Tunneling

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The emerging markets crisis of 1997–1998 offers many instances of looting of firms by their controlling shareholders. Assets were transferred out of companies, profits were syphoned off to escape creditors, and troubled firms in a group were propped up using loan guarantees by other listed group members. Johnson et al. (2000) show that countries whose legal systems restrict such looting of firms more effectively had milder financial crises in 1997–1998. In this paper, we use the term "tunneling," coined originally to characterize the expropriation of minority shareholders in the Czech Republic (as in removing assets through an underground tunnel), to describe the transfer of assets and profits out of firms for the benefit of those who control them.

We take on several questions about tunneling. Does it occur only in emerging markets, with their generally poor law enforcement, or does it also happen in developed countries? Is it possible to tunnel a company legally? What forms does legal tunneling take? Finally, *how* does the law in countries with good law enforcement accommodate tunneling?

These questions bear on recent research showing that legal protection of minority shareholders and creditors is an empirically significant determinant of financial development across countries (La Porta et al., 1997). This research also shows that company law in civil-law countries, especially French civil-law countries, is less protective of minority shareholders than that in common-law countries (La Porta et al., 1998). In this paper, we focus specifically on the legal treatment of minority shareholders in different legal systems with respect to tunneling.

Using well-known cases from France, Italy, and Belgium, we show how legal tunneling happens in developed civil-law countries. We focus on French civil-law countries, although cases from German civil-law countries indicate similar problems. We present three judicial decisions, which legal experts and textbooks view as indicative of situations in the respective countries, where courts allowed substantial expropriation of minority shareholders. Courts did so not through neglect or incompetence, but using specific legal logic. By focusing on advanced market economies, and on tunneling which was explicitly blessed by courts, we show that tunneling occurs in countries with effective law enforcement, and not just in emerging markets.

I. How the Courts Allow Tunneling

We use the term "tunneling" narrowly to refer to the transfer of resources out of a company to its controlling shareholder (who is typically also a top manager). Most public companies in Western and Eastern Europe, Asia, and Latin America have such controlling shareholders (La Porta et al., 1999). As we use the term, tunneling does not cover other agency problems, such as incompetent management, placement of relatives in executive positions, excessive or insufficient investment, or resistance to value-increasing takeovers.

Tunneling comes in two forms. First, a controlling shareholder can simply transfer resources from the firm for his own benefit through self-dealing transactions. Such transactions include outright theft or fraud, which is

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illegal everywhere (though often goes undetected or unpunished), but also asset sales and contracts such as transfer pricing advantageous to the controlling shareholder, excessive executive compensation, loan guarantees, expropriation of corporate opportunities, and so on. Second, the controlling shareholder can increase his share of the firm without transferring any assets through dilutive share issues, minority freeze-outs, insider trading, creeping acquisitions, or other financial transactions that discriminate against minorities. Here we focus primarily on the first kind of tunneling, but we mention the second at the end.

The laws of most countries prohibit certain kinds of tunneling. In assessing conduct, courts generally use two broad principles, which appear in all major legal systems. The first is duty of care, which in this context refers to the responsibilities of corporate directors (and applies to controlling shareholders insofar as they also serve as directors). The duty of care, derived from the Roman concept of *mandatum,* requires a director to act as a reasonable, prudent, or rational person would act in his position. In most countries, courts implement the duty of care using the "business judgment rule," which gives directors the benefit of the doubt when conflicts of interest are absent, unless the plaintiffs demonstrate willfulness or negligence on the directors' part. In the United States, for example, courts rely on the business judgment rule to protect transactions that provide nonmonetary benefits to insiders at the expense of outside shareholders (e.g., empire-building), decisions on executive compensation that are approved by a majority of disinterested shareholders, and most takeover defenses. Not surprisingly, these are the areas where the abuse of minority shareholders in the United States is perceived to be significant.

The second general principle is the duty of loyalty, or fiduciary duty, which specifically addresses situations with conflict of interest. This duty requires that insiders do not profit at the expense of shareholders, or of the corporation as the case may be, depending on whom they legally owe loyalty to. The duty of care may allow a transaction that benefits insiders at the expense of outside shareholders unless the latter can show that it does not have a legitimate business purpose and that its sole intent is expropriation. The duty of loyalty, in contrast, may statutorily rule out such self-serving conduct or invite the court to examine its fairness.

In common-law countries, the duties of loyalty and care are associated with very different standards of proof. "In the case of duty of care, there must be a requirement for exercising a certain amount of care, and when a director fails to exercise such care, he is considered guilty of negligence, whereas in the case of fiduciary duty, the very fact that the interests of a director are in conflict with those of the company itself constitutes the basis for liability, and if the interests of the company are prejudiced as a result of such conflict, liability for breach of fiduciary duty arises ..." (Mitsuko Akabori Shibuya, 1972 p. 127).

A further obstacle for a plaintiff attempting to prevail under the duty of care is the absence of a simple rule (e.g., maximize profits) to characterize the behavior of a "rational" manager. In the United States, the Delaware Supreme Court held that directors resisting a hostile takeover bid are protected by the business judgment rule if they show a threat to the "corporation" by considering the impact on "... creditors, customers, employees, and perhaps even the community generally" (*Unocal Corp.* v. *Mesa Petroleum Co.*). The interests of stakeholders play an even larger role in some Continental European countries (e.g., Germany) where insiders are not only allowed to take into account the interests of stakeholders, but *must* do so. In fact, in many continental European countries the interests of stakeholders are allowed to weigh in even in standard self-dealing cases. Of course, shareholders are less likely to obtain remedy where conflicts of interests are assessed through the lens of stakeholders.

There is another important difference between civil- and common-law countries. Regulating self-dealing behavior involves a basic trade-off between legal predictability and fairness. Civil-law countries emphasize the predictability of the law and rely on statutory rules to govern self-dealing behavior. They do so even though the formal statutory rules that are consistent with legal certainty may invite insiders to structure unfair transactions creatively so as to conform to the letter of the law. In contrast, common-law countries emphasize the notion of fairness, and as a result, the "... general fiduciary duty of loyalty is a residual concept that can include situations that no one has foreseen and categorized. The general duty permits, and in fact has led to, a continuous evolution in corporate law" (Robert C. Clark, 1986 p. 141). Precisely because the common-law notion of fiduciary duty is associated with a high level of judicial discretion to assess the terms of transactions and to make rules, it is at odds with the civil-law emphasis on legal certainty. As a consequence, while civil-law courts in developed countries can stop outright theft and fraud through the application of statutes, they find it more difficult to stop self-dealing transactions with a plausible business purpose.

A clear example of the reluctance of courts in civil-law countries to apply the principle of fairness broadly to corporate directors comes from Japan. After the war, the Americans introduced the concept of the duty of loyalty of directors into Japanese corporate law. However, "in considering whether there has been a conflict of interest, the Japanese courts have shied away from attempting any detailed analysis of the case ... . While it is clear that the American draftsman intended to import into Japanese law principles that would be recognized by any common-law lawyer as involving essentially fiduciary standards, this is certainly not the way in which the Japanese judiciary has proceeded. Their approach has been very much on the basis of commercial law and fair dealing rather than the need to eschew breaches of stewardship. Consequently, the law in Japan is very much more formal and, therefore, inflexible than in its common-law counterparts" (Chizu Nakajima, 1999 p. 51).

In sum, courts in civil-law countries may accommodate more tunneling than courts in common-law countries because of: (i) a narrower application of the duty of loyalty largely to transactions with no business purpose, (ii) a higher standard of proof in conflict-of-interest situations, (iii) a greater responsiveness to stakeholder interests, and (iv) a greater reliance on statutes rather than fairness to regulate self-dealing transactions.

II. Cases on Tunneling

In this section, we discuss several well-known cases of tunneling in Western European countries, which are generally taken by legal scholars as indicative of how the courts see the law.

1. *SARL Peronnet* (Corporate Opportunities [D. Schmidt, 1999]).—SAICO, a minority shareholder of SARL Peronnet, a French company controlled by the Peronnet family, sued the directors from the Peronnet family. The Peronnet family established a new company, SCI, solely owned by family members. SCI bought some land and took out a loan to build a warehouse. SCI then leased the warehouse to SARL Peronnet, which expanded its business and used the proceeds to repay the loan. The plaintiff argued that the Peronnet family expropriated the corporate opportunity of SARL Peronnet (namely, to build a warehouse) and thereby benefited itself at the expense of minority shareholders.

The court ruled against SAICO, on two grounds. First, it held that the decision by Peronnet to pay SCI to warehouse its products was not against the social interest, as evidenced by the fact that sales of SARL Peronnet expanded during this period. Second, the court held that SARL Peronnet's expansion had benefited SAICO as well. It could thus be argued that the decision to build a warehouse through SCI was not taken with the sole intention of benefiting the majority shareholders (i.e., the Peronnet family) and had a legitimate business purpose. Under French law, this was sufficient to rule against SAICO. The court took no interest in the questions of whether the creation of SCI, and the prices it charged SARL Peronnet for the use of the warehouse, were fair to SAICO and other minority shareholders. The court took a very particular interpretation of the effect of the deal on the minority shareholders of SARL Peronnet: as long as they have not suffered an actual loss, the business judgment rule protected the Peronnet family. In the United States and the United Kingdom, courts would be very suspicious of the conduct of the Peronnet family unless it could demonstrate that it closely mimicked an arms-length transaction through an independent valuation of the lease or approval by independent directors.

2. *Marcilli* (Transfer Pricing [Lorenzo Stanghellini, 1995]).—Marcilli, an Italian machinery maker, was 51-percent owned by its

controlling shareholder, Sarcem, a Swiss machinery maker, and 49-percent owned by two minority shareholders, Luigi Anguissola and Alberto Mignani (the plaintiffs), who sat on the board. Philip Bonello, the President and CEO of Sarcem, also became President of Marcilli in 1982. Shortly afterward, the plaintiffs resigned from the board, and sued Sarcem. They demanded a court inspection and intervention, since the absence of derivative suits made it impossible for minority shareholders to seek damages without the consent of Sarcem. The plaintiffs alleged that Sarcem, among other things: (i) precluded Marcilli from exporting its products directly, requiring that they only be sold through Sarcem; (ii) charged too high a markup for Marcilli products it resold, compromising Marcilli's market share and pocketing short-term profits; (iii) sold and exhibited Marcilli products under its own trademark; (iv) overcharged Marcilli for the services it provided such as costs of participating in international fairs; and (v) did not pay Marcilli for its goods on time.

The court declined to appoint a judicial investigator since it found that the influence exerted by the majority shareholder was consistent with a group policy, and therefore a well-defined and explicit business discipline could not be excluded. In deciding for Sarcem, the court focused on the duty of care, with two further twists favoring the defendant. First, the duty of Marcilli's President (Bonello) was to the group including Sarcem rather than to the shareholders of Marcilli. Second, since the issues involved day-to-day business transactions as opposed to explicit board decisions, none of the statutory rules governing conflicts of interest kicked in, because these rules only apply to resolutions of collective organs (shareholders' meetings or boards of directors). Again, no fairness test was used, and the court sanctioned tunneling from a company to its controlling shareholder through transfer pricing.

3. *Flambo and Barro* (The Plunder of Barro [Eddy Wymeersch, 1993]).—A French firm, Flambo, was the controlling shareholder in a Belgian company, Barro. Several significant minority shareholders of Barro (the plaintiffs) sued Flambo, arguing that it literally stripped Barro of its assets, and demanded judicial intervention and remedies. The plaintiffs argued that Flambo: (i) tried to pledge Barro (i.e., the whole company) as collateral to guarantee Flambo's debt; (ii) forced Barro to acquire all of the new shares of Flambo in a capital increase; (iii) withdrew a substantial sum from Barro's accounts without subsequent repayment; (iv) diverted an important contract with Rank Xerox from Barro to Flambo; and (v) made use of the utilities belonging to Barro without paying for them.

Since Belgium has no statutory rules relating to intergroup transactions, the court relied on the business judgment rule and held that Flambo's conduct was consistent with the interest of the group as a whole. The court pointed out that, in principle, it was not objectionable for a subsidiary to support its parent as long as the subsidiary itself was not in danger of bankruptcy. Fairness to the minority shareholders of Barro did not come up in the ruling, and while the court disallowed Flambo to continue transferring resources from Barro without judicial review, it did not propose any remedies for past expropriation or even a change in Barro's board. As in the previous case, the court took a broad view of the interests of the group rather than the subsidiary company and therefore (up to a limit) saw no problem with the tunneling of resources out of a subsidiary to the controlling shareholder.

In addition to tunneling assets, profits, or corporate opportunities, the controlling shareholder can expropriate minority shareholders through financial transactions, such as diluting their stakes through a closed subscription to new shares. Such transactions are relatively common in emerging markets, such as Russia. In Western Europe, the forms of financial expropriation are subtler. In one German case, a company avoided honoring its minority shareholders' preemptive right to a new issue of equity by raising capital in kind. In another famous case, Volkswagen, the controlling (75-percent) shareholder of Audi, bought out a small equity stake of a minority shareholder in Audi for 145 DM per share. The price was based on a valuation provided by Volkswagen. Two weeks later, Volkswagen bought out a very large (14-percent) stake in Audi from the British-Israeli Bank for 220 DM per share. The German Supreme Court refused to hear the complaint from the small shareholder on the grounds that the controlling shareholder did not owe any duties of good faith or loyalty to the minority shareholders. The court also agreed that Volkswagen was under no obligation to reveal its negotiations with the British-Israeli Bank, because such a revelation might have negatively affected the valuation of Volkswagen's shares.

III. Conclusion

In this paper, we use legal cases to establish four propositions. First, even in developed countries, tunneling—the diversion of corporate resources from the corporation (or its minority shareholders) to the controlling shareholder—can be substantial.

Second, much of the tunneling is legal (i.e., consistent with both the statutes and the basic principles followed by judges). Although some tunneling (especially in emerging markets) takes the form of theft or fraud, legal tunneling takes place in developed countries as well.

Third, such legal tunneling takes a variety of forms, including expropriation of corporate opportunities from a firm by its controlling shareholder, transfer pricing favoring the controlling shareholder, transfer of assets from a firm to its controlling shareholder at nonmarket prices, loan guarantees using the firm's assets as collateral, and so on. Tunneling can also take the form of financial as opposed to real transactions, dilution of minorities being the leading example.

Finally, we have identified some potential differences between civil- and common-law countries in how courts approach tunneling cases. In civil-law countries, the expropriation of minority shareholders by the controlling shareholder in a transaction with a plausible business purpose is often seen as consistent with directors' duties, especially if the controlling shareholder is another firm in the group. Self-dealing transactions are assessed in light of their conformity with statutes, and not on the basis of their fairness to minorities. In contrast, fairness to minority shareholders as a broad principle going beyond statutes is central to the analysis of self-dealing transactions by common-law courts, and the burden of proof in such cases is favorable to outside shareholders. (Perhaps the reason that pyramidal group structures are relatively rare in the United States and the United Kingdom is that many transactions inside a group would be challenged on fairness grounds by minority shareholders of subsidiaries, who would get a receptive hearing in court.)

These findings are broadly consistent with a growing body of research suggesting that civil-law countries are less protective of minority shareholders than are common-law countries. Moreover, these findings suggest yet again that it is the laws themselves, and the ways in which the courts apply them, that matter for real outcomes, including the extent of tunneling. Earlier research (e.g., La Porta et al., 1998, 2000; Johnson and Shleifer, 1999) has focused on statutes in describing the differences in legal systems. Here we find that, in addition, the application of general principles such as the duty of care and the duty of loyalty by courts may influence how firms in different countries organize and finance themselves.

Of course, one can argue that, while these elements of legal systems have stunted the development of stock markets in advanced civil-law countries, they have not had a major effect on economic development, as these countries have found substitute mechanisms of limiting expropriation and financing firms. This is surely true to some extent. Two points, however, are worth stressing. First, in recent years, the advanced civil-law countries, encouraged in part by a technology boom and in part by the flow of funds from foreign investors, have found it attractive to promote stock-market financing for new firms via legal reform. The creation of Neuer Markt in Germany and Nouveau Marché in France, with their greater protection of minority shareholders, illustrates this policy. Second, for less-developed countries, including those that suffered from the Asian crisis, the failure of the legal system may be very costly precisely because it accommodates vast amounts of tunneling. Using legal reform to reduce tunneling is then a crucial element of promoting financial and economic development.

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