.[60] Its success depends to a large extent on the ability of these countries to build effective market institutions, in particular courts and antitrust agencies whose task is to watch over the observation of the rules of the game. They need to carefully manage the transition process between the Skylla of excessive concentration of economic power in response to adverse market conditions, and the Charybdis of excessive regulation. The latter might dwarf economic activities, if market transactions are too costly and regulation prevents the internalization of transaction costs by forming groups.

In most countries, transition countries as well as others, the national jurisdiction has become too narrow to deal with issues of competitiveness. Markets are becoming increasingly international thereby challenging the national boundaries of regulation. The bundling of national antitrust laws at the European level is a reaction to this development, but appears not to be sufficient in an era of globalization. The smaller countries of Central and Eastern Europe are strongly affected by this process. In fact, as the – admittedly limited – data we present in Appendix 1 suggest, transnational groups are a far more important factor in

[59] For a detailed analysis of the relation between corporate and antitrust law in the US and its impact on the development of the corporate sector, see Hovenkamp, *Enterprise and American Law, 1836-1937* (Cambridge, Mass, 1991). For an analysis of the relation between merger waves and changes in antitrust law, see Kovacic, "Failed Expectations: The Troubled Past and Uncertain Future of the Sherman Act as a Tool for Deconcentration", 74 *Iowa Law Review* (1989) 1105.

[60] See Commander, Dutz and Stern, "Restructuring in Transition Economies: Ownership, Competition and Regulation", *Proceedings of the Annual Bank Conference on Development Economics* (Washington, D.C. 1999) for an assessment of the competitiveness of markets in transition economies. See also EBRD, *Transition report – Ten years of transition* (London 1999) ch. 7.

these countries than purely domestic groups.

The most important regulatory tools to deal with group related issues are the prohibition of cartels, merger control, and intervention when firms exploit their market dominant position.[61] The appropriateness of these tools, the criteria used to define a restraint on competition, and the theoretical assumptions on which they rest is subject to considerable and ongoing debate. Whatever the merits of this debate, those transition economies that are in the process of joining the European Union have relatively little choice over the tools and concepts for their future competition policy, which is set in Brussels, not in Warsaw, Prague, or Budapest.[62] In fact most countries, including second tier accession countries have designed and reformed their competition laws already in the shadow of European competition regulations.[63] While the existing regulatory framework may not be a perfect match for new Member States, opting out of this framework raises substantial political as well as economic costs, which may not be worth the effort. In fact, the very existence of a developed and thus predictable legal framework for competition law may facilitate rather than hinder the reform process.[64]

This still leaves open the question as to how rigidly these regulations should be applied to transition economies, and whether temporary exemptions should be made for specific sectors. This could be justified by the old infant industry argument, namely that countries should be given the time to nurture and grow their domestic companies before exposing them to the rules of international competition. Apart from the fact that infant industry protection strategies have rarely been successful, the factual situation in transition economies is quite different. They inherited a highly concentrated industry structure from the socialist system, which tends to crowd out small and medium size enterprises. Still, an extensive, rigidly enforced merger control without any exemptions might also be undesirable in economies where mergers perform an important function in the process of "secondary privatization".[65] This concept refers to the reallocation of property rights subsequent to privatization. Since privatization programs could not assure that those who would use the assets most productively would obtain control right away, the subsequent sale of assets was widely regarded as a crucial part in reforming the ownership structure of firms.

[61] For a detailed account of these tools, compare Dreher in *EBOR* (2001) Issue 2.

[62] For a critical assessment of these policies and their implications for transition economies, compare Kirchner's contribution to the symposium, forthcoming in Hopt et al., *supra* n. 8.

[63] See Dreher, *supra* n. 61.

[64] A similar point was made by Fornalczyk at the symposium.

[65] For a similar argument see Soltysinski, "Transfer of Legal Systems as Seen by the 'Import Countries': A View from Warsaw", in: Drobnig, Hopt, Kötz, Mestmäcker (eds.), *Systemtransformation in Mittel- und Osteuropa und ihre Folgen für Banken, Börsen und Kreditsicherheiten* (Tübingen 1998) 69. Cf. also § 37 (3) of the German Anticartel Act 1998. This provision exempts financial intermediaries from merger control if they do not vote their shares and resell them within one year.

In addition, the market for control could play a potentially useful role as a corporate governance device.[66] Regulatory intervention, e.g., by a mandatory bid provision coming in at too low a participation level, may make such transactions too costly, and, even though well-intended, may therefore have adverse consequences. Yet, regulatory supervision could also function as a check on the extent to which companies choose group membership as a defense strategy against corporate control mechanisms and the force of competition. This may be a case for prohibiting managers of target companies from frustrating action in case of a takeover.[67] Proponents of the equivalent of the infant industry argument in the market for corporate control would argue that requiring neutrality may expose domestic companies to foreign takeovers at a time when a level playing field has not been established yet. In fact, this argument is frequently made to protect European firms from takeovers by American companies. If one assumes that takeovers are usually efficiency enhancing, this argument is not convincing as companies and ultimately the economy would benefit from the change in ownership and new inputs of capital and expertise. If, by contrast, takeovers are part of a strategy to ensure market control and eliminate competition, one cannot deny some merit to this argument. In transition economies (as elsewhere), there is evidence for both scenarios. Until stronger evidence makes a case for intervention, this would suggest regulatory neutrality and intervention only in cases of obvious misuse.

These considerations demonstrate that it is difficult to make a clear-cut case for the design of competition law in transition economies or its application in practice. This is equally true for explicit exemptions from the application of such rules. Examples for explicit exemptions reflecting past or present practice in other Member States of the European Union include exemptions for small

[66] On takeover transactions as a control device and their impact on management behavior, see Coffee, "Shareholders Versus Managers: The Strain in the Corporate Web", in: Lowenstein and Ackerman (eds.), *Knights, Raiders and Targets, The Impact of the Hostile Takeover* (Oxford 1988); Romano, "A Guide to Takeovers: Theory, Evidence, and Regulation", 9 *Yale Journal on Regulation* (1992) 119, also in Hopt and Wymeersch (eds.), *European Takeovers* (London 1992) 3. Cf. also Hopt, Kanda, Roe, Wymeersch and Prigge (eds.), *Comparative Corporate Governance* (Oxford 1998) ch. 8.

[67] Cf. Mülbert, "In Defense of Passivity – on the Proper Role of a Target's Management in Response to a Hostile Tender Offer", 1 *EBOR* (2000) 445. The Thirteenth EU Directive (see n. 82 *infra*) contains such a rule; cf. Hopt, "The Duties of the Directors of the Target Company in Hostile Takeovers – German and European Perspectives", in: Ferrarini, Hopt and Wymeersch (eds.), *Capital Markets in the Age of the Euro* (London: Kluwer 2001) (forthcoming). See also Bebchuk and Ferrel, "Federalism and Corporate Law: The Race to Protect Managers from Takeovers", 99 *Columbia Law Review* (1999) 1168.

and medium size enterprise cartels, for cartels in industry sectors affected by structural crises, or sometimes for export cartels. All of these exemptions are very much disputed, in particular export cartels, which foster a "beggar thy neighbor" policy and run afoul of competition theory.[68] An argument in favor of exemptions at least in transition countries is that this might give these economies the time needed to accomplish reforms and to buffer economic shocks for specific sectors. At the same time, experience both in EU Member States and in transition economies suggests that these buffers may delay reforms rather than facilitate gradual restructuring. Important examples include the coal and steel or the shipbuilding sectors.[69] An additional political economy argument that cautions against the liberal use of exemptions is that governments in transition economies face the challenge of making reform strategies credible. Weakening newly announced rules by combining them with extensive exemptions may send the wrong signal and induce lobbying for more exemptions. Exemptions should therefore be granted conservatively and where possible should be limited in duration.

Finally, some countries vest antitrust authorities with the right to order a divestiture of companies that have seriously violated competition rules. This practice is most common in the United States, where it is also not undisputed.[70] Divestiture is also provided for in Germany under certain restrictive circumstances, while most other European merger control regimes do not include divestiture. For transition economies, the question whether the state should attempt to restructure and/or divest companies was most virulent when privatization strategies were first designed. The separate privatization of sub-units of larger conglomerates offered a relatively simple way to implement divestiture policies. As state ownership is prevalent in the largest companies in transition economies, future privatization strategies could be used to achieve some unbundling of conglomerate structures. By contrast, implementing divestiture orders as a general antitrust measure is a complex administrative undertaking, requiring years of supervision of the divestiture process by well-staffed and well-trained regulators. Transition economies may simply not have the resources to implement such policies.[71]

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[68] The German antitrust reform after many years has done away with exemptions for export cartels.

[69] For a vigorous argument against any exemptions of this kind, compare Fornalczyk in *EBOR* (2001) No. 2.

[70] The debate has received renewed attention with the proposal of Judge Jackson to force Microsoft to legally separate its software and operation system production lines. See Hahn, *U.S. v. Microsoft: Breaking Up Should be Hard to Do* (Washington, D.C. 2000).

[71] Obviously, divestiture as part of privatization also requires substantial expertise. Yet, the monitoring problem is less severe when the state can order particular outcomes as the owner of assets. Even then, it can hardly prevent the reassembling of enterprises into company groups subsequent to privatization.

The latter point raises a more general issue. One of the greatest challenges for transition economies has been to build up human capacity in the state administration. Contrary to expectations, the transition to a market economy has not involved a considerable downsizing of the state bureaucracy. Yet, substantial pay differentials between the private and the state sector have made it difficult to attract talent to government posts. This is not a problem unique to transition economies.[72] However, given their task to simultaneously build up new capacities in various sectors of the state administration, it is particularly severe in these countries. Morality in the state sector is low, as demonstrated by relatively high levels of corruption.[73] Government interventions that may seriously impede the earning potential of private actors – such as merger transactions – are likely targets of side payments. The (partial) transfer of jurisdiction over competition issues to the European Union may therefore have a positive impact,[74] since at least the decision-making will be taken out of the hands of local bureaucrats.

The lack of regulatory capacity and the difficulty involved in enforcing antitrust policies particularly in this environment also calls for alternative strategies. Facilitating new entries and lowering entry barriers is paramount to antitrust policy and should be a cornerstone of such alternative strategies also in transition economies. In the past, much emphasis has been placed and much money spent on privatizing the former state owned enterprises. Yet real growth and restructuring is coming from new enterprises, not the old dinosaurs.[75] Thus, competition policy should be not only proactive but foresightful by investing the limited resources where they can be most effective.

4.2 Shareholder and creditor rights

Competition law sets the limits of permissible inter-firm co-operation, for mergers, and, one may argue, for co-operation within groups of companies. Apart from this, for legally sanctioned company groups the question arises

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[72] Most recently the point has been made by Sanio, the president of the German Bank Supervisory Agency, as to supervising large multinational banks, in particular in the context of checking bank internal risk models under the Basle II reform.

[73] See the latest ranking of the corruption perception index compiled by transparency international available at <www.transparency.de/documents/cpi/>. The index includes 99 countries ranked higher the lower the level the corruption. Hungary ranks as 31, the Czech Republic as 39, and Poland as 44.

[74] A (partial) retransfer of jurisdiction to the Member States of the European Union is now taking place despite some severe criticisms, cf. Mestmäcker, "The EC Commission's Modernization of Competition Policy: A Challenge to the Community's Constitutional Order", 1 *EBOR* (2000) 401.

[75] For a similar argument see Broadman, *supra* n. 20. He shows that Russian industry structure differs from the one in the US not so much in size, but in the rate of new entries.

whether special rules are required to deal with the interests of company stakeholders, including shareholders and creditors[76] in group members. In economic terms, the potential problems that may arise for shareholders and creditors of firms that are group members are not fundamentally different from those of shareholders or creditors of independent firms – the fact that German corporate group law is based on this very distinction notwithstanding. Most of these problems can be analyzed in the framework of principal-agency theory, albeit one with multiple agents. Shareholders need to be concerned not only with how to control management or a particular blockholder, but how to ensure that their interests receive adequate attention as part of the group strategy (as minority shareholders in the subsidiary, but also in the parent company).[77] Creditors need to be concerned with group strategies that may affect the viability of the firm they contract with. They should also assure themselves of the extent to which they can have recourse not only against that firm, but perhaps against other group members, should their contracting party fail to perform. Finally, a company group that is subject to the same group management may require its independent internal organization, raising the question about the need for legislative models for group organization law.[78]

The response to the question about the need for a group law depends to a large extent on the commentator's position in the debate about the nature of the corporation. If one regards the firm or the corporation as a network of contracts, there is little room for legislative intervention other than for offering a set of optional rules to reduce the costs of corporate contracting.[79] Shareholders and (voluntary) creditors of member firms are then conceived as rational economic actors who should assess the firm value taking into consideration the fact that it is part of a group as opposed to an independent firm and price their capital investment accordingly. Given the benefits of intra group transactions in an environment where market transactions are deemed too costly, shareholders of network restructuring groups at least may well pay a premium in the short to medium term.

[76] The notion of stakeholder is often used in a more narrow sense comprising only those who are not shareholders.

[77] Cf. the prominent German *Holzmueller* case, *BGHZ* 83, 122 (1982). This case dealt with the possible dilution of shareholder rights in the parent when parts of its operations were spun off to a subsidiary.

[78] Cf. Forum Europaeum, *supra* n. 55, at p. 174. On the function of corporate law as organizational law, compare Hansmann and Kraakman, "The Essential Role of Organizational Law", 110 *Yale L.J.* (2000) 387.

[79] The nexus of contracts theory goes back to the seminal paper by Jensen and Meckling, *supra* n. 33. From a legal perspective, see Easterbrook and Fischel, *The Economic Structure of Corporate Law* (Cambridge, Mass. 1991). For a comparison of various theories of the firm written by a leading economist of the property rights theory for a legal audience compare Hart, *supra* n. 32.

An important prerequisite for a market approach to group law that relies exclusively on contracts is that stakeholders have adequate access to information. Legislative intervention may enhance disclosure of relevant information, for example by requiring consolidated group accounts as the Seventh European Company Law Directive already does.[80] Leaving the responsibility for contracting around group membership with shareholders and creditors also assumes that at the time of contracting the relevant company is already part of a group, or this is at least foreseeable. Changes in midstream in the status of a company, i.e., after a contract has been concluded, may substantially alter the value of the original contract.[81] There might be a case for legislative intervention, if such a change in status is deemed a contingency that stakeholders cannot be expected to foresee *ex ante*, and because lack of legal clarification of investor rights in such a situation may result in under-investment. Legislative intervention may take one of two forms. It may ensure investors an effective exit option in the case of a status change. Alternatively, it may seek to ensure adequate protection of investors in companies that have become group members, perhaps combining this with an exit option, should their rights and interests be seriously impeded.

The main difference between these two approaches is exemplified by differences between the Draft Thirteenth European Takeover Directive on the one hand,[82] and traditional German group law on the other. The EU Draft Takeover Directive gives shareholders an effective exit option in the case of a takeover (which may result in the integration of a firm into a group) by forcing the acquiring company to make a mandatory offer to the remaining shareholders,

[80] The directive is available in Hopt and Wymeersch, *European Company and Financial Law*, 2nd ed. (1994) 232. Note that the EU will move away from the present Seventh Directive towards mandatory application of the International Accounting Standards (IAS) for consolidated accounts by 2005 at the latest (Proposed Regulation concerning the application of international accounting principles as of Feb. 13, 2001).

[81] The issue of changes in midstream was first raised by Bebchuk in his contribution to the debate about mandatory versus optional corporate law: Bebchuk, "Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments", 102 *Harvard Law Review* (1989) 1820. See also Bebchuk, "Federalims and the Corporation: The Desireable Limits on State Competition and the Corporation", 105 *Harvard Law Review* (1992) 1437.

[82] Note as to the Thirteenth Directive: The Council had reached a Common Standpoint as of June 2000. The European Parliament had rejected it and made 15 far-reaching amendments, in particular as to the controversial prohibition of frustrating action by the board of the target. German Chancellor Schroeder himself made an unexpected and very unfortunate volte-face and intervened in the Council for keeping national post-bid defenses. This drew harsh criticism by German financial circles including the German Takeover Commission. At the end, on June 5, 2001 just before the legal lapse of the draft directive, Germany was clearly outvoted in the Concil-iation Committee. It seems that the Directive is now out of the woods including the antifrustration which is modeled after the British City Code.

should it acquire a controlling stake.[83] German group law, by contrast, protects shareholders by giving them an exit option only *ex post*, i.e., once the agreement has been concluded.[84] Its primary focus is the protection of shareholders in companies that are already group members by, for example, giving them the right to request an independent audit.[85] Thus, German group law attempts more than ensuring access to information and securing exit rights in case of status change. It seeks to protect shareholders who have consciously decided to invest in a company they knew was a member of a group or that remained in that company after it became one. Whether such a comprehensive group law is desirable or effective remains subject to debate.[86] The approach is certainly consistent with the general approach of German corporate law, namely to establish a mandatory legal framework for corporations with relatively few opt outs. This model obviously is in stark contrast to the contractarian approach to corporate law discussed above.[87] What is beyond dispute now, is the fact that the *ex post* approach German style is not a substitute for an *ex ante* protection as provided for by a mandatory bid as in Article 5 of the Draft Thirteenth Directive.[88] The Common Standpoint no longer includes the option for Germany to avoid the mandatory bid provision by sticking to its traditional group law.

[83] Art. 5 of the directive requires that the acquirer offers either liquid shares or cash. A reprint of the directive can be found in the German language in Neye, "Der gemeinsame Standpunkt des Rates zur 13. Richtlinie – ein entscheidender Schritt auf dem Weg zu einem europäischen Übernahmerecht", 45 *Die Aktiengesellschaft* (2000) 289 at p. 296. The English version is available at <www.europa.eu.int/search/s97.vts>.

[84] Compare Art. 305 of the German Marketable Share Companies Act according to which the merger agreement or a contract that transfers control rights to another company in the group must include provisions to compensate shareholders wishing to leave the company. See the still very informative contribution by Wiedemann, "The German Experience with the Law of Affiliated Enterprises", in: Hopt (ed.), *Groups of Companies in European Laws* (Berlin/New York: de Gruyter 1982) 21; cf. also Hommelhoff, "Konzerneingangsschutz durch Takeover-Recht?", in: Bierich, Hommelhoff and Kropff (eds.), *Festschrift Semler* (Berlin/New York 1993) 455

[85] Compare Art. 315 of the German Marketable Share Companies Act.

[86] Based on interviews of practitioners and legal experts Hommelhoff, "Praktische Erfahrungen mit dem Abhängigkeitsbericht", 156 *Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht* (1992) 295 concludes that German group law offers a viable framework that should be promoted within the European Union. A more sceptical and nuanced view is presented by the Forum Europaeum Konzernrecht, *supra* n. 55.

[87] See § 23 (5) of the German Marketable Share Companies Act, according to which deviations from the letter of the law are permissible, if the law explicitly allows for them. This provision is criticized in the literature. Cf. Hopt, "Gestaltungsfreiheit im Gesellschaftsrecht in Europa – Generalbericht –", in: Lutter and Wiedemann (eds.), *Gestaltungsfreiheit im Gesellschaftrecht* (Berlin/New York: de Gruyter 1998) 123.

[88] Cf. Hopt, "Europäisches und deutsches Übernahmerecht", 161 *Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht* (1997) 368 at pp. 387 et seq.

A common group law for the European Union does not exist as of now. An important step towards the development of a common regulatory framework are the propositions developed by the Forum Europaeum Konzernrecht (Forum), a group of legal experts from various Member States.[89] The recommendations include rules aimed at enhancing information, including special investigation by auditors at the request of a minority, and ensuring exit options, as well as selected provisions designed to protect shareholders and creditors in existing groups.

With respect to the protection of shareholder rights, the recommendations support additional disclosure requirements for groups, a mandatory takeover bid, a put option (a compulsory sell-out right) with appraisal rights by minority shareholders, and the right of minority shareholders to call an independent audit if there are substantial grounds for suspecting misconduct.[90] For transition economies, the most demanding of these proposals are appraisal rights. Disclosure requirements, including consolidated group accounts, are already part of the package transition economies are mandated to harmonize. The implementation of new accounting rules is not an easy task,[91] but there is little disagreement about their importance. Consolidated group accounts may add to the complexity of the task, but they do not fundamentally alter it. The same could be said for a special investigation procedure at the request of a minority. Yet, it should be recognized that the implementation and enforcement of this procedure by independent auditors under the control of the court is already demanding.

Appraisal rights can be effectuated only when minimum accounting standards are established and followed in practice. Since many companies in transition economies are not listed on the stock exchange, or, if listed, their shares are not very liquid, the market value of shares will be quite difficult to determine.[92] Experience from Germany with company evaluations shows substantial divergences in outcome, frequently followed by lengthy litigation, lasting often up to ten years. Those charged with implementing appraisal rights in transition economies, i.e., in the last instance judges, therefore need to develop alternative standards for assessing the value of shares when exit options shall be realized. The legislature may set a framework and certain guideline principles, which should be complemented with examples to facilitate their

[89] Forum Europaeum, *supra* n. 55.

[90] Compare in particular proposals 5, 6, and 7 at pp. 261-262 in the English version.

[91] Bailey, "Accounting in Transition in the Transitional Economy", 4 *The European Accounting Review* (1995) 595 offers an interesting discussion of accounting reforms in transition economies and the impediments to such reform efforts.

[92] For an overview of the number of firms listed on stock exchanges in transition economies and the liquidity of firms measured by the value traded and the turnover ratio, compare Standard and Poors, *Emerging Stock Markets Factbook* (New York 2000).

interpretation, but it cannot fully replace judicial assessments.[93] Sufficient expertise of judges to set standards for, or assess the quality of appraisals is therefore crucial. Only then can such measures provide the expected protection. Given the shortage of well-trained accountants and judicial personnel in most transition economies, as well as the particularly complex task of determining accurate accounts and fair market value in the context of transition economies, not too much can be expected in the short term. In the interim, it might be worthwhile considering a procedure, which does not necessarily assure an accurate evaluation, but one that is acceptable to both parties. The 1899 Delaware corporate law, for example, provided that three arbiters would determine the price at which a shareholder would be bought out, one appointed by the shareholder, one by the corporation, and the third by the two arbiters thus appointed.[94]

With respect to creditor rights, the Forum's recommendations require highly differentiated judicial assessments of conflicts of interest between creditors of a group member on the one hand, and the group, in particular the leading company in the group, on the other. An example is the *Rozenblum* doctrine, which was developed by French courts.[95] Under the doctrine, creditors of a group member can have recourse against the group only if the member makes transfers to the group without accruing any benefits from group membership. In effect, it limits recourse by creditors against the group by asking courts to balance the transfer payment against the overall benefits a member may receive, including long-term benefits. An important condition for this doctrine to apply is that the group is relatively consolidated and it is therefore possible to speak of "group interests", which may be compared to the interests of an individual group member. The *Rozenblum* doctrine thus allows a general assessment of the relation among group members, rather than forcing courts to evaluate specific transfers against specific compensations as is done, for example, under German group law.[96] Legal practice in Germany gives ample evidence that the latter is by no means an easy task. Yet, this does not mean that a broad assessment of group interests is any easier. To assess the likely impact of this doctrine

[93] A good example of an attempt to provide such alternative standards, which demonstrates how difficult this is, is the Russian Marketable Share Companies Act, which provides in s. 77: "The market value of property, including the value of a company's shares and other securities, is the price at which a seller having full information about the value of [the property] and not obliged to sell the property, would agree to sell it, and a buyer having full information about the value of the property and not obliged to acquire [the property] would agree to acquire it." English translation by Bernard Black and Anna Tarassova (1996).

[94] S. 56 Delaware Corporate Law 1899, in: *Laws of Delaware 1899*, p. 445.

[95] See Forum Europaeum, *supra* n. 55, at pp. 197 et seq. See also Fleischer, *supra* n. 56; Wymeersch, "Financial Institutions as Members of Company Groups in the Law of the European Union", 2 *EBOR* (2001) 81 who clarifies that this doctrine was developed in criminal law.

[96] See § 311 German Marketable Share Companies Act.

in transition economies, it is worth remembering the legacy of the former socialist countries, where the interests of the people or the state prevailed over individual economic or personal interests. Judges, even if well-trained, independent and impartial, will be familiar with this kind of reasoning and therefore are likely to err on the side of overstating group interests. It seems therefore advisable to caution against the introduction of this doctrine in transition economies. The doctrine may be useful to modify atomistic economic interests once these are fully recognized, but may undermine the very recognition of such interests if introduced prematurely.

Conflicts of interest between creditors of a group member and the leading company arise in particular in crisis situations. The English "wrongful trading doctrine" addresses this situation. It requires that in case a group member faces a crisis, the group management must take a decision to either liquidate the company or take measures to ensure its survival. Should it fail to take such a decision, the leading company of the group may be held liable for the member's obligations. The rationale for such a rule is that the leading company of the group should not be allowed to reap the benefits from group membership, but avoid responsibilities and hide behind the veil of limited liability should a member firm face serious difficulties. The doctrine punishes the parent company and its directors not for taking the wrong decision (i.e., attempting reorganization when liquidation would have been in order), but for not taking a decision at all. It assumes that the parent company knew the advent of a crisis and allows creditors of the group member to seek recourse against the parent company.

In effect, the wrongful trading doctrine challenges the ability of other group members to rely on the formal claim of limited liability when it comes to allocating the losses of a company that has gone under. Its application in practice requires that courts develop reliable criteria for a crisis that should trigger action by the leading company. Moreover, they need to estimate the damage creditors may have suffered from inaction. Whether courts in transition economies could live up to these expectations is questionable for the reasons discussed above. Even more important, it will be difficult to develop reliable criteria for events that could be deemed a crisis in accordance with the doctrine given the conditions of the transition process. Certainly during the early stages, the majority of companies in transition economies faced serious crises and in fact were technically insolvent. This has led several commentators to question the ability of bankruptcy laws to clear the market from insolvent companies.[97] The 1998

[97] For a comparative analysis of bankruptcy regimes in transition economies see Mizsei, "Bankruptcy and the Postcommunist Economies of East-Central Europe", 30 *Russian and East European Finance and Trade* (1994) 34 and the contributions in Balcerowicz, Gray and Hoshi (eds.), *Enterprise Exit Processes in Transition Economies: Downsizing, Workouts, and Liquidation* (Budapest/ Ithaka, NY 1998).

spill-over from the Asian and Russian financial crises has demonstrated once more the vulnerability of transition economies to exogenous shocks, and by implication of firms in these countries to crisis situations. Forcing lead companies of company groups into action when they themselves are likely to be affected by similar conditions, might be asking too much. The wrongful trading doctrine thus might be a useful device for relatively stable economies, but may not be appropriate for economies in transition, where many companies still find themselves in constant crisis management. Legislative circumscription of crisis situations may be considered as a remedy. In addition, if adopted, the doctrine should be extended to allow recourse by shareholders of the parent company against a subsidiary in cases where viable operations have been shifted to a subsidiary and have left the parent vulnerable to crisis.

A simpler device to protect creditors against abuses of limited liability is the piercing of the corporate veil doctrine.[98] Since the nineteenth century, corporate law has vested shareholders of marketable share companies with limited liability.[99] The liberalization of entry barriers that occurred with the shift from the concession to the registration system in combination with the benefits of limited liability gave rise to substantial misuses of creditor rights. A common practice was to establish undercapitalized firm, raise substantial amounts of debt finance and then take the assets and run.[100] The situation in transition economies has not been dissimilar from the historical founder booms. At a time when the sustainability of the new economic policies was still questionable and legal institutions too weak to deter even egregious violations of the law, it is not surprising to see many taking advantage of potential benefits that legal devices, such as limited liability, afford them.

In response to extensive violations of creditor rights, the Russian legislature inserted a provision in the Civil Code that holds parent companies liable for obligations of their subsidiaries, should they have influenced its management

[98] Cf. most recently Haar, "Piercing the Corporate Veil and Shareholders' Product and Environmental Liability in American Law as Remedies for Capital Market Failures – New Developments and Implications for European and German Law after 'Centros'", 1 *EBOR* (2000) 317.

[99] For a useful overview of the historical development, compare Blumberg, *The Multinational Challenge to Corporation Law* (New York/Oxford, 1993) 316; and Horn, "Aktienrechtliche Unternehmensorganisation in der Hochindustrialisierung (1860-1920), Deutschland, England, Frankreich und die USA im Vergleich", in: Horn and Kocka (eds.), *Recht und Entwicklung der Großunternehmen im neunzehnten und frühen zwanzigsten Jahrhundert* [Law and the Formation of Major Enterprise in the 19th and early 20th century] (Göttingen 1979) 123.

[100] For an account of the founders' boom in Germany after the liberalization of the law in 1870 see Hommelhoff, "Eigenkontrolle statt Staatskontrolle – Rechtsdogmatischer Überblick zur Aktienrechtsreform 1884", in: Schubert and Hommelhoff (eds.), *Hundert Jahre modernes Aktienrecht* (Berlin/New York 1985) 53.

decisions.[101] Other countries have been reluctant to include a similar provision in their law.[102] In fact, an outcry from foreign direct investors met the Russian move. Their key concern was that the relevant provision in effect undermined limited liability of parent companies. Whether this is the case depends on the interpretation of what constitutes a parent's influence. The drafters of the Russian marketable share companies law sought to limit the fall-out from the provision of the Civil Code by requiring an explicit contract between the parent and its subsidiary.[103] How courts will interpret this discrepancy in the law remains to be seen. For the purpose of our analysis, the Russian case is a good reminder that strong creditor protection devices, such as piercing the corporate veil doctrines, may undermine the confidence of shareholders, in particular of (foreign) strategic investors. These devices should therefore be used with some care. Much will depend on the ability of courts to balance the interests of shareholders and creditors, and thus on their expertise and credibility. This is already true for countries with a highly developed group law, but even more so for transition economies without such experience.

To summarize, we argue that there is a strong case for improving accounting standards in transition economies and improving disclosure for company groups, perhaps also for introducing special investigation procedures at the request of minorities. Investors should have low cost access to information when making investment decisions. In addition, they should be given exit options when faced with a change in status of the company they invested in, including its joining a company group or delegating managerial rights to a leading company. By contrast, there is less strong a case for shareholder and (voluntary) creditor protection in existing company groups. While we recognize that applying general corporate or contract law to intra-group relations may not be fully satisfactory, conditions for a more refined adjudication of these complex relations do not seem ripe. In particular, given the legacy of the former socialist countries and the lack of economic expertise of the judiciary we fear that legal doctrines such as the *Rozenblum* or the wrongful trading doctrine may be used in ways not consistent with the general goal to encourage risk taking and independent entrepreneurship.

Another question is, whether general corporate and contract law is sufficient

[101] Art. 105 (2) Russian Civil Code.

[102] The only other transition economies that adopted a similar provision are Albania, Kazakhstan and Kyrgyzstan. See Pistor, "Patterns of Legal Change: Shareholder and Creditor Rights in Transition Economies", 1 *EBOR* (2000) 59.

[103] Art. 6 (3) of the Russian Marketable Share Companies Act states that "(...) a principal society (partnership) is considered to have the right to give mandatory instructions to a subsidiary company only if this right is established in a contract with the subsidiary company or the charter of the subsidiary company". English translation by Bernard Black and Anna Tarassova (1996).

to deal with the problem of transnational groups. Legislatures in transition economies realize that in their countries company groups are not primarily a domestic, but a transnational phenomenon. In fact, the introduction of group law provisions in the recent changes of the Hungarian law was aimed at protecting domestic companies against undue influence by foreign parents.[104] This raises a more fundamental question about the influence of domestic law on cross-border transactions with different bargaining power of the two partners. Perhaps a sensitive group law increases the bargaining power of domestic partners, but it should be remembered that in a world of capital mobility domestic legal protection is losing much of its power.

5. Financial Institutions as Members of Company Groups

The development of a viable financial sector has been one of the most difficult tasks for transition economies.[105] Banks that were created on the basis of the former socialist mono-bank system were under-diversified and inherited bad loan portfolios from the past. The economic downturn in all transition economies after the introduction of economic reforms implied that enterprises accumulated additional arrears rather than paying down their old debt. A response to the bad loan portfolio taken in several countries was to recapitalize banks by giving them equity stakes in privatized companies. This made banks important equity holders of firms. In addition, banks acquired shares in companies in the process of privatization or through subsequent market transactions.

Whether banks should in fact own shares in production companies has been a matter of controversy in transition economies.[106] While some have hailed the German universal banking system or the Japanese house banks system as a model for transition economies,[107] others have warned that banks in transition

[104] See the contribution by Sándor and Sárközy, 2 *EBOR* (2001) No. 2.

[105] Advocates of a more gradual approach to economic reforms strongly argued for a reform of the financial sector prior to privatization and price liberalization. See Brainard, "Reform in Eastern Europe: Creating a Capital Market", *Economic Review* (1991) 49. On banking reform in transition economies more general compare Buch, *Creating Efficient Banking Systems* (Tübingen 1996) and Rostowski, "The Banking System, Credit and the Real Sector in Transition Economies", in: Rostowski (ed.), *Banking Reform in Central Europe and the Former Soviet Union* (Budapest 1995) 16. A more recent assessment of the financial sector can be found in EBRD, *Transition Report – Financial Sector in Transition* (London 1998).

[106] For an overview of the debate compare Dittus and Prowse, "Corporate Control in Central Europe and Russia: Should Banks Own Shares?" in: Frydman et al. (eds.), Vol. 1, *supra* n. 17, at p. 20.

[107] Aoki and Patrick, *The Japanese Main Bank System: Its Relevance for Developing and*

economies lack the expertise to function as corporate monitors, and the financial resources to develop into important creditors.[108] Transition economies have stayed away from a clear prohibition of banks owning equity stakes along the Glass Steagall Act.[109] As a result, there are a substantial number of banks that hold equity stakes in companies. Moreover, many banks are either directly or through affiliated investment funds involved in company groups. This raises concerns about the potential impact of group membership on the viability of individual banks and the banking sector as a whole. From the firm's perspective, the involvement of a bank in the group may lower the cost of external finance. Even if banks charge the same interest rates, search costs will be lower and banks affiliated with a group may require less security. From the bank's – and by implication from the regulator's perspective – this very arrangement may threaten the viability of the banking sector. There looms the danger of a continuation of a soft budget constraint, i.e., of firms using cheap access to financial resources to continue inefficient business practices. Underperforming firms will endanger the viability of banks forcing the state to choose between enforcing a hard budget constraint and letting banks go under, or saving banks, thereby creating a moral hazard problem for the future. The current struggle of the Japanese banking sector seems to suggest that a too cozy relationship between firms and banks may create substantial costs in the long term.[110]

Yet, just as with competition policies, it seems important to distinguish between short term and long-term effects. In the short term, equity holdings by banks and access to relatively cheap credit may be a prerequisite for the survival of many firms and thus for economic development. Absent developed capital markets that can enable corporate control transactions, central monitoring by relatively few banks, which in turn are well regulated and supervised, may be a viable option. The alternative is a control vacuum. A prohibition of equity investments by banks therefore seems to be counterproductive – the long term costs of such a strategy notwithstanding. A better approach seems to be to require banks to diversify their holdings, thus reducing their risk exposure to any particular company or company group. The Second Banking Directive of

Transforming Economies (Oxford/New York 1994).

[108] Rostowski, *supra* n. 105.

[109] Most recently this Act has been repealed after having been sternly defended by lobbyists for decades. Cf. Gramm-Leach-Bliley Act (GLBA) 12 November 1999.

[110] See "Financial Regulation in Japan: In with the Old...", *The Economist*, 6-12 Jauary 2001, 68.

the European Union[111] is a move in this direction and acceding countries from Central and Eastern Europe will need to comply with it.

"Should banks own shares?" was not the only question regulators in transition economies faced. They also had to decide on the desirable structure of the banking sector and the licensing of foreign banks. Looking only at the Czech Republic, Hungary, and Poland, we find three very different strategies. In the Czech Republic, the banking sector remained highly concentrated. Hungary soon opened its borders to foreign banks and by 1993 had already licensed 17 institutions. Poland, by contrast, had a much less concentrated banking sector and protected it from foreign competition, although it orchestrated a substantial consolidation in the mid 1990s.[112] These different conditions imply the need for different regulatory strategies, and thus regulatory capacity and expertise. Unlike in the area of competition policy, there is no European agency to piggy-back on, as the European Central Bank has not taken over the regulation of Member State banks. Other means should therefore be considered to find adequate solutions that match the structure of the domestic banking sector and to strengthen compliance with regulations. Encouraging the development of codes of conduct by self-regulatory organizations or delegating supervisory tasks to these organizations may be a possiblity. The impetus for such a reform strategy is given by the introduction of bank internal risk models as currently proposed by the Basle Committee. Whether this strategy could succeed depends on the degree of financial sector self-organization, and the professionalism of these organizations in different countries.

Banks can be part of company groups the other members of which engage in non-financial activities. Alternatively, they may be members of a group that offers only financial services. Some countries have encouraged the formation of financial services groups to enhance the viability of financial institutions and facilitate their supervision.[113] These groups are often not a purely domestic phenomenon, but domestic banks may be part of a transnational group. Hungary's banking sector is a prominent example. The regulation of transnational financial service groups is particularly difficult and requires close

[111] Second Council Directive 89/646/EEC of 15 December 1989 on the co-ordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC, *OJ* [1989] L 386/1 (30 December 1989). Most recently the EU bank supervisory directives have been consolidated in one single directive 2000/12/EC as of 20 March 2000, *OJ* [2000] L 126/1 (26 May 2000).

[112] Bonin and Leven, "Polish Bank Consolidation and Foreign Competition: Creating a Market-Orientated Banking Sector", 23 *Journal of Comparative Economics* (1996) 52 at p. 58.

[113] This is the case, for example, in Poland, which has adopted special rules on banking groups, even though company groups in general have not been regulated. See the contribution by Szumanski at the symposium in: Hopt et al. (eds.), *supra* n. 8.

co-operation among supervisors who have jurisdiction over different entities of the group.[114] This would presuppose the co-ordination of domestic regulators. Whether there is a case for one single supervisory body encompassing bank, insurance and market supervision as most recently proposed in Switzerland[115] and in Germany[116] and what the role of the Central Bank should be in this, is currently a highly controversial issue.

6. Conclusion

The purpose of this paper was to give an overview of the issues that arise with the existence of company groups in transition economies. The analysis was hampered by the lack of better data on the legacy and importance of groups in different transition economies. Nevertheless, there is sufficient evidence to alert legislatures, regulators and law enforcers to develop appropriate responses to the problems that may arise with company groups. We discussed the case for regulatory intervention drawing heavily on the proposals for a European groups law that were developed by the Forum Europaeum. In lieu of a conclusion we present a set of propositions that were discussed at the symposium. Some have been more controversial than others.[117] We attempt to present what we perceive to be the broad consensus on these issues and hope that they will stimulate further debate.

7. Propositions

1. General Considerations

1.1 The need to regulate company groups is not self-evident, but arises only if company groups pose a threat to the competitiveness of markets or to rights of

[114] For details see Wymeersch, *supra* n. 95.

[115] Expertengruppe Finanzmarktaufsicht, *Finanzmarktregulierung und –aufsicht in der Schweiz (Banken, Versicherungen, Allfinanz und Finanzkonglomerate, andere Finanzdienstleistungen), Schlussbericht* (Zufferey-Kommission) (Bern 2000) pp. 63 et seq.

[116] "Eichel plant Super-Finanzaufsichtsbehörde", *Frankfurter Allgemeine Zeitung*, 26 January 2001, No. 22 p. 13. In the meantime a draft act concerning the creation of an integrated financial market supervision has been issued by the German Ministry of Finance. It is available on the Ministry's webside. See also the Ministry's draft 7th central bank act modification act as of April 2001.

[117] A slightly shorter set of propositions was presented to the participants at the symposium.

economic agents (such as shareholders, creditors or competitors), which they on their own cannot guard against.

1.2 Law, including tax law, corporate law, antitrust law, as well as regulations should not create incentives for establishing company groups, but be neutral with regard to the choice of organizational form. Company groups that are partially or wholly owned by the state should not be privileged over other company groups. This applies also to company groups that were created by state intervention, or in which the state holds a golden share.

1.3 Company groups in transition economies are not an isolated phenomenon, but reflect the growing interconnectedness of economies around the globe. Domestic legal solutions will have only limited reach in case of transnational groups, which play an important role in transition economies. The growing number of transnational groups not only in Europe, but also around the globe requires a reassessment of the mechanisms available for cross-border law enforcement especially of regulatory measures. This task confronts jurisdictions well beyond transition economies, wherefore the following propositions are limited to domestic legal issues.

1.4 To assess the need for regulating company groups at the domestic level, it is important to consider the legal, political and economic conditions and the special circumstances of the transition process and existing conditions in transition economies. In a nutshell, important characteristics of the earlier phases of the transition process are lack of information transparency, high transaction costs, underdeveloped capital markets, uncertainties concerning the progression and possible results of the transition process, as well as a weak institutional framework combined with legal uncertainties and corruption. In this environment company groups have an important co-ordination and governance function. To the extent that they substitute for underdeveloped markets, they can be called transaction enabling.

1.5 Following progress in the transition process the said characteristics are likely to fade away. Yet, the organizational forms that emerge during the process of transition may have long-term implications for the structure of the economy. When assessing the costs and benefits of regulatory intervention, it is therefore important not to focus only on present conditions, but to take into account the possible long-term consequences of the emerging structures for the economy as a whole and for small and medium size enterprises in particular.

1.6 A viable institutional infrastructure is paramount for the long-term stability of transition economies and their ability to regenerate. Legal certainty and effective law enforcement are essential conditions for economic actors to rely on contract (market relations) rather than control (hierarchy). Of particular

concern in transition economies is law enforcement by courts as well as regulatory agencies. The quality and capacity of these institutions has implications for selecting regulatory instruments.

1.7 Jurists in the former socialist countries tend to take a highly positivistic approach to the interpretation of legal statutes. Frequently this runs counter to the purpose of the law. Legislatures may encourage judges to interpret the law in light of the circumstances of a particular case by giving enumerated examples and interpretative guidelines. By contrast, highly specific legislation would be counterproductive, as it would reinforce overtly positivistic judicial practice and impose unwanted rigidities in an environment of constant and often unforeseeable change that demands a more flexible approach to law-making and law enforcement.

1.8 The enforcement of court rulings and regulatory decisions is a matter of particular concern in transition economies. New regulatory agencies may be better equipped to tackle these issues than old institutions that need to undergo substantial reforms, such as courts, provided they are well staffed.

1.9 Regulators might become subject to regulatory capture. Rather than regulating an industry, they might further its interests. This danger is aggravated by substantial pay differentials between the private and the public sectors, which creates incentives for both sides to use side payments in order to achieve an agreeable outcome. This is not a problem unique to transition economies, but requires special attention in countries that lack a tradition of an accountable public service. Allowing highly qualified personnel to rotate between the private and public sectors may attract more talent to the public sector and reduce the incentives for bribe taking while in office. However, this practice might increase rather than reduce the danger of regulatory capture.

1.10 Transition economies joining the European Union (EU) are in the process of harmonizing their laws with European law. This will result in convergence of legal rules in the area of antitrust law as well as in company group law to the extent it has already been harmonized (accounting rules, bank groups, etc.). Absent harmonized laws, it is important to pay close attention to conflict of law rules. Antitrust, corporate, capital market law and financial regulations use different connecting factors which may lead to quite different results.

1.11 When developing those areas of law that are relevant for company groups, law-makers need to choose among different options. They may opt for a wholesale reception of foreign law, prefer partial reception, or choose to only marginally adapt their own rules to foreign or international standards. This choice should be informed by the need for regulatory intervention in light of the

special circumstances of transition economies and the capacity of institutions that are necessary to enforce these rules.

1.12 Candidate countries should use the flexibility of European regulations to find adequate solutions for the particular problem they face. From a European perspective, it can hardly by desirable to implement a "legislative tornado" as is currently happening in several countries in an attempt to prepare them for accession to the EU. The principle of subsidiarity should take priority and transition economies should be encouraged to use their legislative autonomy to develop legal solutions that are appropriate for their circumstances. Moreover, EU entry conditions should not focus on the letter of the law, but on the effective realization of key aspects thereof.

2. Antitrust law: demarcating market and hierarchy[118]

2.1 The purpose of antitrust law is protecting competition. Regulations of cartels, mergers and market controlling companies define the limits of permissible organizational forms that are characterized by control, hierarchy, and co-operation.

2.2 The basic features of EU competition law, including the prohibition of cartels as well as the prevention of the misuse of market power are thus spreading across Central and Eastern Europe. These tools allow regulators in transition economies to tackle uncompetitive practices of company groups. Divestiture rules, by contrast, are not common in European Member States. In light of the administrative costs and the high demands this particular tool places on the capacity of courts, there is not a strong case to adopt it in transition economies.

2.3 While there may be a case for some transition economies for deviating from EU standards, this would not come without costs. At least for countries set to join the EU, this would entail that domestic and transnational cases would be governed by different sets of rules. Overall, EU standards are also sufficiently flexible to be adapted to special needs of some countries.

2.4 Many EU Member States have used exemptions from antitrust rules, including export cartels, crisis cartels, and exemptions to foster the competitiveness of domestic companies. To the extent that they are made transparent *ex ante*, are clearly circumscribed and limited in duration, similar exemptions could be made in transition economies. However, it should be kept in mind that exemptions may undermine the commitment to market reforms and may be difficult to reverse especially when politically influential constituencies benefit from them.

2.5 The dominant role of the state in the formerly socialist countries has left a strong imprint in many transition economies and has fostered the creation of company groups under state guidance. From an antitrust perspective this should be countered by greater transparency of industrial policies and the clear allocation of administrative decision-making rights and responsibilities. The adoption of laws to curb state subsidies along the lines of the EU model would be another option.

3. Governance of company groups

3.1 The demarcation of market and hierarchy as defined by antitrust law determines if and to what extent it is necessary to develop special rules for governing company groups.

3.2 Corporate governance has been identified as a key problem in transition economies. Company groups create additional problems as the substitution of markets and contracts with internal group relations removes the management of the group even further from shareholders and creditors than is the case in independent firms.

3.3 These issues could be addressed with the help of general contract and tort law (civil law), corporate law, or by adopting special rules on company groups. A unified corporate group law is not on the agenda for EU-wide harmonization. Even in Germany, the mother country of a systematic group law (*Konzernrecht*), it exists only for marketable share companies, not for limited liability companies.

3.4 Even in the absence of a comprehensive group law, a consistent definition of the term "company group" is important to minimize confusion and distortions. In order to avoid the danger of over-regulation, it is advisable to use a rather restrictive definition at the outset, which focuses on equity holdings rather than *de facto* control.

3.5 The key areas of company group law currently discussed in the EU address
(1) disclosure and accounting rules;
(2) the protection of shareholders, in particular of subsidiaries as members of company groups;

[118] The propositions in this section draw on a set of propositions developed by Professor Dreher. For details see his contribution to the symposium, forthcoming in *EBOR* (2001) No. 2.

(3) the protection of creditors, in particular of subsidiaries, be it by making the parent company directly liable to the creditors of the subsidiaries, or through internal liability *vis-à-vis* the subsidiary, and
(4) the internal organization of the company group.

3.6 Disclosure and accounting rules: Irrespective of whether or not additional rules will be enacted, it is indispensable to require the disclosure of equity holdings beyond a minimum threshold and determine the requirements for proper accounting for the entire group. These rules form part of the (to be harmonized) European law. An extension of the disclosure principle is to allow minority shareholders to request an independent audit in well-defined circumstances. An important condition for this to be effective is the existence of an auditor profession.

3.7 Additional protection of shareholder rights

3.7.1 Mandatory takeover rule: The economic costs and benefits of a mandatory takeover rule are fiercely debated in light of the proposed European takeover rule. The enforcement of this rule, which protects shareholders at the time a merger takes place, might be easier than trying to protect shareholders after the group has been formed. Nevertheless, for transition economies it should be considered, whether a mandatory takeover rule unduly increases the costs of reallocating property rights on the secondary market, particularly in light of privatization programs aimed at such a secondary reallocation rather than a final allocation.

3.7.2 Put option (compulsory sell-out right): A put option enables minority shareholders to exit the company in a fair procedure and to sell their shares at a fair market price. The threshold for a put option is typically the remaining 5-10% of total stock. Some transition economies also grant put options in case the shareholder meeting overrules minority shareholders on other important issues, such as the sale of major assets. This may have important signaling functions for minority protection. However, exercising this right typically entails the involvement of courts and an appraisal of shares and thus places high demands on local institutions.

3.8 Creditor rights

3.8.1 Piercing the corporate veil: The protection of creditors, i.e., through piercing the corporate veil provisions, needs to be weighted against the implied dilution of limited liability. Piercing the corporate veil should be permitted only in special circumstances, i.e., in the case of asset mingling among members of a company group. Enforcing liability against a parent company may be difficult

in cases where the parent is located abroad, unless it has assets in the country where the subsidiary is located.

3.8.2 Wrongful trading: Another proposal for EU group law is special liability rules for the parent company for its conduct in case a subsidiary is affected by a crisis. The purpose of the wrongful trading doctrine as applied to company groups is to induce the parent company to make an explicit decision about liquidation or reorganization (financial reconstruction) of the subsidiary when a crisis hits. In case the management fails to make such a decision, it is liable to the subsidiary's creditors. Effective enforcement requires a definition of a crisis situation, which is not an easy task in an environment where the majority of companies are struggling for survival. Moreover, a modification of the doctrine may be required to address the not uncommon scenario that a reallocation of viable operations leaves the parent rather than the subsidiary vulnerable in a situation of crisis.

3.8.3 Liability of parent company for lack of compensation: Cooperation within a company groups entails a give and take among its members. The law may require adequate compensation in each single case. Alternatively, the gives and takes may be assessed in a wholesale manner, taking into account the synergy effects group members benefit from. Such a flexible demarcation of direct and indirect compensation, however, creates high demands on courts when interpreting appropriate forms of compensation.

3.8.4 In the above cases, personal liability of the directors of the parent company may also be considered. However, this should be restricted to cases of abuse, i.e., to clear conflicts of interest between company management on the one hand and creditor interests on the other.

3.9 Company group organization law: With respect to the internal organization of the group, the legislature has the option to leave this to the parties concerned or to offer a model. For the EU it has been proposed to give the parent company an option to subject group members to its direct control and management. This might enhance efficiency of group management. As long as the parent company can be held fully liable for misconduct *vis-à-vis* shareholders of member companies, such a measure does not necessarily violate their rights. In the context of transition economies, this option could, however, reinforce tendencies to central administration and management. It may also cement group relations and thus could run counter to the objective of preventing irreversible economic concentration in the long term. If central administration should in fact be more efficient, the parent has still the option to buy out minority shareholders.

4. Financial institutions and company groups

4.1 Financial institutions are the backbone of the economy. The law on banks and banking supervision seeks to avoid crises even of single institutions, because of the possible contagious effect for the entire financial system (systemic risk).

4.2 In transition economies, banks are often closely intertwined with production companies. The relation between banks and companies may facilitate access of group members to capital and the reallocation of resources among group members and can therefore substitute underdeveloped capital markets.

4.3 The close relation of companies and banks may, however, also lead to a prolongation of the "soft budget constraint". As a member of the same group a bank may be inclined to extend credits according to criteria that are not market based, a practice which may retard the restructuring of the enterprise sector.

4.4 A meaningful regulation should weigh the benefits of the internal allocation of resources within company groups that include banks against the potential costs. A flat prohibition of equity holdings by banks appears to be not only inappropriate, but may even be counterproductive, because of the beneficial effect the internal allocation of capital may have under the conditions of the transition process.

4.5 A possible solution could be liability rules for group members that hold stakes in banks and influence its business strategies along the lines of the liability rules discussed above.

4.6 Diversification requirements, such as the rules included in the Second European Banking Directive, may be imposed to limit the risk exposure of a bank to a single group.

4.7 It is worth considering, whether the regulation of financial institutions is best left to the legislature or should involve representatives from financial institutions and regulators, who could contribute their practical experience. A combination of legislative standards and professional codes of conducts might be appropriate.

4.8 In the EU, harmonization requirements for banks are far more advanced than for the non-financial enterprise sector. While they can serve as an important guideline, transition economies should exploit the flexibility of the relevant directives which leave them to develop solutions that fit their own needs best. Enforcement is a key issue here as elsewhere. This suggests paying

close attention to the staffing of regulators with highly qualified personnel.

4.9 Financial institutions may also form their own purely financial groups, often referred to as financial holdings. Their creation may be a way to consolidate a highly dispersed financial sector as it has emerged in some transition economies and may facilitate regulatory supervision.

4.10 Where financial institutions in transition economies are part of a transnational financial holding, domestic regulators are called upon to co-operate with foreign regulatory agencies.

Appendix 1: Ownership of largest companies in transition economies[119]

- Data were not available for all countries or for all top 15 companies in a given country.
- Included are non-financial companies that belong to the top 15 listed companies according to market capitalization.
- Not included are banks and other financial institutions.
- Owners are classified as state, domestic or foreign. F denotes financial institution.

Czech Republic

Company (rank based on market capitalization)	Largest SH*	Type	2nd largest SH*	Type	3rd largest SH *	Type
Aliachem AS (1)	49.25	Domestic	NA	–	NA	–
Ceska Pojistovna AS (2)	30.25	State	20.10	Domestic (F)	19.87	Foreign
Ceske Radiokomunikace (5)	51	State	20.79	Foreign	20.79	Foreign
Cesky Telecom AS (6)	51.10	State	27.00	Foreign	NA	–
Cokoladovny AS (7)	97.7	Foreign	NA	–	NA	–
Jihomoravska Energetika AS (9)	46.66	State	33.54	Foreign	18.88	Municipalities
Philip Morris CR AS (11)	77.6	Foreign	Na	–	NA	–
Prazska Energetika (12)	48.19	State	33.84	Municipality	16.81	Foreign
Unipetrol (13)	62.99	State	2.36	Domestic (F)	2.22	Domestic (F)
Zapadoceska Energetika (14)	48.30	State	20.10	Domestic (F)	11.20	Domestic (F)
Average			*22.53*		*12.41*	

* = percentage of total shares

[119] Data source: Bloomberg L.P.

Hungary

Company (rank based on market capitalization)	Largest SH*	Type	2nd largest SH*	Type	3rd largest SH *	Type
Borsodchem Rt (1)	24.79	Foreign	11.46	Foreign (F)	8.61	Foreign (F)
Egis Rt	50.91	Foreign	NA	–	NA	–
MOL (10)	25.00	State	24.60	Foreign (F)	NA	–
Pannonplast Rt (12)	12.30	Foreign	10.84	Foreign (F)	6.91	Foreign (F)
Pick Szeged Rt (13)	32.98	Domestic	NA	–	NA	–
Gedeon Richter Rt (14)	25.20	State	NA	–	NA	–
Tiszai Vegyi Kombinat Rt. (15)	19.60	Domestic	13.40	Foreign (F)	9.50	Foreign (F)
Average			*15.075*		*8.34*	

* = percentage of total shares

Poland

Company	Largest SH*	Type	2nd largest SH*	Type	3rd largest SH *	Type
Agora (1)	33.89	Foreign	14.39	Foreign (F)	10.21	Domestic (F)
Elektrim Kable (8)	76.62	Domestic	NA	–	NA	–
Elektrim (9)	5.01	Foreign (F)				
KGHM Polska Miedz (10)	49.53	State	25.96	Foreign (F)	5.00	Foreign (F)
Orbis (12)	20.00	Domestic	9.99	Foreign	6.24	State
Rolimplex (14)	92.01	Foreign	5.11	State	NA	–
Average			*13.86*		*7.15*	

* = percentage of total shares