PROBLEMS OF CREATING SHAREHOLDER VALUE IN GROUPS OF COMPANIES

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Abstract

Groups of companies play a significant role in the Polish economy. However, many of them do not increase their value. The aim of the article is to indicate the transfer of value as one of the reasons for value destruction in groups of companies. The legal aspects of the functioning of groups of companies are also presented. In Poland, the holding law will implemented in 2021, but it will not probably fully apply to listed companies. The reasons for and consequences of such treatment of listed companies were explained.

Keywords: parent company, transfer of value, destruction of value, groups of companies, horizontal conflict of interests.

1. Introduction

The problems of creating shareholder value will be presented in relation to Polish public companies listed on the Warsaw Stock Exchange. They generally function in groups of companies, often at the same time as parent companies in low-level groups of companies and as subsidiaries in high-level groups.

It is believed that compared to a single enterprise, a group of companies has more opportunities to derive benefits from its activities due to the economies of scale, scope and synergy. However, it turns out that in practice, there is also a destruction of value.

The aim of the article is to indicate the transfer of value as one of the reasons for value destruction in groups of companies listed on the Warsaw Stock Exchange. The transfer of value (the terms such as „transfer of profit", „tunnelling" will be used interchangeably) is one of the leading issues in the corporate governance literature. Looking at this phenomenon from the point of view of groups of companies will fur-

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ther show the determinants of this phenomenon, which are insufficiently discussed in the literature.

It's not just about drawing attention to the losses that minority shareholders in subsidiaries face. Companies that are subject to the transfer of value are undervalued by the market, as a result of which their ability to raise capital through the issue of shares is limited. This negatively affects the development of the capital market as does the weakening of the investor confidence in companies in which the transfer of value takes place (Postrach, 2015).

2. Efficiency of groups of companies

The reasons for forming, and the objectives of operating, groups of companies are multiple. As already indicated above, they come down to benefits that are impossible or unprofitable to obtain by a single enterprise (Trocki, 2004). Groups of companies should therefore have higher efficiency than individual enterprises. However, it is very difficult to demonstrate this not only with respect to domestic groups, due to (Aluchna, 2009):

— lack of access to data that would make it possible to compare the efficiency of a group of companies and companies operating individually to the required scope,
— difficulties in ensuring the comparability of results; meeting this condition requires the selection of such individual companies that are comparable to particular companies forming part of a group of companies (in terms of internal characteristics and the environment in which they operate).

The first comprehensive study of economic efficiency of groups of companies in Poland was conducted for 21 construction groups of companies listed on the Warsaw Stock Exchange in the years from 1996 to 2004 (Trocki and Subda, 2010). The study shows that construction groups of companies led to the destruction of value both in accounting terms (based on net profit and cost of equity) and in market terms, calculated on the basis of TSR (total shareholder return). Only one group achieved a positive average annual residual return (Trocki and Subda, 2010).

On the other hand, the study conducted by A. Aluchna (2007), which included non-financial companies listed on the main market of the Warsaw Stock Exchange in the years from 1997 to 2002, showed that in terms of efficiency calculated based on ROE, companies not belonging to a group were more efficient in this respect than those forming part of a group.

Companies forming part of a group are characterised by a concentrated ownership structure. The parent company in the group the performance of which was evaluated was also a subsidiary in the group of its dominant shareholder (most often an industry shareholder)[2]. It was able to take advantage of its position to make

[2] We can therefore say that groups of companies have multi-level (pyramid) structures.

a transfer of profit. This may have had a negative impact on the efficiency of the study groups. This is one of the reasons that explain the results of the study relating to the excess return on equity presented in Table 1.

Table 1. Return on equity and excess return on equity in the companies included in the study

Year	Median ROE (%)	Median ROE_{-CE} (%)	Structure of companies by the level of excess return on equity (ROE_{-CE})		
			<– 10%	–10–0%	> 0%
2004	6.3	–6.2	36.2	25.9	37.9
2005	4.8	–5.0	35.6	26.3	38.1
2006	9.3	–1.8	22.3	29.8	47.9
2007	9.4	–1.8	18.9	41.0	40.1
2008	5.4	–7.4	40.2	35.3	24.5
2004–2008	7.3	–4.2	30.6	31.7	37.7

Source: Szewc-Rogalska, 2012, pp. 223–224.

The excess return on equity (ROE_{-CE}) is calculated, among other things, based on the rate of return expected by shareholders, i.e. cost of equity (C_E). Seen from this perspective, the excess return of equity is a relative approach to a simplified form of economic value added (EVA), i.e. economic return for owners based on net profit (Szewc-Rogalska, 2012).

The study analysed 124 non-financial companies listed on the Warsaw Stock Exchange for at least 5 years. The presented data show that in the analysed period, only a small percentage of companies had a positive excess return on equity (from 24.5% to 47.9%). Most of the companies led to the destruction of shareholder value in accounting terms (Postrach, 2015).

However, it should be noted that the performance of listed companies as subsidiaries is adversely affected not only by the transfers of profit as a result of both the abuse of position by the dominant shareholder and certain actions taken by the parent company to optimise the performance of the group by exploiting the economies of scale, scope and synergy, categorised as private benefits of control.

3. Destruction of value in groups of companies

The problem of the transfer of profit at the expense of minority shareholders concerns groups consisting of private companies to a much lesser extent. The reason for that is a small number of owners, which means that they do not have the same problem of agency between the controlling shareholder and minority shareholders as listed companies. Subsidiaries are often wholly owned by the parent company; the transfer of value taken together is therefore of little or no benefit to the parent company.

The transfer of profit, on the other hand, is one of the main issues discussed in relation to corporate governance in public companies. In such companies, conditions are favourable for the dominant shareholder to take advantage of its position at the expense of other shareholders. This problem is referred to as the horizontal agency problem. The vertical agency problem, which occurs in enterprises with dispersed ownership structures, generally does not affect groups of companies, as it involves a conflict of interest between weak owners (shareholders) and strong managers (Roe, 2004). It was previously formulated as part of the classical agency theory.

There is a reason to believe that such transfers are not an isolated phenomenon. One of the CEOs of Michelin argued at a meeting with investors in France that the profits of the parent company are of the utmost importance and all subsidiaries, including those located abroad, should work for those profits. Therefore, he advised to buy only the shares of the parent company. For this reason, foreign analysts responsible for the management of assets after some strategic investors have entered Polish companies often delete them from their investment portfolios (Jarosz, 1999). It is worth mentioning that Stomil Olsztyn had to make additional payments in the amount of PLN 222 million to its dominant shareholder, Michelin, in the years from 1997 to 2000. It was only after the intervention of financial investors that Michelin delisted Stomil as a result of a tender offer for shares at a price satisfactory to shareholders (Postrach, 2015).

The transfer of value takes place in different ways. The most common type of transactions is self-dealing, e.g. when a controlled company buys assets from its controlling shareholder at inflated prices or sells them to the controlling shareholder at lower prices or pays various unjustified or excessive fees to the controlling shareholder. These are examples of typical transfer methods, but there are also more sophisticated ways of obtaining private benefits of control such as overvalued contributions in kind. As a result, tangible benefits are obtained at the expense of other shareholders because the overvaluation of the contribution in kind allows the dominant shareholder to acquire a greater number of shares than it would be possible based on its actual value (leveraging of control). Such a transaction is also carried out in the form of hidden contributions in kind (Postrach, 2014).

Groups of companies that intend to gain control by leveraging votes in relation to capital commitment, adopt a pyramid structure. This structure is most often

associated with the transfer of profit from a given company to its controlling shareholder, which is also known as „tunnelling" (Postrach, 2012). However, this does not mean that the transfer of profit occurs in every group of companies with a strategic industry investor, but it is difficult to ignore it when analysing the causes of the destruction of value in such groups. The level of capital commitment ensuring the control of the company may be an indicator. The lower it is (also as a result of the above-mentioned leverage), the more likely the transfer of value is to occur.

The study on the efficiency of the above-mentioned groups of companies operating in the construction industry (Trocki and Subda, 2010) revealed the destruction of value. In practice, it could have been higher; the study was based on consolidated results, which did not include the aforementioned transfers due to the obligation to exclude internal transactions. The most common way to transfer value is for the controlling company to force the controlled company to buy or sell assets at unfavourable prices. The equivalent of such transfers in the construction industry is a construction contract in which the subcontracting company, as the parent company, sets the terms of the contract that deviate from market conditions in favour of this company (Postrach, 2015)[3].

4. Dilemmas of the creators of the Polish holding law

In 2021, the Code of Commercial Companies is to be amended by introducing the regulation relating to holding law (law of groups of companies). The draft amendment to the above-mentioned Code has aroused controversy not only among experts in commercial law but also among the members of the Association of Individual Investors, who submitted an opposition to the Ministry of State Assets (SII, 2020). Therefore, it is worthwhile to present the causes of controversies that arise in relation to such an important amendment of the Commercial Companies Code.

In the model view, a group of companies should be mutually beneficial to the parent shareholder and the subsidiaries. After all, they can pursue common market goals, accelerate technological progress, disperse investment risk, and achieve synergies. However, in practice, the distribution of these benefits is sometimes uneven – it is more beneficial for the parent company, bringing harm to the subsidiary, its other shareholders and creditors (Jeżak, 2010). We are facing dilemmas arising from the autonomy of members of a group of companies. The doctrine of law orders each of them to be guided by its own interest, when at the same time sometimes it does not coincide with the interest of the group of companies. The autonomy of the interest of the company leads to „paralyzing" the concept of the group of companies as a single economic entity (Romanowski, 2010).

[3] A transfer involving the purchase of worthless receivables by Polnord, which was controlled by Prokom Investments, from that company for nearly PLN 73 million a few years ago caused a sensation in the construction industry.

It is difficult to define what the interest of a group of companies is, unless one assumes that it is the interest of the dominant company (the PCCC mentions the interest of the company, but does not say what the interest of a group of companies is). But then this will be unacceptable for listed companies whose ownership structure must include minority shareholders (this is due to the nature of a listed company) exposed to profit transfers. At the same time, it points to the need to legalise the actions of a dominant shareholder, which, although they may be detrimental to the subsidiary and its minority shareholders, are justified from the point of view of the interests of the group of companies. This is because the parent company strives to optimise the group's results by taking advantage of economies of scale and synergies, which may involve acting to the detriment of its subsidiaries. This means that the objectives of the parent company are broader than those of the minority owners of the subsidiaries, whose objective is to maximize the return on capital invested in the subsidiary. (Postrach, 2013).

It is therefore necessary to define in the holding law the permissible scope of interference of the parent company in the activity of subsidiaries, which, after all, from the formal point of view are independent legal entities and should be guided by their own interests. These will be important determinations because they will affect how the company is managed within the group and thus the operation of subsidiaries where minority shareholders are exposed to profit transfers (Postrach, 2012).

The draft holding law was based on the concept of an economic holding company. In the light of the economic concept, a capital group is a single economic organism aimed at achieving the objectives defined for the entire group and its individual members by the parent company (Romanowski, 2008). This prescinds from actions that may be detrimental to the subsidiary, while the focus is on the benefits that accrue from group integration activities.

As the law currently stands, companies forming a group of companies are treated in the same way as companies that do not belong to it. Members of management boards and supervisory boards of subsidiaries are formally obliged to take actions beneficial to the companies in which they perform their functions under pain of civil as well as criminal liability. Consequently, such regulations lead to (Postrach, 2013):

1. Depriving the parent company of the ability to conduct centralised management of the group of companies and to fully implement the group's strategy if its implementation requires taking actions that are detrimental to a subsidiary[4].
2. Depriving members of the bodies of subsidiaries and parent companies of legal security. As R. Kwaśnicki points out, members of the bodies of subsidiaries often balance between the risk of incurring civil or criminal liability and the need

[4] We omit here the fragmentary holding law regulation contained in Art. 7 of the Commercial Companies Code, which refers to the so-called holding agreements [Act of 15 September 2000].

to implement the policy of the holding company, including the instructions of the parent companies (Kwaśnicki, 2011). When they carry out such instructions, which are disadvantageous for their companies, we are dealing with a situation detailed in the paragraph below.

3. Exposing the creditors of the subsidiaries and their minority shareholders or partners to damage that is impossible to compensate in practice (Kwaśnicki, 2011).

For the reasons given above, the development of the law of groups of companies was undertaken. Its two primary functions are mentioned, i.e. protective and organisational function (Staranowicz, 2009). The protective function is to safeguard the interests of the entities involved in the concern from concern threats (Domański and Schubel, 2011). This protection applies to the subsidiary, its creditors and its minority shareholders. The organisational function, on the other hand, means „the creation of a legal framework that enables efficient management and legally secure organisation of legal relations in a group of companies" ([Domański and Schubel, 2011). In this case, it is about protecting the parent company, the members of its bodies, and the group itself. According to T. Staranowicz (2009, p. 393), „the essence of this function is, in contrast to the protective function mentioned above, to base the regulation on provisions that provide greater protection for the interests of the parent company than is the case for a typical company. This is to enable the parent company to effectively manage the group of companies. This will be possible when legal security of this company and its bodies is ensured."

The draft holding law focuses on the organisational function at the expense of the protective function. According to A. Opalski (2020), the main shortcoming of the draft holding law consists in the maintenance of virtually unlimited possibilities of interference by the parent company in the property substance of subsidiaries, as the orders were connected with a blanket exclusion of civil and criminal liability of managers of subsidiaries for their execution.

There has also been criticism of the misuse of the Rozenblum doctrine, which, in a nutshell, means the need to balance the conflicting interests of participants in a group of companies. Meanwhile, the draft provides that a manager of a subsidiary may refuse a binding instruction only if there is a justified concern that the parent company will not remedy the damage within two years of the damage occurrence. This is an unrealistic requirement because it is hard to assume that the managers of a subsidiary can predict the parent company's conduct in this regard.

The specific nature of companies listed on the Warsaw Stock Exchange (which has already been mentioned), to which the provisions of the discussed draft do not apply, should be pointed out. For example, the conditions that must be met in order for a subsidiary to refuse to comply with a binding order of the parent company should be considered too far-reaching. This refers to damages that threaten the continued existence of the subsidiary. In such a situation, profit transfers can be successfully implemented as long as they do not threaten the continued existence of

the subsidiary, although they will cause damage to its minority shareholders. Even if the conditions for refusing to carry out a binding order of the parent company are present, in practice it will be difficult to count on the refusal to carry out the order as the composition of the subsidiary's bodies is dominated by persons representing the interests of the parent company. A member of the parent company's management board is aware of the consequences of refusing to comply with such an order in the form of dismissal.

It is true that a shareholder of a subsidiary may bring an action for damages caused to it by the parent company, although it should be acknowledged that in practice it will be used to a strongly limited extent, as is currently the case with a similar provision of Art. 486 of the Commercial Companies Code. This is because the inconveniences associated with bringing an action outweigh any potential benefits, which can be accrued only by the company anyway (by shareholders only indirectly). The phenomenon of „fare dodging" also applies here.

In the opinion of the Association of Individual Investors, the introduction of such regulations strikes at minority shareholders and will also significantly limit the future possibility of raising capital by entities operating within the structures of groups of companies. It would be difficult to expect investors to finance the development of entities whose management boards, thanks to the tools provided for in the drafted provisions of the Commercial Companies Code, would be able to act to their detriment without being held liable for any damage caused. Moreover, banks or contractors may potentially refrain from financing such entities in a situation where the regulations provide for and allow in a legally constituted manner the possibility of causing them damage. According to the Association of Individual Investors, this may significantly affect the development of very many companies in Poland, including public companies operating within groups of companies, and indirectly, it may strike at the interests of the national economy. The objection of the Association of Individual Investors relates to the intention to introduce a solution under which a parent company within a group of companies will be able to issue a binding instruction to a subsidiary with respect to the conduct of its affairs. According to the Association of Individual Investors, this means that minority shareholders can be harmed while providing a „protective umbrella" to those who cause that harm. At the same time, these regulations do not guarantee sufficient tools to remedy the damage done to minority shareholders (SII , 2020). The Polish Association of Listed Companies also formulated a similar opinion.

As a result of these critical voices, a significant change was made in the latest version of the draft holding law in the scope of subject matter by excluding the application of the provisions on groups of companies to public companies that are subsidiaries (in practice, this means listed companies). The exclusion of public companies as subsidiaries from the operation of the proposed legislation should, in light of what has been said above, be considered a fully justified change. However, this means that

the issue of liability for damages and criminal liability of board members of listed subsidiaries for the implementation of the holding company's policy will still remain to be resolved. In this case, it is primarily a policy justified by the interests of the holding company, the implementation of which may cause damage to the subsidiary in the short term, but in the long term, participation in the group of companies will be profitable for it.

5. Summary

Companies listed on the Warsaw Stock Exchange are generally subsidiaries. The problem is that in addition to transfers justified by the parent company's optimisation of group results through the use of economies of scale, scope and synergies included in private benefits of control, there is an abuse of position by the dominant shareholders in listed companies, as subsidiaries, as a result of which minority shareholders of these companies are exposed to losses. From an economic perspective, those transfers that result in profits for foreign entities should be considered particularly harmful.

There was a fundamental change in the Commercial Companies Code – the law of groups of companies (holding law) was introduced. Constructing this law in such a way as to satisfy all stakeholders equally was downright impossible. That is the source of the criticism from the investor and legal communities. The chairman of the team that drafted the law of groups of companies and one of the co-authors of the Commercial Companies Code stated that „various conflicting interests are concentrated in a group of companies, i.e. interests of the parent company, the subsidiary, the minority shareholders of the subsidiary, its creditors, as well as its managers, i.e. members of the management and supervisory boards of the subsidiaries. These contradictions make it possible to „write" different holding laws, e.g. in favour of parent companies to ensure their efficient management of groups of companies, or in favour of subsidiaries to protect them, then their minority shareholders as well as the managers and finally the creditors of a given company"(Szumański, 2020).

The opinions cited earlier suggest that the holding law was „written" exceedingly in favour of parent companies. With respect to listed companies, which are often subsidiaries, this treatment was unacceptable and the inclusion of these companies in the latest version of the draft was ultimately dropped.

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PROBLEMY TWORZENIA WARTOŚCI DLA AKCJONARIUSZY W GRUPACH KAPITAŁOWYCH

Streszczenie

Grupy kapitałowe odgrywają dużą rolę w polskiej gospodarce. Okazuje się jednak, że wiele z nich nie powiększa swojej wartości. Celem artykułu jest wskazanie na transfer wartości jako jedną z przyczyn destrukcji wartości w grupach kapitałowych. Zaprezentowano także aspekty prawne funkcjonowania grup kapitałowych. W Polsce od 2021 roku będzie obowiązywało prawo holdingowe (prawo grup spółek). Prawdopodobnie nie będzie dotyczyło w pełni spółek giełdowych. Wyjaśniono powody oraz konsekwencje takiego potraktowania spółek giełdowych.

Słowa kluczowe: spółka dominująca transfer wartości, destrukcja wartości, grupy kapitałowe, horyzontalny konflikt agencji.