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The Governance of Corporate Groups

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Introduction

We propose a sociological approach of corporate groups governance. Corporate groups are sets of legally separate firms owned by the same decision maker. These last years, enterprises have increasingly chosen to organize and conduct their business operations in the form of a cluster of various separate corporations, rather than as a single corporate entity. Corporate groups dominate the economies of many developed countries, they are worth considerable attention. But since component firms are legally separate and corporate groups have no clear legal status in a lot of countries, their study is difficult. Corporate groups can be invisible. Moreover, the literature is highly focused on the idea of the corporation as an autonomous unit.

The aim of this paper is to further our understanding of this organizational structure. How to characterize the link between parent company and subsidiary ? What is the nature of corporate groups ? Why does this form emerge ? "Understanding business groups is a special case of a central problem of modern sociology : what determines the scope of relationship in which individuals and larger social units engage." (Granovetter, 2005)

In corporation law, corporate groups can be analysed as a model living under a typical separation between ownership and control. But this perspective is not satisfactory. Unexpectedly, we observe that subsidiaries can be integrated units or, conversely, can be autonomous.

Our aim is to show the complexity of this organizational form. We propose to consider corporate groups as hybrid structures where there is an unification rather than a separation of ownership and control. The parent corporation appears to be simultaneously the owner and the manager of the subsidiary. This analysis is based on two arguments. First, the parent company can take advantage of an open range of prerogatives vis a vis its subsidiaries. This is a continnuum of governance between autonomy and control. Secondly, all corporate groups face management dilemma. It is an evidence of tensions or contradictions between diversity and unity.

We conclude that the corporate group is a flexible structure, an "ambivalent" structure, capable of adjusting its behavior to various conditions. This form has developed new ways to mobilize resources, complete complex tasks... The great empirical significance of this structure may be explained by this potential flexibility.

Our analysis is based on eight case studies including French and international groups. We interviewed managers and executives both within parent company and subsidiaries[1].

This paper is composed of three sections : firstly, it focuses on the "positions of governance". The second part considers groups as hybrid structures : there is a continuum of governance. Finally, we see that all groups face management dilemma concerning, for example, transfer prices, parent company liability... On the whole, we try to characterize the relations between firms in corporate groups.

1. "Positions of governance" : autonomy versus control

The traditional model of the firm is that of the large public corporation (Chandler, 1977). This firm is owned by numerous powerless shareholders and governed by independant managers

[1] Our analysis is based on groups and subsidiaries implanted in France and, thus, regulated by french law : our thoughts dependent on it.

(Berle and Means, 1932). This strucure is characterized by the separation between management and ownership. Thus, the archetype of the corporation is the “single firm”.

In a corporate group, the parent company is the dominant shareholder. And the governance structure could be marked by the separation between ownership and management. But, in our case studies, we observe that parent company can have contrasted behaviors. Group phenomenon is extremely heterogeneous. From our observations, we wish to sort out some references for analysis. Our aim is to draw a “cartography of corporate groups”. The first point is the split between control and autonomy. In this respect, autonomy and control are the two sides of the same phenomenon : the power in corporate groups ; not only legally, but also from an organizational point of view. Indeed, parent company can keep its control just to the minimum level of intrusion on subsidiaries business. Inversely, it can tightly monitor all subsidiaries business activities. Thus, there is two opposite positions : the parent company can be loosely or strongly engaged in their subsidiaries.

In integrated groups, the parent company intervenes extensively in the entire business activity and management of its subsidiaries. The dominant corporation can supervise all fields of group life because, as a rule, the firm owns the totality of the equity capital of the subsidiary corporation. First, the parent corporation draws up strategic plans. Strategic and financial decisions are centralized by the top management. But also, choice of technology, information systems, marketing policies are under control of the dominant firm. Subsidiaries have no autonomy : affiliated corporations “ratify” and implement the parent projects. The aim is to standardize and homogenize group functioning. In order to achieve this, the parent company uses management tools such as contracts, procedures... These are mechanisms of coordination and control. By integrating its subsidiaries, the firm alleviate legal, geographic separations. In this case, the interests of the parent company and those of the subsidiaries are the same. In this

type of structure, intragroups relationships are not the major problem : the central question is that of tensions between centralization and decentralization, center and periphery.

In these integrated groups, various subsidiaries profiles can be pointed. First, we find some vertically integrated subsidiaries. Subsidiary integration can be explained by its integration to the production cycle. Relations between units are “customers/ suppliers”. Subsidiaries can have different functions :

- specialized, in production or commercialization,
- general : in this case, subsidiaries are “replicas” of the parent company for a market or a country.

In the second place, we find “binded subsidiaries”. Actually, the subsidiarization can be an obligation for legal or commercial reasons. For example, local laws can oblige multinational groups to create subsidiaries : the subsidiary is a legal declension of international development.

In autonomous groups, the subsidiaries are considered as actual firms : the parent company does not constrain the daily functioning. The affiliated firms enjoy a high level of self determination in the conduct of its own business. In fact, the group of corporations applies its legal rights. The first is the voting right. Thus, the dominant firm can choose subsidiaries corporate executives in general assembly. This right has a noteworthy consequence : the parent company can indirectly influence subsidiaries’ strategies. For instance, the parent company pays a detailed attention to subsidiaries activities, resources, investments... As a dominant shareholder, the parent company has aslo the right to be informed. Headquarters request all financial, commercial... information. This means that subsidiaries have to do a regular reporting. Finally, we can say that the parent company pilots subsidiaries, but does not control them. The group sets targets to its subsidiaries but their functioning remains “a black

box" for the parent company because results are audited a posteriori. In these groups, affiliated firms are independent in choosing their suppliers, in recruiting their employees, in adopting their own internal organization... The affiliated company is the guarantor of its activity, of its economic viability...

In autonomous groups, several subsidiaries profiles can be sorted out. The first is a non-strategic subsidiary, also called 'spin-off'. In this case, subsidiarization offers a lot of advantages. The group confines economic risks in a new independent entity and the subsidiary enjoys the group support regarding financial, commercial operations. The second profile is that the subsidiary whose core competence, or activity in general, is very different from that of the group. This group is called 'conglomerate'. In conglomerates, subsidiaries are independent and the only link is financial because productive logic, markets... are very different. Conglomerate groups have the advantage of being present on contracyclic markets. The 'multidivisional subsidiary' is the last profile. This subsidiary is similar to the traditional M-form (multi-divisional form) where centralized control exercised by top management is combined with far-reaching decentralization granted to group sub-units or 'profit centers.'

To sum up this part, we propose the following diagram :

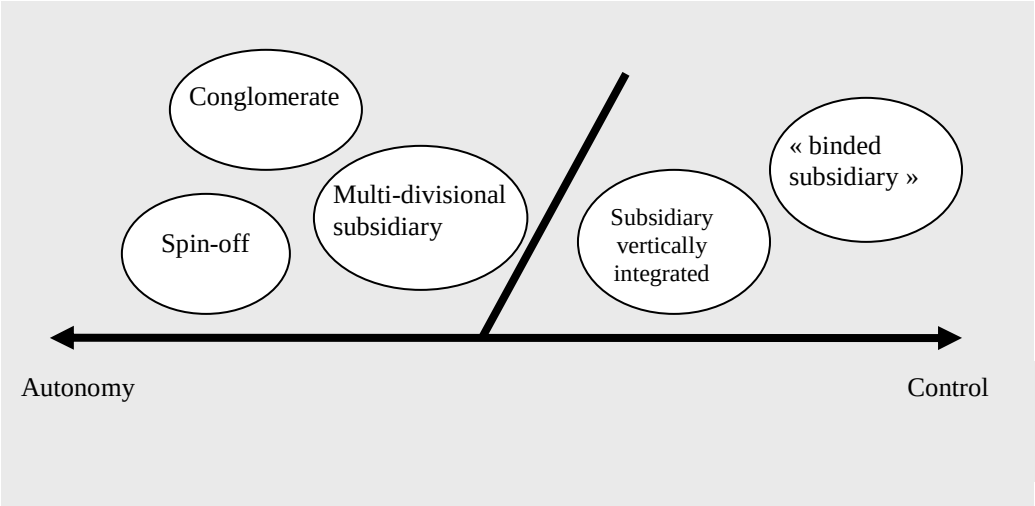

Table 1. Two polar forms of governance and subsidiaries profiles

2. The continuum of governance

Autonomy and control are lying at the ends of the organizational spectrum. But, these situations correspond to theoretical or polar cases. There are probably no fully integrated or autonomous groups. Actually, a situation of total autonomy is impossible because it is incompatible with the centralization imperatives imposed by the existence of unified management. Also, a situation of full control by the parent company is also completely impossible both on practical and legal grounds.

For a better understanding of parent-subsidiary relationships, we propose to consider that autonomy and control constitute an organizational continuum. In this regard, the parent company can take advantage of an open range of prerogatives vis a vis its subsidiaries. We observe that subsidiary dependency is complex and nuanced.

From our interviews, we have built six levels of involvement of the parent company in subsidiary activites : the financial link, the strategic control, the control as a preemption right, the creation of 'common spaces', the managerial control and the organizational integration. The result is the following diagram.

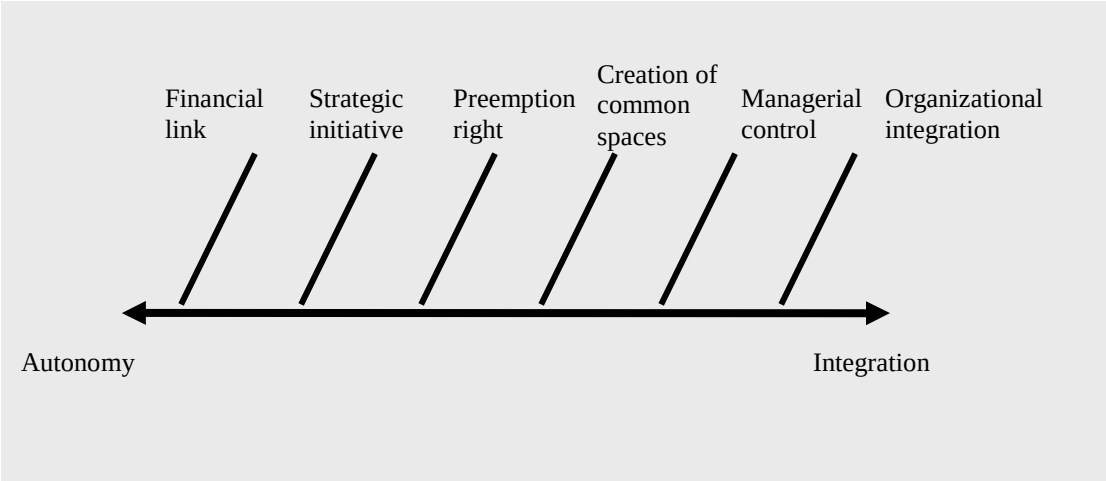

Table 2. The continuum of governance

In corporate groups, the minimum link is financial. The parent company plays only its shareholder role. Thus, the dominant firm applies legal rights – voting right, information right...

The strategic control represents an additional step : the parent company involvement is more extensive. Headquarters have the possibility to choose activities fields of subsidiaries and to allocate resources. They take an interest in the strategic or budgetary planification, investments, markets targeted, group boundaries...

In other situations, the parent company can infer in subsidiaries business : it is a preemption right. This is particularly true concerning transfer prices or relationships between subsidiaries and external firms. Therefore, the financial link allows the parent company to prescribe its choices.

Another control level is the creation of 'common spaces' concerning taxes, labor markets... For example, in France, there are agreements to integrate subsidiaries for taxes or accounting ('convention d'intégration fiscale', 'convention de trésorerie'). About labor market, the parent company can encourage intragroup mobility.

But the control of the head office can go even further with the managerial control. In this case, the parent company manages information system, quality devices, meetings planning...

Then, at the right-hand extremity of our continuum, we find organizational integration. The parent company behaves as if subsidiaries were integrated divisions. There is an unification, rather than a separation, of ownership and control : the parent company is not only the owner but also the manager of the subsidiary. In our case studies, we observe two clues of this situation: the subordination of subsidiaries'managers and the equivalence between organizational structures (subsidiary and parent company have a similar structures, similar flowsharts).

The interest of this continuum is twofold. First, it shows different ways of governing. Secondly, it allows to think strategies variations as movements on the continuum. Indeed, the parent company has the possibility to change its position depending on circumstances - economic environment, “economic health”... Groups constantly change their positions in the continuum : corporations “balance” between autonomy and control.

3. Management dilemma

The core problem of corporate groups is identified as being the tension between unity and diversity, between control and autonomy. The hybrid governance has consequences on groups management. Corporate groups face management dilemmas, which are evidence of complexity and difficulties to govern these organizational structures. We now consider two examples. We begin with the question of transfer prices : what is the ‘medium’ which govern them, the market or the hierarchy ? In the second place, we mention the liability problems : what connections between power and liability ?

- Transfer prices : hierarchy or market ?

In corporate groups, competition can be considered at two levels : first, subsidiaries can compete with each other. Second, they can face competition from the outside. We want to understand prices mechanism : who is in charge of pricing ? Can a subsidiary refuse a transaction ? How are the conflicts managed ? ...

Financial managers point that the transactions between affiliated companies are based on market prices. However, beyond this formal discourse, we quickly realize that several nuances have to be taken into account. First of all, these prices are negotiated between parent company and subsidiaries’managers. These discussions often generate opposite interests and conflicts

between firms'managers; everyone trying to take advantage. In these bargainings, the parent company acts as decision maker in last resort. Moreover, if a subsidiary has economic troubles, the parent company can decide to "freeze" prices for a certain period of time. So, a subsidiary's future can depend on the parent company's appreciation.

Subsidiaries are not necessarily free to trade with external firms. When transactions are considered as strategic by the parent company, it can choose the trade partner and impose it : the subsidiary is a "captive partner". So we state the difficulties to conciliate the collaboration and the management of antagonistic interests.

Every transfer pricing policy has purposes : transfer prices enables the head firm to shift profits to its subsidiaries. Therefore, affiliated firms are considered as cost center or profit center ; the parent company being the decision maker.

We conclude that the determination of transfer prices is a prerogative used by the parent company as a preemption right. Therefore, these prices are nothing but the result of a power game, ultimately led by the parent company. So, this mechanism is not a mere problem of resources allocation as argued by some economists. *"Even if the managers of the parent company believe in the market, they do not let the invisible hand operate"* (Bouquin, 2001). As a stockholder, the head company can monitor transfer prices. Although the parent company "fakes" a free market, organizational mechanisms actually govern intragroup relations. *"The group looks like a sort of internal or organized market, where a permanent manipulation and reallocation of resources of different affiliates is being carried out by the parent corporation with a view towards maximizing investment return and exploiting the best business chances"* (Engracia Antunes, 1994).

- Corporate groups : power without liability ?

Enterprise activity is risky. The firm constitutes an independent legal entity, with its own rights and duties, with it own assets and liabilities. This means that the corporation is a corporate body. But corporation law is, in fact, the law of the individual corporation.

Moreover, it is necessary to know that french law contains some legal provisions regarding a few fragmentary aspects of groups, which nevertheless cannot be viewed as a global regulatory framework for such phenomenon. Innovation on the topic is coming from other branches of law – labor law, tax law...

Nevertheless, since the beginning of last century, some enterprises have evolved as corporate groups. Nowadays, corporate groups are a central facet of capitalism. This mutation in the organization and structure of the modern enterprise has introduced a gap between the law and reality. Indeed, the area of corporate liability, or more precisely the way to deal with liability issues, in the context of parent-subsidiary relationship, has to be adapted.

We have seen that the parent company is the decision maker in a lot of cases but, the corporation law restricts its liabilities because each corporation, in the group, is an autonomous and separate entity. Even when a subsidiary owned by another corporation and is completely integrated, classical corporation law still insists on the formal autonomy of the affiliate corporation.

In French law, it is the concept of "group interest" which has called our attention. This concept is a jurisprudence creation, which allows group managers to favor group interest at the expense of subsidiaries interest. Thus, group interest transcends the corporate body. It is particularly true concerning 'l'abus de bien social[2]'. Thus, since thirty years, the jurisprudence acknowledges the group phenomenon. But in some cases, the recognition of group interest

[2] 'L'abus de bien social' correspond to abusive or fraudulent behavior of parent company.

also permits to prevent from the risk of 'confusion de patrimoine[3]' : the jurisprudence reasserts the separation between entities. The negation of corporate body is rare.

The organization of the modern enterprise allows to "switch off" the power and the liability. The law ignores actual dependency links. In this regard, the corporate body is a tool to divide up and to border economic risks.

Conclusion

In conclusion, we ask why firms adopt the organizational form of groups rather than some other form and what are reasons of their emergence.

There is many variations in the way groups of corporations are constructed. Group can emerge out of a single firm that acquires firms by diversification or by specialization. Groups can also emerge out of a single firm that spins off multiple subordination firms. Regarding the emergence of corporate groups, there is no singular and general theory. Previous studies have focused on three theories : market imperfections, cultural heritage and political economy. In economics, corporate groups emerge in response to economic problems : alleviate transaction costs, reduce agency problems... Cultural explanations establish a connection between the family, value system... and the rise of groups. Another set of theories focuses on the political economy of societies. These explanations suggest a connection between the emergence of groups and national model of buisness.

We consider that the specificity of corporate groups consists in the conduct of a business through extremely flexible governance and action structure. Groups can be an avatar of modern organizational forms : its structure permits to exploit many advantages. Organizationnally, groups can "balance" between centralization and decentralization. Groups can also change their position of governance. Thus, the parent company can, not only manage

[3] 'La confusion de patrimoine' is characterized by abnormal flux between two legal persons.

subsidiaries business, but also its liability is not necessarily engaged. Their specificity may explain their central role in capitalist economies. The flexibility of corporate group becomes particularly evident if one reflects on the evolution of organizational forms from an economic-historical viewpoint. This starts with H-form (holding form), a loosely organized firm, it then evolves into the U-form (unitary form), a tightly controlled firm and it reaches the M-form (multi-divisional form), where centralization is combined with decentralization in the divisions. In this regard, the corporate group would be the most effective hybrid form.

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