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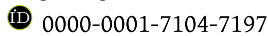
Controlling Shareholders and Intra-Group Transactions: A Special Framework

ALPEREN AFŞIN GÖZLÜGÖL

Alperen Afşin Gözlügöl is an Advanced Researcher in the Law & Finance cluster of the Leibniz Institute for Financial Research SAFE, Frankfurt am Main(Germany). For valuable comments, the author would like to thank Wolf-Georg Ringe and the anonymous reviewer.

@ gozlugol@safe-frankfurt.de

0000-0001-7104-7197

ABSTRACT

Controlling shareholders and their activities in publicly traded companies have long stirred debate and controversy. Still dominating the corporate landscape across the world, concentrated ownership has been associated with both extraction of private benefits of control (P.B.C.) and entrepreneurship. Drawing on the theories on corporate control, this article contributes to accomplishing the law's goal of promoting the entrepreneurial role of controlling shareholders, yet keeping P.B.C. extraction under restraint at the same time in the specific context of intra-group transactions – a breeding ground for both P.B.C. extraction and the implementation of an entrepreneurial idea by corporate controllers. The article submits nuanced and different means of overseeing intra-group transactions in a way that would optimally allow the implementation of a business plan by a controlling shareholder in a corporate group and protect minority shareholders, along with the examination of other issues that are relevant to the oversight of intra-group transactions.

KEYWORDS

Controlling Shareholders; Related-party Transactions; Intra-group Transactions; Corporate Groups; Minority Shareholder Protection

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INTRODUCTION

In most jurisdictions across the world, share ownership of public companies is characterised by a blockholding that effectively grants the control of the company to that shareholder.[1] While the existence of a controlling shareholder is associated with certain benefits, it also gives rise to a conflict of interest between the controlling shareholders and minority shareholders.[2] Most importantly, controlling shareholders can extract P.B.C.[3] to the detriment of the company and thus, of minority shareholders.[4]

Corporate controllers take different shapes.[5] And the question of why these corporate controllers hold onto the control of the company rather than disposing of the

[1] Only in the U.S., the U.K. and partly in Japan, dispersed share ownership is more common. *See*, *e.g.*, Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. Fin. 471 (1999); Mara Faccio & Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. Fin. Econ. 365 (2002); Julian Franks et al., *The Ownership of Japanese Corporations in the 20th Century*, 27 Rev. Fin. Stud. 2580 (2014); Stijn Claessens et al., *The Separation of Ownership and Control in East Asian Corporations*, 58 J. Fin. Econ. 81 (2000).

[2] *See* John Armour, Henry Hansmann & Reinier Kraakman, *Agency Problems and Legal Strategies*, *in* The Anatomy of Corporate Law 29, 30 (Reinier Kraakman et al. eds., 2017).

[3] On private benefits of control, *see* Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 Harv. L. Rev. 1641, 1663 (2006) (distinguishing between *pecuniary* private benefits of control and *non-pecuniary* private benefits of control). The former is defined as "the nonproportional flow of real resources from the company to the controlling shareholder" while the latter indicates "forms of psychic and other benefits that, without more, involve no transfer of real company resources and do not disproportionately dilute the value of the company's stock to a diversified investor such as social or political status resulting from the control of a large company." *Id.* at 1663–64.

[4] These private benefits of control are documented in studies that examine the control premia charged for controlling blocks or the price differentials between high- and low-voting shares. *See* Michael J. Barclay & Clifford G. Holderness, *Private Benefits from Control of Public Corporations*, 25 J. Fin. Econ. 371 (1989); Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. Fin. 537 (2004); Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis*, 68 J. Fin. Econ. 325 (2003). Some studies also show that the market values the same cash flows/investments differently, depending on whether they can be expropriated by controlling shareholders or not, which reflects again private benefits of control. *See*, *e.g.*, Bernard S. Black et al., *Does Corporate Governance Predict Firms' Market Values? Evidence from Korea*, 22 J. L. Econ. & Org. 366 (2006); Bronwyn H. Hall & Raffaele Oriani, *Does the Market Value R&D Investment by European Firms? Evidence from a Panel of Manufacturing Firms in France, Germany, and Italy*, 24 Int'l J. Indus. Org. 971 (2006).

[5] Corporate controllers can be companies, individuals, families, institutional investors, the state etc.

controlling block of shares and pursuing a diversification strategy is vehemently debated. A common view is that corporate controllers exist because of the private benefits of control available to a controller in a jurisdiction that has implemented rather weak measures against tunnelling.[6] A relatively recent view argues that corporate controllers are entrepreneurs and hold a controlling block in order to be able to implement their idiosyncratic vision.[7] In this article, drawing on these theories associated with corporate controllers, I set out to examine a special context where controllers can both extract P.B.C. and implement an entrepreneurial vision: intra-group transactions.

Intra-group transactions as related party transactions [hereinafter R.P.T.s] are a breeding ground for corporate controllers to divert company value to themselves.[8] In jurisdictions dominated by controlled companies, corporate groups and intra-group transactions are prevalent.[9] Via such transactions, corporate controllers may divert value from a (public) company in a corporate group to another where their economic stake is greater.[10] On the other hand, intra-group transactions can be beneficial; even necessary. In particular, they can be important for corporate controllers to implement their idiosyncratic vision. In such a case, companies enter into intra-group transactions within the context of an entrepreneurial idea where market transactions would not serve towards this purpose. In other words, transactions with unrelated parties would not be able to substitute the goods or services received under the R.P.T. for the implementation of the idiosyncratic business plan.

Acknowledging that intra-group transactions can be used for both consuming private benefits of control and implementing an idiosyncratic vision (in accordance with the view that corporate controllers can be both entrepreneurs and P.B.C.-consumers), I propose a special framework for the oversight of intra-group transactions as R.P.T.s that not only monitors private benefit extraction but also allows corporate controllers to

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[6] Tunnelling is a term used to describe the practices of corporate insiders to divert company value to themselves. *See* Simon Johnson et al., *Tunneling*, AM. ECON. REV., 2000, at 22; Vladimir A. Atanasov et al., *Law and Tunneling*, 37 J. CORP. L. 1 (2011).

[7] *See infra* notes 17–19 and accompanying text.

[8] On intra-group transactions, *see generally* Sang Yop Kang, *Rethinking Self-Dealing and the Fairness Standard: A Law and Economics Framework for Internal Transactions in Corporate Groups*, 11 VA. BUS. L. REV. 95 (2016); Jens C. Dammann, *Related Party Transactions and Intragroup Transactions*, *in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS 218 (Luca Enriques & Tobias H. Tröger eds., 2019).

[9] Some jurisdictions even have a special regime for corporate groups in general and for intra-group transactions in particular. *See* Luca Enriques et al., *Related-Party Transactions, in* THE ANATOMY OF CORPORATE LAW 145, 163-64 (Reinier Kraakman et al. eds., 3rd ed., 2017).

[10] For an example, see Kang, *supra* note 8, at 117–18. In particular, corporate controllers can achieve corporate control despite a very low economic stake in a company through dual-class shares, cross-shareholding and pyramid structures. *See generally* Lucian A. Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, *in* CONCENTRATED CORPORATE OWNERSHIP 295 (Randall K. Morck ed., 2000).

implement their entrepreneurial idea. In addition, I examine several other issues in screening intra-group transactions.

The article proceeds as follows: Section 1 introduces the theories associated with corporate controllers and concludes that corporate controllers do not have clear-cut characters. Therefore, one must differentiate between transactions that can be used to divert value (*value-decreasing*) or to accomplish entrepreneurial controllers' vision (*value-increasing*). In this respect, Section 2 turns attention to intra-group transactions, proposing a proper framework for their oversight and addressing several other issues related to their screening. The last Section summarises the findings of this article and concludes.

1. CORPORATE CONTROLLERS: THIEVES OR ENTREPRENEURS

The issue of the existence of corporate controllers and their activities have long occupied the minds of many law and finance scholars.[11] This is important because a precise understanding in this regard will lead to a more effective and efficient regulation of corporate controllers and their actions. Two main views have emerged, offering different theories of corporate control and its implications.[12]

Corporate controllers are generally associated with expropriating (*stealing*) corporate wealth at the expense of (minority) shareholders and ultimately creditors. The reason why they hold onto corporate control, it is argued, is because of the existence of private benefits of control.[13] In other words, concentrated ownership results from the availability of private benefits of control in controlled companies for the controlling shareholder.[14] Such a view is not without criticism.[15] And it is unable to explain the

[11] For a survey of empirical research on fundamental questions associated with blockholders, *see* Clifford G. Holderness, *A Survey of Blockholders and Corporate Control*, ECON. POL'Y REV., April 2003, at 51.

[12] Admittedly, the following examination of several theories will necessarily be incomplete. Especially, political economy accounts of corporate control are missing. *See in this regard*, MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT (2003).

[13] *See, e.g.*, Lucian A. Bebchuk, *A Rent-Protection Theory of Corporate Ownership and Control* (Nat'l Bureau of Econ. Research Working Paper No. 7203, 1999), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=203110; Lucian A. Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127, 142–49 (1999).

[14] A related literature shows that concentrated ownership is more common in countries that provide weak shareholder protection. *See, e.g.*, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998).

[15] *See, e.g.*, Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, (2016) 125 YALE L. J. 560, 572 (arguing that "it assumes that most controllers around the world are opportunists who take advantage of imperfect markets and weak protections for minority shareholders").

prevalence of concentrated ownership in countries where the law is supposedly good enough to constrain private benefits of control and P.B.C. extraction remains very low (e.g. Sweden).[16]

A different theory considers corporate controllers as entrepreneurs who hold onto the control of a company not to extract P.B.C. but to be able to implement their vision in a manner they see fit.[17] Control protects entrepreneurs from subsequent midstream investor doubt and objections resulting from asymmetric information or differences of opinion regarding their idiosyncratic vision.[18] The controller -entrepreneurs' vision is defined broadly as 'any business strategy that the entrepreneur genuinely believes will produce an above-market rate of return'.[19] Such a theory, as Goshen and Hamdani claim, explains why concentrated ownership exists even in countries with strong investor protection laws.[20]

Both theories combined suggest that investors, lawmakers, and courts need to balance the objectives of minority shareholder protection (against controllers' extraction of P.B.C. and abuse of control) and allowing the controller-entrepreneurs to pursue their idiosyncratic vision (which can produce above-market returns that will be shared among controlling shareholders and investors on a *pro rata* basis). In the context of self-dealing practices of corporate controllers, this understanding ultimately leads to the conventional wisdom's dichotomy of value-increasing R.P.T.s and value-decreasing R.P.T.s, and to the aim of devising an R.P.T. regime that optimally screens R.P.T. (preventing value-decreasing ones while allowing value-increasing ones).

Related party transactions can be both a way of implementing the idiosyncratic vision of the entrepreneurial controller and a way of expropriating minority shareholders.

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[16] *See generally* Gilson, *supra* note 3. Gilson however argues that *non-pecuniary* private benefits of control help explain the existence of concentrated ownership in countries with strong investor protection laws. *Id.* at 1665–67. *See also* Roe, *supra* note 12, at 5 (noting that many nations that have very good institutional structures and strong institutions (corporate, legal, and otherwise) have nevertheless concentrated ownership).

[17] *See generally* Goshen & Hamdani, *supra* note 15. *See also* Alessio M. Pacces, *Controlling the Corporate Controller's Misbehaviour*, 11 J. Corp. L. Stud. 177, 187–88 (2011)(noting that "the pursuit of long-term strategies and rewards to firm-specific investments is what normally motivates a controlling shareholder to bear the costs of an undiversified investment").

[18] Goshen & Hamdani, *supra* note 15, at 565. *See also* Eric Van den Steen, *Disagreement and the Allocation of Control*, 26 J. L. Econ.& Org. 385 (2008)(studying the allocation of control when there is disagreement about the right course of action).

[19] Goshen & Hamdani, *supra* note 15, at 560, 577–79 (detailing the features of the entrepreneur's idiosyncratic vision). Goshen and Hamdani distinguish between the pursuit of idiosyncratic vision by the controller-entrepreneurs and the pursuit of nonpecuniary benefits of control. While the former will benefit all shareholders equally (as the pursuit of idiosyncratic vision is *believed* to produce above-market returns), the latter refers to benefits that only the controller derives (e.g., personal satisfaction, pride, fame, and political power). *Id.* at 566, fn. 16. Above-market returns indicate positive net present value of a project. *Id.* at 577, fn. 53.

[20] *Id.* at 572, 575.

In particular, intra-group transactions in a corporate group (as R.P.T.s) provide a special context for both implementing entrepreneurial vision and extracting P.B.C. . The next section examines this tension and proposes a framework which monitors value-diversion from the company and also allows the controllers the freedom of action that is necessary to realise the idiosyncratic vision.[21]

2. INTRA-GROUP TRANSACTIONS

Related party transactions are a key matter of concern for minority shareholder protection.[22] However, as mentioned above, while such transactions can be used by corporate controllers to divert company value, they can also be value-increasing.[23] In this regard, R.P.T.s can be instrumental in implementing a business plan that is supposed to produce above-market returns for *all* shareholders. This necessarily creates a tension between the controller-entrepreneurs and minority shareholders, and challenges for lawmakers and courts in preventing value-decreasing transactions while allowing value-increasing ones.

Such challenges and tensions in conflicted transactions involving controller-entrepreneurs are clearly presented by a recent high-profile case, namely the acquisition of SolarCity by Tesla.[24] SolarCity was a private company, specialising in solar energy services. It was co-founded and controlled by the entrepreneur Elon Musk. Tesla, a public company controlled also by Elon Musk,[25] acquired SolarCity in 2016. Such a transaction was clearly subject to conflicting interests because of Elon Musk's stake in

[21] *See id.* at 560 (arguing that "corporate law for publicly traded firms with controlling shareholders should balance the controller's need to secure her idiosyncratic vision against the minority's need for protection").

[22] *See* Atanasov et al., *supra* note 6, at 5–9 (detailing how insiders can extract value from firms through self-dealing transactions); Simeon Djankov et al., *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430 (2008)(presenting the anti-self-dealing index as a new measure of legal protection of minority shareholders against expropriation by corporate insiders).

[23] *See, e.g.*, Luca Enriques, *Related Party Transactions: Policy Options and Real-World Challenges (with a Critique of the European Commission Proposal)*, 16 EUR. BUS. ORG. L. REV. 1, 6-7 (2015); Alessio M. Pacces, *Procedural and Substantive Review of Related Party Transactions (RPTs): The Case for Noncontrolling Shareholder-Dependent (NCS-Dependent) Directors*, *in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS 181, 182 (Luca Enriques & Tobias H. Tröger eds., 2019); Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CAL. L. REV. 393, 400 (2003).

[24] *See* Stuart C. Gilson & Sarah L. Abbott, *Tesla: Merging with SolarCity* (December 2017, revised November 2018), available at https://www.hbs.edu/faculty/Pages/item.aspx?num=53652 (last visited April 9, 2022).

[25] Although Mr. Musk's share ownership amounts to only 22.1% of Tesla shares, in a recent litigation, the Delaware Court of Chancery found that Mr. Musk was a controlling shareholder. *See, e.g.*, *In re Tesla Motors, Inc. Stockholder Litig.*, WL 1560293 (Del. Ch. Mar. 28, 2018)(consolidated C.A. No. 12711-VCS (Del. Ch. Feb. 4, 2020).

both companies.[26] Tesla argued that the acquisition of SolarCity was crucial for the implementation of its business plan and will offer unique synergies.[27] However, at that time, SolarCity was in a liquidity crisis and faced some issues in its business, which triggered a negative investor sentiment against the transaction and a ten percent decline in share price on the announcement.[28] Some Tesla shareholders also brought a liability suit challenging the transaction, claiming that it was an attempt to rescue a company in which Elon Musk had a substantial stake at the expense of Tesla shareholders.[29]

This article will specifically focus on intra-group transactions, which most clearly reflect these tensions and challenges. On the one hand, in corporate groups, such transactions may be used to divert value from listed companies where the controlling shareholder has a lesser economic stake. For example, assume that in a corporate group, a parent company has an eighty percent equity stake in Company B, while holding only forty percent of shares of Company A. In such a case, the parent company will have incentives to divert value from Company A to Company B via intra-group transactions.[30]

On the other hand, some intra-group transactions remain important and even essential, especially within the context of implementation of an idiosyncratic vision (a business plan). Within a group structure where sister companies produce inputs for a

[26] Not only Mr. Musk but also a few of Tesla directors and his relatives had an interest in SolarCity. *See* sources cited in *infra* note 28 (detailing the sources of conflicts of interest surrounding the transaction).

[27] *See* TESLA, *Tesla and Solar City* (Nov. 1, 2016), https://www.tesla.com/blog/tesla-and-solarcity (last visited, April 9, 2022)(arguing that "Tesla's acquisition of SolarCity is an important part of creating [its vision for] t[he] future"). It is further argued that people first doubted Tesla's vision that the future of automobiles lies in electric vehicles, which proved to be true. And "those same naysayers" will have similar doubts about solar and storage, and Tesla's acquisition of SolarCity. *See id.* However, the fact that idiosyncratic vision can fail without producing any value for the shareholders is demonstrated by Elon Musk's own confession that he would not support the transaction if he could go back in time. *See* M. Matousek, *Elon Musk said he probably wouldn't support Tesla's controversial SolarCity deal if he could go back in time*, Business Insider (Oct. 28, 2019), https://www.businessinsider.de/international/elon-musk-says-he-would-not-support-solarcity-acquisition-again-2019-10/?r=US&IR=T.

[28] *See* Lora Kolondny, *Tesla's Elon Musk knew SolarCity faced a "liquidity crisis" at time of 2016 deal, legal documents show*, CNBC (Oct. 28, 2019, 3:41 PM EDT), https://www.cnbc.com/2019/10/28/musk-deposition-stockholders-v-tesla-solarcity.html (last visited April 9, 2022); Dana Hull & Austin Carr, *Elon Musk's Solar Deal Has Become the Top Threat to Tesla's Future*, Bloomberg Businessweek (Nov. 13, 2019, 11:00 CET), https://www.bloomberg.com/news/articles/2019-11-13/elon-musk-s-solar-deal-has-become-top-threat-to-tesla-s-future (last visited April 9, 2022); Linette Lopez, *The future of Elon Musk's empire was in peril in 2016, and new documents reveal more about the desperate plan to save it*, Business Insider, https://www.businessinsider.de/international/elon-musk-tesla-solarcity-merger-frenzied-plan-new-filings-show-2019-10/?r=US&IR=T (last visited April 9, 2022).

[29] *See* Steven Haas & Richard Massony, *Fiduciary Duties of Buy-Side Directors: Recent Lessons Learned,* HARV. L. SCH. F. ON CORP. GOVERNANCE (2018), https://corpgov.law.harvard.edu/2018/06/30/fiduciary-duties-of-buy-side-directors-recent-lessons-learned/. Recently, the Delaware court has ruled in favor of defendant Elon Musk, denying any fiduciary liability for the SolarCity acquisition. See Lora Kolodny Jessica Bursztynsky, *Elon Musk wins shareholder lawsuit over Tesla's $2.6 billion SolarCity acquisition*, CNBC (Apr. 27, 2022, 9:06 PM EDT), https://www.cnbc.com/2022/04/27/elon-musk-wins-shareholder-lawsuit-over-the-companys-2point6-billion-solarcity-acquisition.html (last visited May 19, 2022).

[30] The parent company will enjoy eighty percent of the gain of Company B from value-diversion while only bearing forty percent of the (equivalent) loss of Company A.

downstream company or provide services for an upstream company, the controller-entrepreneur can tailor the products and services according to the needs of his or her business plan for the downstream/upstream company. This can be exemplified by the following scenarios. A public company in a corporate group (Company A) produces and sells home appliances to consumers. The controller-entrepreneur makes firm-specific capital (including human capital) investments (via the parent company) in another sister company (Company B) to produce a technology that he or she believes will make home appliances more efficient and thus more environment-friendly and will ultimately attract more customers than other firms that rely on standard technology. A transaction whereby Company B provides such a technology to Company A will be an intra-group transaction conducted in the implementation of an idiosyncratic vision. Such a vision, in the example, includes *inter alia* a belief that such a technology is necessary to make products more efficient, and that generating more environment-friendly products (through new technology) will attract more consumers who are becoming more environment-conscious and ready to spend more money to reduce their carbon footprint. Another example would be entering into a distribution agreement with a sister company that aims to reach overlooked potential customer areas and implement a different strategy (than other distributors) which is believed to be capable of capturing more of the market.

The task therefore is to create a workable legal regime that will achieve the optimal balance between preventing value-diversion via R.P.T.s and allowing corporate controllers to implement their ideas via the same.[31] For non-conflicted transactions, the protection afforded by the business judgement rule in the case of a court review of business decisions in a company provides ample room for controlling shareholders to implement their business plans.[32] However, in the case of conflicted transactions, like intra-group transactions, the need to protect minority shareholders necessarily limits the freedom of action of corporate controllers. Furthermore, while it is important to provide controller-entrepreneurs with a certain freedom of action to enable the implementation of their idiosyncratic vision, protecting minority shareholders by preventing/limiting the private benefit extraction will also facilitate the emergence of

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[31] *See generally* Goshen & Hamdani, *supra* note 15, at 595–97. *See also* Filippo Belloc, *Law, Finance and Innovation: The Dark Side of Shareholder Protection*, 37 CAMBRIDGE J. ECON. 863 (2013)(finding that "countries with stronger shareholder protection tend to have larger market capitalisation but also lower innovative activity").

[32] *See* Goshen & Hamdani, *supra* note 15, at 598–601. *Cf.* Albert H. Choi, *Concentrated Ownership and Long-Term Shareholder Value*, 8 HARV. BUS. L. REV. 53, 79 & 80-81 (2018)(arguing for a heightened scrutiny of controlling shareholders' business decisions even if no conflicts of interest are present). On the business judgement rule, *see also* JOHN ARMOUR ET AL., *The Basic Governance Structure: The Interests of Shareholders as a Class*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 49, 69-71 (Reinier Kraakman et al. eds., 3rd ed. 2017)(providing a comparative analysis of the review of business decisions by courts).

controllers that are best positioned to increase firm value (like entrepreneurs) rather than those controllers that are best positioned to syphon value from the company and thus are willing to pay the most for a controlling stake.[33]

Not all intra-group transactions will involve the implementation of an idiosyncratic vision. Such transactions lend themselves to be differentiated and thus will be subject to a normal review. In other cases where an intra-group transaction *can* serve towards the attainment of an entrepreneurial idea, several difficult issues arise in terms of finding an optimal regime where mistakes are minimised in protecting the minority and allowing controller-entrepreneurs to conduct transactions in a manner they see fit. The following parts will examine both groups of R.P.T.s.

2.1. INTRA-GROUP TRANSACTIONS INVOLVING HOMOGENOUS PRODUCTS/SERVICES

Intra-group transactions may involve transacting in homogenous products/services that the company could easily acquire via transacting with unrelated third parties. An example would be to buy certain commodities as inputs from a sister company that operates in the upstream market. Since such transactions involve buying a *standard* product from a related party, they do not form a crucial part of any idiosyncratic vision.[34] The company can implement its business plan also by transacting with unrelated parties.

Normally, such transactions are inefficient because they produce no surplus different than arm's length market transactions but create monitoring costs.[35] The latter stems from the need to screen such transactions to ensure that the company at issue does not lose value by transacting with a related party. However, entering into such intra-group transactions can still be justified on various grounds.

Corporate groups are an intermediate form of coordinating resource allocation in production that sits between a fully integrated business enterprise and spontaneous market transactions.[36] In corporate groups, although each entity preserves its legal

[33] *See* Jens Dammann, *Corporate Ostracism: Freezing Out Controlling Shareholders*, 33 J. Corp. L. 681, 705-06 (2008). It will also permit good controllers to raise capital at a lower cost, preventing the adverse selection problem.

[34] *See* Raghuram G. Rajan, *Presidential Address: The Corporation in Finance*, 67 J. Fin. 1173, 1193 (2012)(stating that "[s]tandardization therefore reduces the idiosyncratic and personalized aspects of the entrepreneur's role, allowing her job to resemble that of a typical CEO, and making it easier for an employee or outsider to replace her as CEO").

[35] *See, e.g.*, Robert C. Clark, Corporate Law 183 (2d ed. 1986); Melvin Aron Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J. Corp. L. 997, 997 (1988) (expressing that "in perfect markets involving only homogeneous goods, there would usually be no reason for a corporation to transact with a director or senior executive rather than transacting on the market").

[36] *See* Tobias H. Tröger, *Corporate Groups - A German's European Perspective*, in German and Nordic Perspective on Company Law and Capital Markets Law 157, 192-93 (Holger Fleischer, Jesper Lau Hansen & Wolf-Georg Ringe eds. 2015).

personality (different from fully integrated firms) they are closely integrated (different from transactions between independent firms in a market). This form of organisation provides a number of benefits. While preserving the positive effects of asset partitioning between separate legal entities,[37] the potential transaction costs are minimised when market frictions are present.[38] In such a case, corporate groups prevent problems resulting from these frictions by internalising the relevant product/service line, bringing about beneficial intra-group transactions.[39] For instance, if buying a commodity from an external supplier in a long-term relationship would cause unstable and low-quality supply, and thus disrupt the business, transacting with an upstream sister/parent company for the purchase of this commodity will avoid these problems. Such benefits would, in turn, justify intra-group transactions that only involve homogenous products/services concluded at market price but produce monitoring costs.[40]

As intra-group transactions that involve only homogenous products/services generate no issue of allowing the controller-entrepreneur to implement his or her idiosyncratic vision, the need to protect minority shareholders becomes central. Available tools in screening self-dealing can be used to their full extent.[41] In other words, these transactions should be subject to procedural safeguards (e.g., approval by independent directors or disinterested shareholders) or to a court review of their merits,

[37] On asset partitioning, *see generally* Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L. J. 387 (2000); Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333 (2006).

[38] Especially, markets may involve monopolies/oligopolies, information asymmetries and hold-up risk from market participants. For market frictions, *see generally* Oliver E. Williamson, *Markets and Hierarchies: Some Elementary Consideration*, 63 AM. ECON. REV. 316 (1973). *See also* Henry Hansmann, *Ownership and Organizational Form*, *in* THE HANDBOOK OF ORGANIZATIONAL ECONOMICS 891, 899-02 (Robert S. Gibbons & John Roberts eds., 2012).

[39] *See* Hansmann, *supra* note 38, at 899 ("There are a variety of costs associated with arm's length contractual transactions that can be reduced by bringing the contracting parties under common ownership"). *See also* Kang, *supra* note 8, at 108–109 (enumerating the benefits of internal transactions between affiliated companies); Tarun Khanna & Jan W. Rivkin, *Estimating the Performance Effects of Business Groups in Emerging Markets*, 22 STRAT. MGMT. J. 45 (2001) (examining business groups in emerging markets where market failures and high transaction costs abound).

[40] *Cf.* Pacces, *supra* note 23, at 196 (stating that "RPTs that have a business purpose cannot be identical to an arm's length transaction"). Of course, such intra-group transactions may also involve prices less than the market price. In such cases, along with avoiding possible market frictions, it is even more in the interest of the relevant company to transact with an affiliate company rather than transacting in the market.

[41] Yet, in order to reduce monitoring and transaction costs of R.P.T.s, jurisdictions may exclude R.P.T.s that are routine, or at market price, or in the ordinary course of business (like most intra-group transactions involving only homogenous products/services) from the review mechanisms or provide lighter review of such transactions. *See, e.g.*, Directive 2017/828, of the European Parliament and of the Council of 17 May 2017 amending Directive 36/EC, 2007 O.J. (L 184) as regards the encouragement of long-term shareholder engagement, 2017 O.J. (L 132) 1, art. 9c(5)(stating that review mechanisms shall not apply to transactions entered into in the ordinary course of business and concluded on normal market terms, and for such transactions, the (disinterested) administrative or supervisory body of the company shall establish an internal procedure to periodically assess whether these conditions are fulfilled).

both of which would normally involve the practice of comparing the substantive terms of the R.P.T.s in question with those of arm's length deals.[42]

2.2. INTRA-GROUP TRANSACTIONS INVOLVING DIFFERENTIATED/SPECIAL PRODUCTS/SERVICES

Intra-group transactions may also involve differentiated/special products/services rather than homogenous ones. As exemplified above, those transactions may serve towards the end of implementing an idiosyncratic vision[43] and therefore call for a special attention in the balancing act of protecting minority shareholders and maximising returns from the controllers' entrepreneurship. Because such transactions are necessarily different from market transactions and involve idiosyncratic elements, a common way of judging the merits of R.P.T.s - comparing their terms to those of arm's length transactions - may fail.[44] In the simplest terms, the intra-group transaction between Company A and Company B regarding the special technology Company B produces for Company A's products is different from a market transaction that involves standard technology, and will inevitably contain distinctive (and most likely costlier) terms. Such transactions should be permitted in order to allow controller-entrepreneurs to implement their business plan.

From the perspective of the controller-entrepreneur, for Company A, market transactions involving other products will not serve towards the attainment of idiosyncratic vision. Furthermore, contracting with an arm's length market participant

[42] *Cf.* Kang, *supra* note 8, at 136 (arguing that in return for a stable and trustworthy supply from an affiliated company, paying a higher price than the market price may be reasonable when the risks from transactions in a market are considered).

[43] *See* Rajan, *supra* note 34, at 1177, stating that:

> To create NPV [net present value], the entrepreneur has to go out on a limb, distinguishing herself from the rest of the herd of potential competitors and thus potentially earning sustainable profits (provided that the limb is narrow enough, the firm's capabilities distinctive enough, or its innovation continuous enough that others cannot follow). Thus, the process of creating positive NPV invariably implies differentiation—whether in creating new products or product varieties that nobody else manufactures, in developing production methods that are more efficient than that of the competition, or in targeting customer populations or needs that have hitherto been overlooked.

[44] In the case of differentiated products/services, the arm's length test translates into an exercise of discerning the range of prices in which a reasonable buyer or seller would be willing to buy or sell the asset/service, dealing under arm's length conditions. *See* Eisenberg, *supra* note 35, at 999. However, intra-group transactions that involve idiosyncratic elements pose a challenge. Consider the above example. Understanding the price Company A would be willing to pay as a reasonable buyer dealing at arm's length for Company B's products would require the relevant body reviewing the transaction to determine the value of the differentiated/special products for Company A – an exercise which is both impractical (*see infra* text accompanying notes 53–55) and tantamount to reviewing the idiosyncratic vision underlying the transaction itself.

for the production of a differentiated product in this regard may not be feasible because in such a case, each party may expose itself to opportunism by the other party. The controller may also prefer to implement his or her business plan through a fully integrated firm (i.e. a multidivisional company) or a corporate group involving only wholly-owned subsidiaries if he or she reckons that the implementation of the business plan through intra-group transactions concluded between two separate legal entities (involving minority shareholders) is not feasible due to legal restrictions on intra-group transactions in such a case. By allowing controller-entrepreneurs a certain freedom of action in concluding intra-group transactions that are different and costlier than market transactions, a legal regime may also support corporate groups involving separate legal and public entities as an organisational form and possible benefits thereof.[45]

However, at the same time, these transactions should be reviewed in order to ensure that they are not a tool of expropriating minority shareholders. The task is therefore to devise an R.P.T. regime that would achieve both ends in an optimal way.[46]

In this regard, Goshen and Hamdani advocate for a liability-rule regime[47] to minimise the interference of minority shareholders in the process of conducting related party transactions while protecting them from value diversion.[48] Such a regime envisages the *ex-post* court review of the merits of R.P.T.s without any *ex ante* vetting of such transactions through procedural safeguards.[49] They do not however clarify how courts would review related party transactions that involve idiosyncratic elements. Pacces, on the other hand, argues that courts cannot review the substantive fairness of

[45] *See also* Dammann, *supra* note 33, at 696 & 707 (noting the benefits of maintaining the controlled company's status as a publicly traded corporation). In the end, "the organization structure most conducive to innovation varies with the characteristics of technology, which dictates the relative advantages and costs of different forms". *See* Sharon Belenzon et al., *The Organization of Innovation Across Countries and Industries* (2013), 1, https://pdfs.semanticscholar.org/e389/d660ab42a1a7415105c5c44ea25d5a3c5ed3.pdf.

[46] *See also* Pacces, *supra* note 23, at 193–94 (referring to allowing value-decreasing R.P.T.s as "false negatives" and preventing value-increasing R.P.T.s as "false positives", and noting that "[e]fficient enforcement requires that the joint cost of these errors be minimized").

[47] For the distinction between "liability rules" and "property rules", *see* Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 Harv. L. Rev. 1089 (1972). If the transfer of an entitlement can only happen in a voluntary transaction where the value is agreed upon by the seller, the entitlement is protected by a property rule. On the other hand, if its transfer can occur at an objectively determined price despite the unwillingness of the seller to sell at that value, it is protected by a liability rule. *Id.* at 1092.

[48] *See* Goshen & Hamdani, *supra* note 15, at 610.

[49] Applying the framework of "property rules" vs. "liability rules" (*see supra* note 47) to legal safeguards against value-diversion via R.P.T.s, Goshen identifies a legal protection as a property rule if "any contemplated transaction tainted with self-dealing cannot proceed without the minority owners' consent". On the other hand, "a liability rule allows transactions tainted with self-dealing to be imposed on an unwilling minority but ensures that the minority is adequately compensated in objective market-value terms". *See* Goshen, *supra* note 23, at 398. The *ex-post* court review of R.P.T.s without any procedural safeguard qualifies as a liability rule regime because in such a regime, corporate controllers can engage in R.P.T.s without any consent of disinterested parties provided that such transactions are "fair". *Id.* at 408.

such transactions because they usually apply the arm's length criterion, which is not useful in such cases.[50] Instead, he proposes a review of R.P.T.s by non-controlling shareholder-dependent directors.[51] Similarly, Pacces does not delineate how these directors would review these transactions. Below, without expressing any preference for court review of R.P.T.s or any procedural safeguard, I propose several ways of reviewing intra-group transactions that involve idiosyncratic elements. These review methods can be applied both in the case of *ex post* court review of R.P.T.s and when procedural safeguards (disinterested shareholder vote on R.P.T.s or independent directors' review of R.P.T.s) are in place.[52] The aim is to look after the minority shareholders' interests with minimal interference in the controller-entrepreneurs' freedom of action.

A reasonable way of reviewing transactions that are clearly conflicted but entered into within the context of implementing an idiosyncratic vision is to find out how much value the implementation of the idiosyncratic vision (via intra-group transactions) would produce/has produced and whether the amount the company would spend/has spent on the project (in transacting with related companies) is less or more than this value.[53] However, there are two difficulties with this approach. First, an idiosyncratic vision that is *bona fide* supposed to produce above-market returns can fail.[54] If these failures will make controlling shareholders liable to minority shareholders for value-diversion, there is risk of over-deterring controller-entrepreneurs from pursuing such projects. Second, it is very difficult to verify the extent of the value produced by the implementation of an idiosyncratic vision (via intra-group transactions).[55] Consider the above example again. The controller-entrepreneur engages in producing a special technology via Company B and makes firm-specific capital investments. Company A buys this technology from Company B to beat the competition and earn handsome profits.

[50] *See* Pacces, *supra* note 23, at 183 & 196–97. He further states that there exists no standard that allows a judge to make a substantive assessment of an R.P.T., particularly whether dealing with a related party has any business purpose at all. *Id.* at 196.

[51] According to his proposal, a minority of the board of directors should be composed of "non-controlling shareholders-dependent directors" who are exclusively nominated, appointed, and removed by the minority shareholders. These directors should have the *sole* mandate of screening R.P.T.s *See id.* at 209–16 (detailing his proposal and potential criticism thereof).

[52] While shareholders do not need to justify their votes on R.P.T.s, institutional investors (that increasingly dominate shareholding across the world) have a fiduciary duty to ultimate beneficiaries of shares, and this duty requires them to vote in the best interest of the company (value). The following ways of reviewing intra-group transactions explained in the text would help institutional shareholders to identify value-increasing/value-decreasing transactions.

[53] *See* Pacces, *supra* note 23, at 189 (stating that "the price of a tailor-made engine could depart from the price of a standard engine up to a point (the "no-tunneling" point) in which noncontrolling shareholders expect to receive at least as much in terms of return from asset specificity").

[54] *See* Goshen & Hamdani, *supra* note 15, at 578, fn. 55 & 600, fn. 122 (acknowledging that the idiosyncratic vision of the controller-entrepreneur can fail).

[55] *See also* Pacces, *supra* note 23, at 197–98.

Whether such a business plan will be successful, or the extent of its success is uncertain and non-verifiable.

Useful insights can be gained however by considering the dynamics in markets involving different products. Product differentiation creates monopolistically competitive markets.[56] In such markets, each firm is a monopoly in that it is the only producer of the unique product. However, unlike monopolies where there are no alternatives, each product is also a close substitute.[57] Monopolistically competitive firms have demand curves less elastic than the one in a perfectly competitive market but more elastic than in a monopolised market. This means that such firms can raise their prices without losing all the demand.[58]

In arm's length transactions, a monopolistically competitive firm will charge a price that reflects the demand for the output produced at an amount where its marginal costs are equal to its marginal revenue.[59] If its average total cost is lower than the market price, the firm will make profits and vice versa.[60] In related party transactions, however, such a firm can charge any price without regard to the demand, transforming into (more than) a pure monopolistic position.[61] In our case, for example, Company B is in such a position *vis-à-vis* Company A because the transaction is imposed on Company A through the controlling power of a controlling shareholder and the terms of the transaction are not determined in an arm's length manner. A few considerations may help understanding whether there is a value-diversion from Company A to Company B in such transactions.

First, if Company B is also transacting with external parties for the same product,[62] there will be a market price (which will be determined in accordance with the dynamics of a monopolistically competitive market). This market price could provide a benchmark to determine value-diversion: whether Company A is charged above this price or not.

However, if Company B is not transacting with external parties (i.e., supplying the relevant product only to Company A), there will be no market price and hence no

[56] *See* KARL. E. CASE, RAY. C. FAIR & SHARON E. OSTER, PRINCIPLES OF ECONOMICS 344–59 (12th ed. 2017).
[57] *Id.* at 353.
[58] *Id.*
[59] *Id.* at 354.
[60] *Id.*
[61] A monopolistic firm sets the market price. However, related party transactions will grant more power to a company than a monopolistic firm has because even monopolies can lose customers if they raise their prices too much as consumers may shift their limited resources to other markets. *See Id.* at 299. For a related party (that has control over the counterparty), the demand will be stable because the other party will not be able to decide of its own volition not to transact any more. Moreover, while a monopolistic firm has to lower the price it charges to raise and sell its output, a related party does not. *Id.* at 302.
[62] The product Company B is producing is specifically tailored for Company A's needs. But it does not mean that it cannot sell it to other parties. For example, rather than selling its product to the competitors of Company A, it may transact with companies from other unrelated industries that may benefit from the same (efficient and environment-friendly) technology that Company B produces for Company A.

benchmark.[63] In such cases, I propose considering whether and to what extent the related company (Company B in the example) has charged prices over its average total cost[64] in transacting with the relevant company (Company A in the example).

A default standard would consider any price more than the average total cost of Company B as value-diversion and prohibit it therefore from charging prices over the average total cost. In such a case, while there will be no losses for Company B, this will leave it with zero profits. Nevertheless, such a situation can still be justified. First, in the case of intra-group transactions entered into in pursuit of an idiosyncratic vision, the controller-entrepreneur's main interest lies in securing above-market returns with his/her business plan for Company A. And he or she dictates Company A to enter into a transaction with Company B to be able to implement his or her idiosyncratic vision. Arguably, the controller-entrepreneur should not be allowed to further use his or her power over Company A to pay prices over the average total cost of Company B where his or her economic interest is greater. The firm-specific capital investment the controller-entrepreneur makes via Company B would not also be stifled or disincentivized if not allowed to charge prices over its average total cost and to make profits because the purpose of such investment is to produce above-market returns via Company A in the first place. Such a rather drastic approach is arguably essential to prevent Company A from paying more than the necessary for a project the value of which is uncertain, and ultimately to protect minority shareholders from expropriation. Second, in the long-run equilibrium, the profits for a monopolistically competitive firm (such as Company B) must be (and will be) zero anyway.[65] One should note that adopting this standard would effectively necessitate Company B to be a wholly-owned subsidiary (with no minority shareholders) because, although there is a certainty of breaking even, public investors would refrain from investing in the equity of such a company as there is no prospect of profit.[66]

[63] *See* Dammann, *supra* note 8, at 219 (stating that "affiliated corporations may produce some of their products and services solely for other affiliated companies, making it difficult to determine their arm's length value").

[64] "Average total cost is total cost divided by the number of units of output". *See, e.g.*, Case, Fair & Oster, *supra* note 56, at 207.

[65] For an explanation of why in the long-run equilibrium there will be zero profits for a monopolistically competitive firm, *see id.* at 354-56. Furthermore, while transacting at price = average total cost provides no profits, it is more advantageous to the related party company than a hypothetical (but possible) scenario where it would transact with external parties, however at a loss (at a price < average total cost) because of weak demand for the differentiated product. *See Id.* at 354. Benchmarking price against average total cost will also allow adaptation to changes in the costs of the related company in producing/rendering the differentiated product/service, which enables it in turn to operate continuously at no loss. Overall, these would help securing the idiosyncratic vision of the controller.

[66] Note that in the scenario where such a standard would be applicable, Company B does not transact with any party other than Company A. Creditors (bondholders, banks and non-bank lenders) would still lend to such a company as they would be paid in full. Capital contributed by creditors and public shareholders would count as fixed cost. *See Id.* at 199.

Alternatively to this (default) standard, it can be agreed that value-diversion would arise when the related company charges prices which are *a certain percentage* higher than the average total cost (which serves as the threshold). For example, a price which is only twenty percent higher than the average total cost can be accepted as justified. This will enable the related party to make profits, which can be important in terms of the ability to finance itself in the first place.[67] Determining the threshold – the percentage margin between the price and the average total cost – would be left to the controller and minority shareholders.[68] Controllers would have an incentive to agree on such a threshold (among others, to leave a certain room of profit for the related party itself–Company B in the example), which gives minority shareholders leverage in the negotiation. Minority shareholders would also have an incentive to diverge from the default standard to allow the supplier-related party to finance itself (on more favourable terms or with more financing options) and ultimately to produce tailored products for the company of which they are a shareholder that would then earn some above-market returns (Company A in the example).[69]

Along with a review of the terms of an intra-group transaction concluded in pursuit of an idiosyncratic vision along the above-explained lines, another useful examination could be to scrutinise whether there is/was a *reasonable* case to pursue such an idiosyncratic vision and to enter into intra-group transactions that are different (and costlier) than market transactions in the implementation thereof. Normally, the business judgement rule would (and should) largely protect the controllers from any interference of a third party (including courts) in determining the business strategy of a company.[70] However, in our case, a conflict of interest taints the transaction.[71] And arguably, an intermediate standard of review may apply, namely whether the R.P.T. in question is/was *reasonably* (emphasis added) implemented in pursuit of an idiosyncratic vision.

In such an examination, courts or other disinterested parties would not police whether the business plan followed by the controller-entrepreneur produced or would

[67] This would be especially relevant for equity finance. In terms of debt finance, the cost of capital can be lower.

[68] A mechanism to achieve this would be an amendment to the corporate charter, which states the threshold for value-diversion in intra-group transactions and which would have to be consented to by (a majority of) minority shareholders. *See also* Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 Harv. L. Rev. 1641, 1663 (2006), (arguing for a framework where controlling shareholders are permitted to contract with investors over private benefit levels).

[69] Admittedly, such an approach may not be frictionless as there may be opportunistic or conflicted minority shareholders as well as those that would suffer under too much information asymmetry to make a reasonable decision.

[70] *See supra* note 32 and accompanying text.

[71] It is in the personal interest of the controller to divert value via the transaction from Company A to Company B where his or her economic stake is greater.

produce sufficient value for the company to compensate for transacting differently than the market conditions.[72] Rather, they will examine whether there is/was indeed a *reasonable* case to make such a business decision in the first place. After all, since the definition of idiosyncratic vision is quite broad,[73] every corporate controller can claim to be pursuing intra-group transactions under a business plan that is believed to be capable of producing above-market returns. Untrammelled discretion for corporate controllers to conduct intra-group transactions may produce inefficient transactions. For example, assume that Company A desires to enlarge its business through entering into new territories (geographic markets), and there are several feasible options (territories) along with one that would entail buying land, building or distribution facilities from a related party (i.e., affiliated company). Further assume that choosing each option would entail different costs and benefits but the latter (the R.P.T. option) is costlier than other options and its benefits are not clear. Normally, a decision of which of the feasible territories a company should expand into is an idiosyncratic assessment of the controller-entrepreneur made under uncertain conditions. However, under the pretence of this assessment, the controller-entrepreneur may try to sell these unused assets of Company B (in order to invest the proceeds in better projects) to Company A, which would be in fact better off in expanding into other territories. In other words, situations may exist where the idiosyncratic assessment loses its significance in terms of a business decision and a prudent reasonable businessperson would (easily) realise that the R.P.T. option is a worse option for the company.

A *reasonableness* test may therefore prevent controllers from pursuing pet projects via harmful intra-group transactions under the pretence of pursuing an idiosyncratic vision. One can object whether such a test would constitute an invasive second-guessing of business strategy. However, it should be noted that even the business judgement rule in non-conflicted situations does not allow ones in charge of decision-making to follow wasteful projects.[74] After all, if the corporate controller cannot persuade the court (or independent directors or minority shareholders) that there is/was a reasonable case for pursuing his or her vision through intra-group transactions, one may infer that there is/was none in the first place. One can also define reasonableness differently, making it a more, or less, strict test. One way to define reasonableness that would only minimally meddle with business decisions is to ask whether the outcome is one which no reasonable decision maker acting reasonably could

[72] For difficulties associated with such a review, *see supra* notes 53–55 and accompanying text.
[73] *See supra* text accompanying note 19.
[74] For example, in the U.S., the classic case law is such that the business judgement rule does not protect directors if they commit an act of corporate "waste". *See* Bayless Manning, *The Business Judgment Rule in Overview*, 45 OHIO STATE L. J. 615, 621 (1984).

have reached, which is close to irrationality. Furthermore, similar to the contours of a duty of care review by the courts of company directors' decisions, some objective standards of conduct for the controllers can be developed under the reasonableness test. For example, the controllers can be required to sufficiently inform themselves before making their decisions following their idiosyncratic assessment, or to acquire an outside view to mitigate the effects of possible bias or blind spots under which they are suffering.

Such an intermediate standard of review becomes even more important when one considers the overconfidence and optimism bias under which the corporate controllers, especially entrepreneurs, suffer along with the explicit conflict of interest.[75] Such biases may make value-decreasing transactions look value-increasing even for well-intentioned controller-entrepreneurs.[76]

Last but not least, the idiosyncratic vision of corporate controllers may not only relate to business strategies that are believed to be capable of producing above-market returns, but also involve consideration of stakeholder interests (*e.g.* climate-friendly, environment-friendly, labour-friendly etc.).[77] In such cases, R.P.T.s (in the form of intra-group transactions) different and costlier than arm's length market transactions may be necessary to implement such strategies (i.e. to produce an output/service in certain ways). For example, if a necessary input for Company A's products is produced by external companies in which the labour conditions in the production line are repugnant to the values endorsed by the Company A and its controller (and maybe its public investors), then the controller may engage in supplying this necessary product through another controlled company, Company B, which ultimately gives rise to intra-group transactions.

The question is what considerations should apply in these cases in terms of the review of such transactions to prevent value-diversion. An implicit idea in allowing the

[75] It is true that courts may suffer from hindsight bias if they review the decisions of corporate controllers after the outcome of the relevant decision clearly materialises. *See* Armour et al., *supra* note 32, at 70. However, it is also important to consider the biases of corporate controllers in decision-making. The overconfidence and optimism bias are among the most important ones. Many interdisciplinary studies show that in forecasting the outcomes of risky projects, the planning fallacy leads entrepreneurs and executives to make decisions based on delusional optimism rather than on a rational weighting of gains, losses and probabilities. *See also* Daniel Kahnemann, Thinking, Fast and Slow 252 (2011). *See also id.* at 255–65 (explaining "optimistic bias" and overconfidence of entrepreneurs and executives); Malcolm Baker & Jeffrey Wurgler, *Behavioral Corporate Finance: An Updated Survey*, *in* Handbook of the Economics of Finance Vol. 2A 351, 386–87 (George M. Constantinides et al. eds., 2013) (same); Itzhak Ben-David, John R. Graham & Campbell R. Harvey, *Managerial Miscalibration*, 128 Q. J. Econ. 1547 (2013) (finding that executives show miscalibration regarding their own firms' prospects and follow more aggressive corporate policies).

[76] *See*, *e.g.,* Kahnemann, *supra* note 75, at 252 (stating that executives "spin scenarios of success while overlooking the potential for mistakes and miscalculations").

[77] In other words, controller-entrepreneurs may maintain control over the company not only to be able to implement a business plan that he or she believes will produce above-market returns but also to be able to run the company and conduct its business in a certain way.

controller-entrepreneurs the freedom of action in pursuing a business plan is that such a plan may produce above-market returns for minority shareholders and may ultimately increase societal welfare.[78] In other words, a *quid pro quo* for allowing controller-entrepreneurs to pursue their idiosyncratic vision and conduct intra-group transactions on different terms than market transactions (which would normally indicate value-diversion) is to share the benefits of such a plan with investors (and to contribute to the social welfare). However, in the case of intra-group transactions entered into under pure "stakeholderist" aims, there is no promise of above-market returns. On the contrary, intra-group transactions costlier than market transactions will reduce profits.[79]

A case for still allowing such transactions can be made on the ground that public investors (minority shareholders) knowingly invest in such companies that pursue rather "sustainable" policies and share the non-pecuniary benefit resulting from following such a stakeholderist strategy.[80] One can object that the company can switch to sustainability after the investors purchased the shares (i.e., after the shares were offered to the public). But, in such a case, disgruntled investors can exit by selling their shares in a liquid secondary market. Furthermore, regimes where companies should or can take into account societal or stakeholder welfare rather than maximising shareholder value would support entering into such transactions. This would be possible

[78] An innovative business plan (e.g., introducing a new product, method of production or organisation, utilising different inputs, opening up new markets) will either increase efficiency and thus decrease expenses or directly result in more profits. It will also lead to economic growth and more social welfare by improving goods and services and making their production more efficient. *See generally* Joseph. A. Schumpeter, THE THEORY OF ECONOMIC DEVELOPMENT: AN INQUIRY INTO PROFITS, CAPITAL, CREDIT, INTEREST, AND THE BUSINESS CYCLE (1911).

[79] In the above example, since Company B will incur more expenses than market counterparties to provide more labour-friendly working conditions, it will charge Company A more for the products it supplies in comparison to external companies which provide the same input. On the other hand, if Company A will be able to sell its products more and thus make more profits as the products are preferred more by consumers who are conscious of the production conditions, then even such intra-group transactions, albeit costlier for Company A in comparison to market transactions, will cause an increase in profits.

[80] Sustainable investing or socially responsible investment is basically an investment strategy that takes into account the concerns about social or environmental issues along with the usual risk and return calculation. Funds invested in companies that follow "sustainable" policies may overperform other funds. *See, e.g.*, Jennifer Thompson, *Sustainable Funds More Likely to Be Top Performers, Study Shows*, FIN. TIMES (Aug. 12, 2019), https://www.ft.com/content/9e71cf86-ba2d-345c-bb3b-0d5887abbc6a. But this may not be the main consideration for investors. *See, e.g.*, Arno Riedl & Paul Smeets, *Why Do Investors Hold Socially Responsible Mutual Funds?*, 72 J. FIN. 2505 (2017)(finding that socially responsible investors expect to earn lower returns and pay higher management fees, which suggests that "investors are willing to forgo financial performance in order to invest in accordance with their social preferences"); Samuel M. Hartzmark & Abigail B. Sussman, *Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows*, 74 J. FIN. 2789 (2019) (finding evidence that investors marketwide value sustainability, and no evidence that high-sustainability funds outperform low-sustainability funds, which is consistent with nonpecuniary motives influencing investment decisions).

if the corporate purpose and directors' duties endorsed in a jurisdiction are based on stakeholder value theory which would allow truly sacrificing profits in favour of improving labour conditions.[81] On the contrary, shareholder primacy (and also enlightened shareholder value) would subordinate stakeholder interests to shareholder value and allow the former to be pursued only when it increases the latter.[82]

On the other hand, such transactions can still also be used to divert company value to corporate controllers. Reviews by courts or disinterested players of such transactions along the lines explained above may be further used to ensure that such intra-group transactions (that are necessarily costlier than market transactions) do not expropriate minority shareholders. Consider again the above example. Company B's average total cost of producing the necessary input for Company A will be higher than those of market suppliers (because of providing more labour-friendly conditions). Yet, courts or disinterested parties may police possible value-diversion by preventing Company B from increasing the price of the input further over its average total cost (which benefits the corporate controller at the expense of minority shareholders of Company A) or by allowing only a certain margin.

2.3. OTHER ISSUES REGARDING THE OVERSIGHT OF INTRA-GROUP TRANSACTIONS

Adequate review of intra-group transactions to ensure the prevention of value-diversion by the corporate controllers is not limited to the above explained issues. First of all, not only the terms of the relevant transaction but also how the transaction is carried out matters. For example, even if the terms of an intra-group transaction between Company A and Company B are entirely fair (which is determined according to one of the various standards of review), issues in the performance of the transaction may still result in value-diversion from Company A to Company B.[83] A simple non-performance or

[81] Stakeholder (value) theory calls for a balancing of different interests of company stakeholders such as employees, suppliers, customers, environment/community, and shareholders. No interest of a stakeholder group would have to be prioritised. On stakeholderism, *see further* Lucian A. Bebchuk Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, (2020) 106 CORNELL L. REV. 91, 103–24.

[82] Shareholder primacy and its nuanced but fundamentally same version, called enlightened shareholder value, pursue shareholder value and prioritise it over other interests in a conflict situation. *See id.*

[83] In the famous case of *Sinclair Oil Corp. v. Levien,* 280 A.2d 717 (Del. S. Ct. 1971), for example, minority shareholders who brought the suit argued that the parent company (i.e., Sinclair) had caused the transaction between its two subsidiaries (i.e., Sinven and International) to be breached in favour of the one where its economic stake is greater (i.e., International). *See Id.* at 723 ("[A]lthough the contract called for payment on receipt, International's payments lagged as much as 30 days after receipt. Also, the contract required International to purchase at least a fixed amount of crude and refined products from Sinven. International did not comply with this requirement"). The court ruled that "[u]nder the intrinsic fairness standard, Sinclair must prove that its causing Sinven not to enforce the contract was intrinsically fair to the minority shareholders of Sinven. Sinclair has failed to meet this burden." *Id.*

faulty/late performance of a contract may cause damages to a company. Normally, such issues are within the purview of contract law and in an arm's length relationship, the damaged party would demand compensation and eventually sue the non-performing party. On the other hand, in transactions between related companies (such as intra-group transactions), as both companies are under common control, the damaged company might not sue the other company. For instance, even if Company A suffers harm because of non-performance of an intra-group transaction by Company B, common control of both companies may mean that Company A foregoes its claim in favour of Company B, which may be underlined by a conflict of interest because this benefits the corporate controller who has more economic stake in Company B.

While not only the terms but also the performance of a related party transaction matters in terms of value-diversion, the latter becomes even more important in intra-group transactions because such transactions are often long-term (such as a supply agreement). The issue therefore becomes how to ensure the *constant* screening of an intra-group transaction. The oversight of courts may prove ineffective because the initiators of derivative suits (namely minority shareholders) may not be able to continuously monitor (performance of) all the intra-group transactions of an investee company.[84] A better alternative is to entrust the issue to independent directors. As mentioned above, normally, directors would decide whether to pursue the claims of a company against counterparties in arm's length transactions. In related party transactions, due to conflicts, they may however drop rightful claims against related companies. Independent or minority shareholder-dependent directors could be entrusted with the charge of pursuing such claims along with their duty of reviewing and approving related party transactions in the first place. Or, in companies that often enter into R.P.T.s, permanent R.P.T. committees (similar to remuneration or audit committees) could be formed or mandated to approve and handle all the issues that arise from an R.P.T.[85]

[84] Such an option would also be costly given the administrative costs of litigating all the intra-group transactions. Furthermore, cost considerations may make most, if not all, minority shareholders rationally apathetic in terms of bringing a derivative suit in the name of the company for non-performance. The option of utilising the general meeting for the decision of bringing a suit (through the majority vote of minority shareholders) which would necessitate a company action in the case of an affirmative vote would provide a better alternative, albeit not a swift one unless extraordinary general meetings are held (as well as being possible only in those jurisdictions where lawsuits against directors can be brought also via a shareholder meeting resolution).

[85] There also exist legal regimes which allow offsetting between different costs and benefits arising from the relationship of the relevant company with an affiliate company. For example, even if there are damages for Company A arising from the non-performance by Company B of a contract, if these damages are offset by another benefit Company A derives from its relationship with Company B, then it is considered that there is no value diversion. For an explanation of such legal regimes, *see infra* note 91. *Cf. Sinclair Oil Corp. v. Levien,* 280 A.2d 717, at 723 (Del. S.Ct. 1971)(refusing to allow the parent company a credit or setoff of all benefits provided by it to the subsidiary with respect to all the alleged damages except that setoff is allowed on specific transactions).

Secondly, as stated above, intra-group transactions are often long-term contracts. This situation creates another issue in relation to preventing value-diversion: even if the relevant transaction is fair at the time of conclusion and review/approval, it may become unfair due to changes in market conditions.[86] Obviously, even in arm's length transactions, parties cannot anticipate every possible change in the future that may require an adaptation, and contract accordingly.[87] Or, imbalances in bargaining power may prevent a contracting party from taking measures against possible detrimental outcomes within the contractual framework. In intra-group transactions, however, a conflict of interest may result in omissions of useful terms that would allow a contracting party to maintain a beneficial position in a contract. At a minimum, therefore, courts may also review whether R.P.T.s conform to standard modal contracts, or whether terms that could have been expected from a reasonable or prudent businessperson and allow adaptation in the transaction exist.[88] Relevant disinterested bodies (such as independent directors) may also be entrusted with ensuring that the pertinent intra-group transaction is not only fair at the time of conclusion but also will not be detrimental to the company during the course of the contract. This task can be achieved by confirming that the relevant (long-term) intra-group transaction includes provisions/terms that can enable the company to adjust according to market conditions (thus maintaining the fairness of the transaction) and actually invoking/enforcing such provisions/terms when needed.

A last issue relates to the oversight of intra-group transactions itself. A long-standing debate in this regard is whether, rather than vetting individual intra-group transactions, the total benefits and costs of the overall relationship of the relevant company with the corporate group and affiliated companies should be considered.[89] The latter approach would arguably provide more flexibility in the

[86] *See* Kang, *supra* note 8, at 134 (noting the problem of a corporate group not adjusting an internal transaction price immediately in response to the wide fluctuation of a fair market price).

[87] Incomplete contracts theory suggests that parties to a contract cannot specify all the relevant contingencies. *See, e.g.*, Oliver Hart & John Moore, *Incomplete Contracts and Renegotiation*, 56 Econometrica 755 (1988).

[88] For example, long-term energy supply contracts generally contain clauses of price formula and price revision (such as indexation mechanisms and hardship clauses). *See* Victor P. Goldberg, *Price Adjustment in Long-Term Contracts*, 1985 Wis. L. Rev. 527, 533–34 (1985); Victor P. Goldberg & John R. Erickson, *Quantity and Price Adjustment in Long-Term Contracts: A Case Study of Petroleum Coke*, 30 J. L. & Econ. 369 (1987). *See* also Pietro Ferrario, The Adaptation of Long-Term Gas Sale Agreements by Arbitrators (2017), (discussing several features of long-term gas sale agreements that allow renegotiation and adaptation of the agreement).

[89] *See, e.g.*, Klaus J. Hopt, *Corporate Governance in Europe: A Critical Review of the European Commission's Initiatives on Corporate Law and Corporate Governance*, 12 N.Y.U. J. L. & Bus. 139, 181 (2015)(noting that:

> [o]pen for future research is the question whether those Member States that deal with related party transactions and group law by imposing duties on the boards and directors of the parents and the subsidiaries (e.g. the UK and others) achieve equivalent as those that tackle the same problem with a more specific group law; similarly open is the question which one is solving the problem better.)

(citation omitted); *see also* Dammann, *supra* note 8, at 232 (stating that "[o]ne question is whether the law should focus on policing individual transactions or whether the priority should be to ensure that controlling shareholders do not, on balance, prove burdensome to the corporations they control").

management of a corporate group and reduce the costs of conducting intra-group transactions.[90] Some jurisdictions indeed implement such a regime albeit following different approaches.[91] While it is recognized that a comprehensive *ex post* review of the costs and benefits of being part of a corporate group may be extremely difficult,[92] such an approach may also increase *ex ante* the cost of capital, and some value-increasing projects may remain unfinanced because such vague concepts may prove unattractive for outside investors who will as a result apply discounts or demand higher interest rates.[93]

An alternative approach, proposed by Dammann, is to grant minority shareholders the right to compel the controlling shareholder to sell his or her shares and leave the company while loosening the review of self-dealing transactions.[94] The logic behind this proposal is that minority shareholders will be the judge of the benefits and costs of the existence of a corporate controller and *rationally* will expel him or her if (and only if) they consider that the costs of the control exceed its benefits.[95] Apart from certain possible glitches in the workings of such an approach,[96] it is not feasible within the framework of controller-entrepreneurs. The latter assumes that the controlling

[90] *See* Dammann, *supra* note 33, at 708–709 (arguing that "a strictly enforced transaction-centered approach is bound to place a considerable burden on those controlling shareholders who double as the controlled corporation's customers or suppliers"); Pacces, *supra* note 23, at 193, fn. 33 (commenting that strictness of R.P.T. regime may discourage corporate groups with minority shareholders).

[91] Germany, for example, requires losses of the subsidiary resulting from acting in the interest of the group rather than in its particular interest to be compensated. *See* §302 (for contractual groups) and §311 Aktiengesetz [AktG][Stock Corporation Act]. Italian legal regime, more flexibly, does not hold a parent company liable for any damage resulting from an intra-group transaction if it has been offset, considering "the overall results of the parent's management and coordination activity." *See* Codice Civile[C.c.] [Civil Code] Article 2497(It.). Lastly, in France, the *Rozenblum* doctrine allows subsidiaries to sacrifice their own interests for the corporate group as long as the structure of the group is stable, there is a coherent group policy, and an overall equitable distribution of costs and revenues among group members exists. *See generally* Enriques et al., *supra* note 9, at 163–164.

[92] *See* Dammann, *supra* note 8, at 235.

[93] *See also* Tröger, *supra* note 36, at 197.

[94] *See generally* Dammann, *supra* note 33, at 686 (calling this mechanism "corporate ostracism") & 718–725 (detailing his proposal).

[95] *See* Dammann, *supra* note 8, at 235.

[96] The proposal basically depends on the vote of the majority of minority shareholders (to ostracise the controlling shareholder or not). *See* Dammann, *supra* note 33, at 718–719. This leads to a number of problems. *See Id.* at 720–25, 738–40. First, it is not clear how minority shareholders will be able to ascertain the point at which they are better off ostracising the controlling shareholder. Second, there might be opportunistic behaviour by the minority shareholders. For example, activist hedge funds, acquiring a substantial minority stake, may leverage the power to ostracise the controlling shareholder to be able to implement the changes they request from the company. Lastly, conflicts of interest of some institutional investors as minority shareholders may lead to undesirable controllers (creating more costs than benefits) not being ostracised. On the conflicts of interest of institutional investors, *see* Bernard S. Black,*Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 595–608 (1990); John C. Coffee, Jr., *Liquidity versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1321– 22 (1991); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L. J. 445, 469–72 (1991). Furthermore, whether, and if so, for which companies corporate ostracism should be a default rule gives rise to a number of complications. *See* Dammann, *supra* note 33, at 725–734.

stake results from a desire to have the ability to implement a business plan without the interference of outside shareholders in the presence of differences of opinion and information asymmetries.[97] If minority shareholders are allowed to expel the controlling shareholder even when they genuinely believe that the costs imposed by the corporate controller are higher than the benefits he or she brings, controller-entrepreneurs will be deterred from having a controlling stake in the first place because this is exactly the situation they would like to avoid by holding onto the control of the company.[98] In addition, the same differences of opinion and information asymmetries may cause minority shareholders to misjudge the costs and benefits of a controller-entrepreneur and his or her business plan. Overall, vetting intra-group transactions *individually* stands out as a better method in comparison to other ways of conducting an overall evaluation of the affairs of the relevant company with related entities.

CONCLUSION

Contrary to expectations a few decades ago, dispersed ownership is still the exception while concentrated ownership and corporate controllers are very likely to stay and become further diversified.[99] Drawing on the theories on corporate control and controlling shareholders, this article argued that controllers are a diverse group and their activities may simultaneously serve towards various ends such as extracting private benefits of control and implementing an idiosyncratic vision as entrepreneurs.

In particular, intra-group transactions in a corporate group can be a means of both expropriating minority shareholders and implementing an entrepreneurial idea. This tension creates the challenge for lawmakers, investors, and courts to optimally balance the goals of minority shareholder protection and allowing controller-entrepreneurs to implement their business plans. Without any preference for any type of review mechanisms employed by jurisdictions to oversee R.P.T.s (such as court review, approval of independent directors or disinterested shareholders), this article has proposed a legal framework including different categories/types of intra-group transactions and various methods of review. The aim is to ensure that controller-entrepreneurs can pursue intra-group transactions in a corporate group

[97] *See supra* notes 17–19 and accompanying text.

[98] *See also* Goshen & Hamdani, *supra* note 15, at 601–603 (arguing that "the controller should be able to prevent a non-consensual change of control from ever taking place.").

[99] *See* Mariana Pargendler, *Controlling Shareholders in the Twenty-First Century: Complicating Corporate Governance Beyond Agency Costs*, 45 J. Corp. L. 953 (2019).

within the context of implementation of an idiosyncratic vision without diverting value from a company to another one where their economic stake is greater.

While the terms of an R.P.T. greatly matter in terms of understanding the existence of value-diversion, this article has indicated that two other issues, namely the performance of the transaction and its fairness during the long duration of the contract, are also important to prevent value-diversion from the relevant company to affiliated companies for the benefit of the ultimate controller. Relevant review mechanisms should also be applied or created regarding these issues.