Theory of Contractual Subordination: Insights and challenges imposed by the existence of a shadow controller.

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Abstract

The takeover of a company is one of the most important tools to create business groups and gain market power. Therefore, acquiring a business outlines several challenges, not only for the parties involved in the transaction, but also to the market and the economy. Those are some of the reasons for the existence of anti-trust and business integration regulations. Nonetheless, legal tools created for the protection of the market and stakeholders involved in a change of control transaction, are useless in cases of the so-called "Contractual Subordination Theory" where the controller is unnoticed or, alternatively, is a shadow controller. This research project contrasts the meaning of a "controlled entity" under the United States and Colombia's legal system. In doing so, this investigation sheds lights on the importance of the concept of "Contractual Subordination" since this theory can be labeled as a takeover method that potentially avoids the enforceability of regulations and procedures that were created in order to protect the market and the parties involved in a change of control transaction. Finally, this research then considers several challenges that the figure imposes with respect to the Colombian law, and some possible legal instruments that can be used by Colombian authorities to address the threats created by the theory.

Keywords (5)**:** Change of control, business groups, shadow controller, stakeholders, anti-trust.

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I. INTRODUCTION

In the global economy, the takeover of companies represents one of the main mechanisms to be used in order to increase the dominant position in a specific market. Consequently, legal systems around the world have developed at least three traditional methods in order to acquire or takeover another entity: 1. Stock Purchase Agreements (SPA); 2. Assets Purchase Agreements (APA) or 3. Merger Agreements. Each of these takeover methods has different consequences and legal regulatory procedures which differ in several respects. For instance, in an SPA the acquiring company seeks to acquire the majority of the shares with voting rights from the target company, with the purpose of achieving control over the decision-making process in the company. Whether the chosen method is any of those previously cited, all agree on the result of increasing the dominance position held in a given market. Hence, the anti-trust authorities have developed legal instruments to study and analyze the possible negative effects that a takeover transaction may cause in the market, since a dominant position can be reached with the acquisition that, in the end, leads to an abuse of the dominant position in the market.

In light of the foregoing, despite the anti-trust authorities have developed various legal and control instruments for business integrations to prevent abuse of dominant position in the economy (for example, the need to notify the corresponding transaction), the reality is that there is another mechanism to takeover companies and create business groups, without the need to use any of the acquisition methods mentioned in the previous paragraph. This method is the figure under study in this investigation: "Contractual Subordination theory." Throughout this research, the reader will be able to identify some doctrine and academic opinions as to the figure (specially in Chapter I and II), however, it is material to note there is just a few comments regarding the theory in the academy nowadays; thus, this research project represents one of the firsts academic works to analyze the figure in the Colombian legal context. In general terms – since the concept and its effects will be analyzed in detail throughout this paper – the theory represents an additional mechanism to achieve the takeover of a company through the signing of a commercial contract that contains restrictive covenants regarding the autonomy of one of the parties to make whether business or corporate governance decisions. Basically, the decision-making process of one of the companies is indirectly subject to the will of another. Although, initially, the object of the contract is simply, for instance, the execution of a franchise or distributorship agreement, the reality is that the restrictive covenants contained in the contract represents a change of control in the company that is unnoticed to the anti-trust authorities; the foregoing, creates a variety of challenges and legal issues, and this is why the main hypothesis of this text is: How does the contractual subordination theory represents a threat to anti-trust/ business integration regulations and stakeholders' protection rights?

The purpose of this research is to offer a descriptive and analytical study as to the effects caused by the "Contractual Subordination" theory, specifically, in the Colombian legal system. By doing so, the reader will be able to identify why the contractual subordination theory represents a threat to anti-trust/ business integration regulations and stakeholders' protection rights. Chapter I offers the legal definition of a "controlled entity" both under the United States and Colombian legal system in order to explain the basics and meaning of the "Contractual Subordination" theory. Subsequently Chapter II, on one hand illustrates the United States regulatory situation towards contractual subordination scenarios and, on the other hand, explains the application of the figure in Colombia and how the Superintendence of Companies has applied and interpretate the concept. In particular, Chapter III considers the main concerns with respect to the Colombian legal system towards scenarios of contractual subordination; issues related to the statute of business integrations are described and also the main challenges imposed by the theory beyond anti-trust law. Chapter IV proposes some possible legal solutions to the challenges and threats that were described and analyzed on the previous chapters. Finally, Chapter V offers some final conclusions and reflections regarding the complexities posed by the figure and measures that should be taken in the Colombian legal system in order to protect the interests of the market and the parties involved in a contractual subordination scenario.

II. MEANING OF CONTRACTUAL SUBORDINATION

A) Definition of Subordination or Controlled Situation:

First of all, it is important to understand the meaning of the word subordination in the context of business groups. In general terms, regardless the legal system, subordination is defined as "The state or fact of being subordinate to or dependent upon someone or something else."[1] Accordingly, the concept of subordination has an important role as to business integration regulations due to the relevance of avoiding market failures[2], which is the main purpose of anti-trust law.

Business integrations (which are achieved thorugh the takeover of entities by subordinating their governance structures) are one of the main concerns in law and economics. The reason for the cited concern is the possibility of creating monopolies and, subsequently, an abuse of market power[3] that is going to affect consumers and, in general, the economy. In light of the foregoing concerns, the lawmakers have developed legal tools in order to protect

[1] John A. Simpson, THE OXFORD ENGLISH DICTIONARY (1991).

[2] "Market failure refers to the inefficient distribution of goods and services in the free market. In a typical free market, the prices of goods and services are determined by the forces of supply and demand, and any change in one of the forces results in a price change and a corresponding change in the other force. The changes lead to a price equilibrium." Corporate Finance Institute. 2021. *Market Failure*. [online] Available at: <https://corporatefinanceinstitute.com/resources/knowledge/economics/market-failure/> [Accessed 13 September 2021].

[3] Abuse of market power could be defined as "the power to force a purchaser to do something that he would not do in a competitive market, and have ordinarily inferred the existence of such power from the seller's possession of a predominant share of the market." Eastman Kodak Co. v. Image Tech. Servs., Inc., 504 U.S. 451, 452, 112 S. Ct. 2072, 2075, 119 L. Ed. 2d 265 (1992)

stakeholders' rights[4] in the acquisition process and, moreover, established requirements[5] that must be complied by the parties involved in the corresponding acquisition process. One of the main lawmaker's duty is to define concepts that are necessary to interpretate the law and determine the scope of a specific regulation; the United States and Colombia's legal system have defined the concept of subordination or controlled situation in the context of business groups as it follows:

- United States legal definition of Control/ Subordinated situation:

Pursuant to the Code of Federal Regulations "Control" means either:

> (i) Holding 50 percent or more of the outstanding voting securities of an issuer or, (ii) in the case of an unincorporated entity, having the right to 50 percent or more of the profits of the entity, or having the right in the event of dissolution to 50 percent or more of the assents of the entity. [OR] Having the contractual power presently to designate 50 percent or more of the directors of a for-profit or not-for-profit corporation, or 50 percent or more of the trustees in the case of trusts that are irrevocable and/or in which the settlor does not retain a reversionary interest. 16 C.F.R. § 801.1(b)

Under the quoted definition, in summary, controlled or subordinated situations in business groups are limited to: 1. Holding a majority (50% or more) of the outstanding voting shares; 2. Having the right to 50% or more of the profits of the entity or 3. Having a contractual power to appoint a majority of directors.

Accordingly to the vision that control is mainly achieved through the ownership of stocks, controlled group of corporations means "any group of corporations which is— (A) A parent-subsidiary controlled group (as defined in paragraph (a)(2) of this section); (B) A brother-sister controlled group (as defined in paragraph (a)(3)(i) of this section) (…)" 26 C.F.R. § 1.1563-1. Consequently, the term parent-subsidiary controlled group has been defined as "one or more chains of corporations **connected through stock ownership** with a common parent corporation." (Emphasis added) Id.

In addition, the Black's Law Dictionary has defined a controlled corporation in the following terms:

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[4] In general terms, stakeholders are defined as any individual (whether an entity or a natural person) that can affect the achievement of a company's business purposes, or that may be affected by the achievement of those purposes. Hence, individuals such as creditors, employees, stockholders, investors and even customers are included in the definition. For a deeper review of the figure see: Freeman, R.E and Reed, D.L, *Stockholders and Stakeholders: a new perspective on corporate governance*, California Management Review, 1983, PP. 83-106.

[5] For instance, in the U.S Legal System some companies in the acquisition process must comply with the requirements imposed by the Hart-Scott-Rodino Act in order to make effective the acquisition. Similarly, lawmakers in Colombia enacted the Statute 1340 of 2009 which establishes the control of business integrations.

> Controlled corporation. (1901) 1. A corporation in which the majority of the stock is held by one individual or firm. 2. A corporation in which a substantial amount (but less than a majority) of the stock is held by one individual or firm. CORPORATION, Black's Law Dictionary (11th ed. 2019)

Based on these definitions, control and subordination terms in the United States legal system are limited in scope, since those concepts assume that control situations are mainly achieved either by holding a majority of the voting shares or a majority in the board of directors. As a result – and this will be explained in more detail in the section titled "Basics of Contractual Subordination Concept" – achieving control thorugh other kind of mechanisms such as the ones proposed by the Contractual Subordination theory seems to be excluded.

- Controlled entities under the Colombian legal system:

Colombia is a civil law country as opposed to the United States, hence statutes are the main legal source. Regarding the definition of subordination, Statute 222 of 1995 and article 260 of the Commerce Code contemplates "An entity is subordinated or controlled when its decision-making power is subject to the will of one or more persons[6] that would be considered the parent or controller (…)" Statute 222 of 1995. Article 26. Republic of Colombia.

Moreover, article 27 of the already cited statute – or alternatively, article 261 of the Commerce Code – provides some presumptions of subordination; specifically it states:

> Article 27. An entity would be subordinated in one or more of the following cases (…) 3. When the parent, directly or through its subsidiaries, based upon a specific act or business with the controlled entity or its partners, exerts a dominant influence as to the management decisions. Id. Article 27.

The foregoing definition, in agreement with Prof. Reyes Villamizar opinion[7], embrace a broad view of controlled situations; the concept is not limited to the fact of holding a majority of stocks, rather the scope is wide in order to foresee situations in which an entity may be controlled without the need of ownership interest just as the theory of contractual subordination proposes.

B) Basics of Contractual Subordination Concept:

Now that the concept of subordination has been described, the basic idea behind the theory of *contractual subordination* is going to be defined and analyzed. By virtue of this kind of

[6] It is relevant to note that the statute uses the term "persons". That means that either natural persons or entities with legal personhood are included. The intention of the Colombian Congress when the statute was enacted was to make the scope as broad as possible. See *Gazette of the Colombian Congress, number 143, June 12 of 1995, page 2.*

[7] See *Francisco Reyes Villamizar. Derecho Societario. Vol. 2. Page 312.*

subordination, a person (understanding person whether as an entity with legal personhood or a natural person) will become the holding or controller of another entity without the need of having a majority in the voting rights or any kind of equity participation; instead, under this hypothesis of control, the necessary element is to have an agreement or contract in which the controller is going to impose restrictive covenants or conditions towards the ability of the other entity to manage the business and company's governance. In other words, the entity to which the restrictive conditions are imposed, will be subject to the will or dominant influence of the other entity, the latter becoming the parent company or holding.

An illustrative example of the situation would be the following: Company X is a very successful corporation in the fast-food industry. Based on her success, the company has adopted a franchise business model and, in order to maintain the good quality of its products, the board of directors (based on their business judgement rule) decided that in every potential franchise agreement the following clause must be included:

"CLAUSE Z. The Franchisee is not able to take any of the following corporate actions or business decisions without the full consent of the Franchisor:

1. Amendments to the Certificate of Incorporation.
2. Appointment of directors and officers.
3. Purchase or Sale of stocks or equity interest.
4. Purchase or Sale of Assets.
5. Declaration and payment of dividends.
6. Any business decision that may reasonably affect the equity of the company."

In the case of nonperformance with this provision, the Franchisor is entitled to cancel the franchise agreement and ask for Liquidated Damages in accordance with the terms agreed in this Contract."

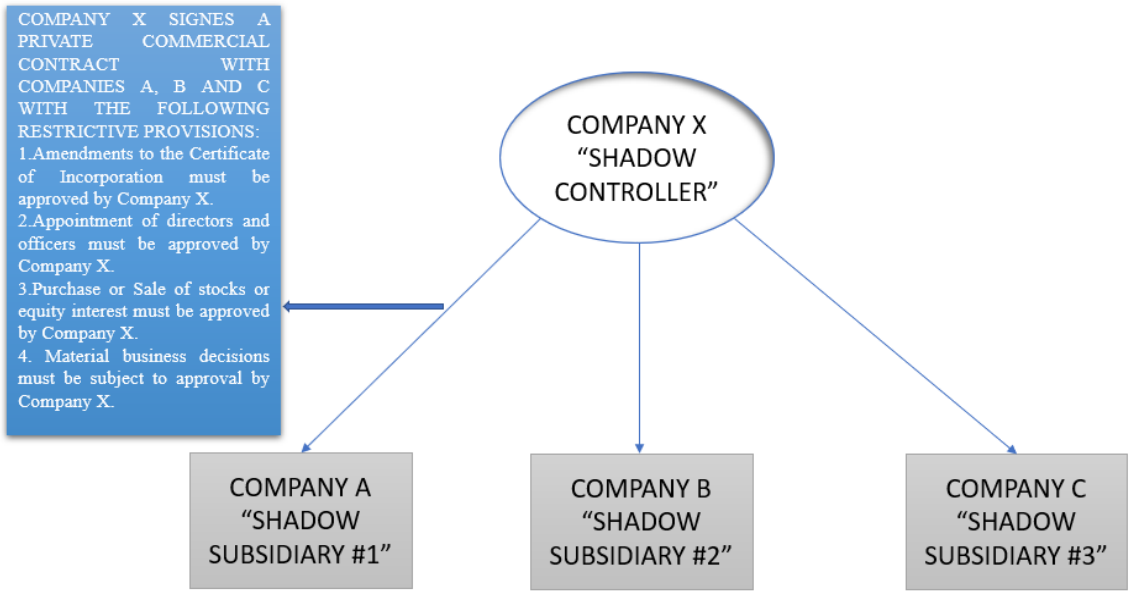
Company Y is an entity created by five investors that have knowledge in the fast-food industry. They made a market study and decided that Company X's products are a fantastic investment opportunity to make profit. Therefore, the CEO of Company Y contacts with Company X and the latter forwards the contract with CLAUSE Z included. After reading the terms of the agreement, Company Y's board of directors is concerned about losing control over the business since they consider that the provision is very restrictive; nonetheless, based on their business judgement rule and assessing the risk-benefit of the transaction, they consider that the company would generate significant profits with the signing of this contract, hence the signing is made and the contract is formed.

The hypothetical case described above, reveals how an acquisition can be achieved without the need of a merger or purchasing neither stocks nor assets, even without a report or authorization for the consummation of the acquisition to any sort of anti-trust agency or

stakeholders. The parent company will become a *shadow controller*[8] that is going to exert her will and dominant influence over the *shadow subsidiary*.

The fact that the franchisor must approve almost every material decision underlines in essence that the franchisee has lost her power over the company. In a practical manner, Company Y would not be willing to take any action against the restrictive provision and Company X is going to exert a dominant influence[9], mainly because the contract will be cancelled and the company would lose its business purpose; furthermore a lawsuit asking for liquidated damages would be filed.

The chart below illustrates how a company imposing those kind of restrictive provisions is able to build a business group without the need of complying with a business integration pre-notification and/or approval requirement:



[8] The term "shadow" is used since the market is not going to have the information regarding the fact that the entities involved in the contract are now a business group. As a result, those companies are able to expand their market power, but by doing so through a contractual subordination mechanism, the effects of the acquisition are unnoticed to the public.

[9] Interestingly, for example some judicial courts in France have made some reference in relation to what they have named as *de facto control*. French jurisprudence stated that dominant influence or *de facto control* situations must be verified case by case and, in light of the contract's provisions, there must be an excess regarding the power that one company has over the other corporate actions or business decisions. (Tribunal of Orleans, 8th of March 2001, Code des Sociétés et des Marchés Financieres, 20e edition, Paris, Edit. Dalloz, 2003, page 817).

Moreover, Portuguese Commercial Code recognizes expressly the figure of Contractual Subordination. Indeed, article 493 of the Business Entities Code provides: "A business entity might, by contract, subordinate the management of the company to another entity, whether as controller or not. The entity who manages will form a group with the other entities, through a subordination contract (…)" Código das Sociedades Comerciais. Article 493. Republic of Portugal.

III. UNITED STATES AND COLOMBIA'S LEGAL APPROACH AS TO THE FIGURE

Now that the meaning of Contractual Subordination theory has been described and legal definitions of control/subordination have been cited, both in the United States and Colombian legal system, this chapter will illustrate an analyze the legal approach under both countries regulations as to the theory.

A) United States regulatory situation towards Contractual Subordination scenarios:

In accordance with the definitions of control already described, the initial thought is that the United States legal system has a limited definition of the term, at least in comparison with the Colombian definition. The United States perspective is that control situations are mainly achieved either by holding a majority of the voting shares or a majority in the board of directors. Hence, there are some legal figures relevant for the purposes of supporting the statement made above.

- "Contractual Power":

Pursuant to the Rule § 801.1(b)(2) control may mean "Having the contractual power presently to designate 50 percent or more of the directors of a for-profit or not-for-profit corporation, or 50 percent or more of the trustees in the case of trusts that are irrevocable and/or in which the settlor does not retain a reversionary interest" 16 C.F.R. § 801.1(b)(2). The purpose of this provision is to cover legally binding shareholder agreements and similar voting agreements; nonetheless, does other types of agreements (such as commercial contracts) might be covered?

> The FTC has generally looked for a more formal agreement giving one party the right to make the voting decision for the other, which agreement is not presently revocable by the granting shareholder (…) **The contractual power must be presently exercisable**. If a condition must occur prior to the arising of the power such as a default, conversion from nonvoting to voting securities, or exercise of a warrant or option, the power may be disregarded. For example, if a person holds convertible securities which are not presently entitled to vote, but which are immediately convertible into 50% or more of the issuer's voting stock, does the person "control" the issuer? Although, in one sense, the person has the "contractual power" to acquire stock giving it the right to designate 50% or more of the issuer's directors, the person does not have **"the contractual power *presently* to designate 50 percent or more of the directors" of the issuer. This interpretation is consistent with the treatment of convertible securities under other provisions of the Rules. (…)**
>
> The definition of "control" set forth in Rule § 801.1(b) has the benefit of relative certainty. However, **it means that many transactions involving the acquisition**

> **of *de facto* control over an enterprise will escape coverage.** (Emphasis added). Acquisitions Under the Hart-Scott-Rodino Act § 4.02

The answer to question stated above seems to be that the definition of "Contractual Power" does not include the situations described under the contractual subordination theory, since restrictive covenants in a commercial contract does not represent a presently exercisable contractual power.

- Transactions or devices for avoidance:

The United States lawmakers recognized the need of foreseeing situations in which individuals may try to manipulate the form of an acquisition transaction in order to avoid filing requirements[10]. Respectively, the Federal Trade Commission regulations provide the following:

> Any transactions or other devices entered into or employed for the purpose of avoiding the obligation to comply with the requirements of the Act shall be disregarded and the obligation to comply shall be determined by applying the Act and the rules to the substance of the transaction. 16 C.F.R. § 801.90.

The application of this rule involves a two-part analysis, firstly ", it is necessary to identify the purpose of the particular transaction. Second, it is necessary to identify the substance of the transaction**. If the purpose is not to avoid a filing obligation, then the analysis ends there, and § 801.90 does not apply. Similarly, if the substance of the transaction is not reportable under the regulations, § 801.90 does not apply**. However, if the transaction or device was chosen for the purpose of avoiding the filing obligation and the substance of the transaction would be reportable under the regulations, then a filing is required, even if the transaction is manipulated such that it would not otherwise require a filing." (Emphasis added). § 12:4. Notification—Can notification be avoided by manipulating the form of the transaction?, 1 Materials on Antitrust Compl § 12:4

Even though there is a rule to address transactions made to avoid filing requirements, whenever the substance of the transaction is not reportable under the regulations, the regulation would certainly not apply. For instance, a franchise agreement or a distributorship agreement are not reportable transactions for these purposes, whereby it is unlikely that the Federal Trade Commission would declare that a commercial contract with restrictive covenants is an acquisition agreement in substance and therefore that a filing must be fulfilled.

[10] The filing requirements represent an effective control of business integrations in order to avoid a negative effect in the market. It is the process in which the corresponding anti-trust agency would study the possible negative effects to the economy and consumers if the transaction is consummated. Without pre-notification and filing requirements, anti-trust agencies would be ignorant towards market information; in other words, asymmetric information would be present, and this is one of the market failures that must be avoided to secure a free market. As stated above, scenarios of contractual subordination lead to the existence of shadow controllers, meaning that the market is unaware or ignorant with respect to the acquisition transaction, therefore creating the corresponding failure.

- Covered Transactions under Hart-Scott-Rodino Act (HSR):

Related to the issue expressed in the previous point, there are transactions that accordingly to US regulations need to be reported; those reportable transactions are the so-called "covered transactions". In this regard, the HSR provides that "no person shall acquire, directly or indirectly, any voting securities or assets of any other person, unless both persons (or in the case of a tender offer, the acquiring person) file notification pursuant to rules under subsection (d)(1)" Hart-Scott-Rodino Antitrust Improvements Act of 1976 (Antitrust Improvements Act.

Pursuant to some academics, the "definition of covered transaction is intentionally broad. It includes mergers, tender offers, asset purchases, and other private acquisitions of stock." Hill, Claire, A. et al. Mergers and Acquisitions: Law, Theory, and Practice. Available from: VitalSource Bookshelf, (2nd Edition). West Academic Publishing, 2019. Regarding this opinion, it could be said that the definition is sufficiently broad in order to include the traditional acquisition methods; nonetheless, once again situations of contractual subordination are beyond the scope of application of this regulation. Therefore, the broadness of the rule seems to be insufficient.

B) Application of the theory in Colombia:

In this subchapter, some insights and reflections are going to be expressed with respect to the Colombian legal definition of "Control". In addition, some resolutions issued by the Superintendence of Companies[11] will be cited and explained, since those administrative decisions recognized the existence of a shadow controller and business groups under the theory of contractual subordination.

- Insights regarding the legal definition of control or subordination in the Colombian legal system:

As it was illustrated in the first chapter of this paper, in Colombia there is a unique statute which defines the situations and presumptions as to controlled entities. Respectively, as quoted before, Statute 222 of 1995 and the Commerce Code contemplate that an "entity would be subordinated in one or more of the following cases (…) 3. When the parent, directly or through its subsidiaries, **based upon a specific act or business with the controlled entity or its partners, exerts a dominant influence as to the management decisions**." (Empahsis added). (Id. at pag 4)

Consequently, the legal definition of control is not limited in scope only to scenarios of traditional acquisition methods such as: stock purchase agreements (SPA), assets purchase

[11] The Superintendence of Companies is an agency from the executive branch, but at the same time is independent since it is decentralized. The duty of this agency in essence is the inspection, surveillance and control of commercial and non-commercial companies or private entities in the country. The agency has the special faculty to declare business group situations in order to preserve a truthful information of the market.

agreements (APA), or mergers among with its different variations. Instead, lawmakers' purpose by drafting the statute was to make as broad as possible the definition, so that control agencies would be able to protect the interests of stakeholders and, furthermore, maintain an accurate information of the market. As a result, situations under the theory of contractual subordination have been recognized by the Superintendence of Companies; some examples are the followings:

- Decisions issued by the Superintendence of Companies declaring control situations under the theory of contractual subordination[12]:

a) Resolution 125-333 of February 26th of 1999. Superintendence of Companies:

In light of this resolution, the Superintendence of Companies declared the corporation "Inversiones Agroindustriales Cachicamos S.A." as the parent company of the "Soceagro S.A." based on the following facts: 1. Soceagro S.A. was a company in bankruptcy; 2. An agreement was signed with the creditors providing terms regarding payment and management; 3. Pursuant to the agreement, the bankrupted company transferred 87.4% of the stocks in the following terms:

- The stocks were transferred to a Trust.
- The trustee bank exerted the stock's rights and managed those shares in agreement with the instructions of a "Consultative Board".
- Cachicamos S.A. directly owned 12.5% percent of the outstanding shares of Soceagre S.A. and, in addition, acquired the fiduciary rights over the cited trust.
- The control over Soceagro S.A. was taken by the Consultative Board since they replaced the Board of Directors in all its functions (this was agreed in the bankruptcy agreement).
- The Consultative Board was formed by 5 members and 3 of them were appointed by Cachicamos S.A. (therefore, they had majority in the board).

Based on those facts, the Superintendence of Companies concluded that Cachicamos S.A. through the Consultative Board was able to take the major decisions in the company; for instance, they instructed the trust with respect to the management of the stocks and, furthermore, they were able to appoint officers and hire employees. Consequently, the Superintendence considered that pursuant to article 27 or 261 (3) of the Commerce Code, Soceagro S.A. was subject to Cachicamo's will, whereby the latter is the parent entity.

b) Resolution 125-001944 of April the 26th of 2005. Superintendence of Companies:

This case establishes the declaration of a business group between two companies that had an agency commercial contract with restrictive covenants. TEAM S.A. was declared a parent company and, Acegrasas S.A., among with 5 other companies, was declared a subsidiary.

[12] These briefs of the cases are based on the text "Grupos empresariales y control de sociedades en Colombia" written by Andrés Gaitán Rozo.

The Superintendence of Companies stated that "by virtue of the contract, TEAM S.A. assumed broad powers in regards to the fundamental governance procedures of the companies (…) The contract involves financial, technical, logistics, commercial and business matters and covers all products, brands and services that these companies provide to the national and international market. The company TEAM S.A. has the possibility to set prices, agree on delivery dates, agree on payment terms, demand guarantees (...) among many other powers."

In addition, the Superintendence observed that "(…) all those attributions have the correlative obligation that all the companies must *strictly observe the instructions issued by TEAM S.A. with respect to the agreement´s constitutive affairs*, [that means] all the major business decisions of the related companies (…). Pursuant to the contract, TEAM S.A. has the power to issue commands to the other companies, which are obligated to perform the instructions. In essence, that is the *control* contemplated in articles 260 and 261 of the Commerce Code: when one or more persons have the possibility to impose decisions over one or more entities."

Moreover, the evidence included some records revealing a significant presence of TEAM S.A. directors in the board meetings of the other companies.

c) Order 410-640 6382 of April the 21st of 1999. Superintendence of Companies:

As opposed to the previous cases, here the Superintendence of Companies concluded that there were no grounds to declare a control situation or business group. The contract involved in this case is a distributorship agreement. DYS Automotores Ltda had the obligation towards Compañía Colombiana Automotriz S.A. (CCA) to provide services to customers who acquired or have acquired Mazda brand products in consideration of CCA's obligation of selling Mazda brand vehicles to the distributor, so the latter at her own risk could sell them to the public.

The contract had the following characteristics:

- An exclusivity clause that prohibits the distributor to engage in the same or similar business activity with another entity.
- CCA had the power to fix prices, modify its line of products, among other business decisions.
- DYS Automotores Ltda was not able to amend her bylaws without previous authorization of CCA. The distributor also committed to submit for review and approval of CCA the bylaw's amendments that they would like to make in relation to the business purpose of the entity, the capital structure, the contribution regime, partner's liability and the powers of the CEO.
- The distributor had the obligation to deliver any corporate document requested by CCA.
- The distributor had to comply with any instruction issued by CCA regarding technical and management affairs.

The restrictions described above, could be interpreted as a clear control situation under Colombian law. Nonetheless, the Superintendence of Companies concluded that, based on the evidence, the distributor's board of directors retained material powers that they were able to exert independently. For instance, the appointment of the CEO and directors was decided by the shareholders without any influence from CCA; furthermore, the shareholders were able to take decisions regarding the approval of income statements, declaration and payment of dividends, among other decisions without the influence of CCA. Hence, the Superintendence stated that "despite the contract's terms created a limited influence, it does not create a dominant influence over the entity's management (…)"

- Conclusions with respect to the scope of the definition and the Superintendence interpretation:

The definition of control or subordination under Colombian law is sufficiently broad to cover situations described by the theory of contractual subordination. Moreover, a government agency has declared the existence of business groups in at least two cases. Indeed, government agencies in Colombia have legal arguments and instruments to declare control situations under the theory of contractual subordination. However, the fact that only two cases in the last 25 years had been analyzed underlines the complexities of piercing the veil of shadow controllers and subsidiaries.

In addition, the extemporaneous declaration of a business group carries several issues that were not exposed or analyzed in the cited resolutions. For instance, the fact that a business group was formed without any kind of notification to the corresponding anti-trust authority, or the potential liability of directors and managers towards shareholders for the signing of contracts that represent a change of control, were ignored issues; even tax evasion problems might appear in these sort of transactions. None of these concerns have been addressed by legal authorities in the country. Consequently, now the question that arises is the following: Is there sufficient and effective legal instruments to prevent the formation of unnoticed business groups in the market under the Colombian legal system? The answer to this question is covered in the following two chapters.

IV. ANTI-TRUST AND M&A CHALLENGES WITH RESPECT TO COLOMBIAN LAW

This chapter illustrates some of the main concerns as to the Colombian legal system regarding situations of contractual subordination. Therefore, the chapter is divided in two main subchapters: 1. Issues related to the statute which regulates the control to business integrations and 2. Main challenges imposed by the theory beyond anti-trust law.

A) Issues related to the statute which regulates the control to business integrations:

As it was stated in the first chapter of this research, Colombia is a civil law country, which means that as opposed to a common law country, the law is mainly created by the legislative branch of power through statutes; judges do not create the law, they interpretate it.

In accordance with this system, Colombia has enacted some relevant statutes with respect to business integrations. Specifically, the Congress enacted the Statute 1340 of 2009 which is the core of control to business integration; it basically describes all the requirements and procedures that individuals must comply in order to complete an M&A transaction.

The above, since the Congress considered that it was material to create a developed control to business integrations in order to preserve the well-being of the economy and, moreover, protect the principle of free market which is established in the Colombian constitution[13].

Hence, Statute 1340 in its article 9 provides: "Companies that are engaged in the same economic activity or participate in the same value chain, and that meet the following conditions, will be obliged to inform the Superintendency of Industry and Commerce[14] about the operations they plan to carry out for the purposes of merging, consolidate, acquire control or integrate **whatever the legal form of the projected operation**." (Emphasis added). Statute 1340 of 2009. Article 9. Republic of Colombia.

The statute contemplates a broad scope of covered transactions, since is clear by stating that there is an obligation to inform to the anti-trust authority regardless the legal form of the projected operation. Thus, a contract with restrictive covenants that generates a dominant influence and a change of control could be certainly included in the definition.

- Is the statute in practice enforceable in situations of contractual subordination?

Although the definition is sufficiently broad to cover transactions such as the ones proposed by the theory of contractual subordination, the reality is that the Superintendency of Industry and Commerce has never decided or study an integration of these characteristics. There are two main reasons:

1. Situations of contractual subordination are not that common, since the usual practice in the country to take over another entity is through the traditional methods (SPA, APA or a merger).

2. Contracts which might contain restrictive covenants (such as the ones analyzed by the Superintendence of Companies) are private and confidential contracts. It is impossible and inefficient for the Superintendency to review all possible commercial contracts to find out whether or not there are restrictive covenants.

[13] "The economic activity and private initiative are free, within the limits of public interests (…) free economic competition is a right which carries responsibilities." Political Constitution of Colombia. Article 333. 1991

[14] The Superintendence of Industry and Commerce, as the Superintendence of Companies, is an agency from the executive branch that is independent. The duty of this agency in essence is the inspection, surveillance and control of commercial activities. For instance, intellectual property affairs are managed by this superintendence as well as consumer protection matters. One of the main responsibilities of this agency is to be the anti-trust authority in the country.

Therefore, in practice there is no effective mechanism to prevent the takeover of an entity through a contractual subordination mechanism. The cited statute in its article 13 provides:

> (i) Without prejudice to the imposition of sanctions for violation of the rules on protection of competition, the anti-trust authority may, after the corresponding investigation, determine the appropriateness of ordering the reversal of a business integration operation when it was not informed or was carried out before the end of the term that the Superintendency of Industry and Commerce had to pronounce (…) Statute 1340 of 2009. Article 13. Republic of Colombia.

The purpose of this provision is to impose a sanction to persons involved into transactions that were not notified and did not comply with the due process to carry out a covered transaction. Lawmakers believe by drafting this provision was to prevent the non-compliance of the requirements established in the statute. Notwithstanding, the reality is that this provision is insufficient because in practice it is extremely difficult for the anti-trust authority to find out the existence of a shadow controller. Therefore, it is material to develop effective legal tools[15] which indeed avoid the formation of business groups through the contractual subordination method.

B) Main challenges imposed by the theory beyond anti-trust law:

Besides anti-trust concerns, there are other legal issues created by the theory of contractual subordination. For purposes of this paper, those legal concerns are going to be limited to the analysis of three main challenges: 1. Threats to stakeholder's rights; 2. Potential liability of the business group, and 3. Liability of directors and officers.

- Threats to stakeholder's rights:

The execution of M&A or consolidation transactions involves several procedures in order to protect the rights of those who are part of the operation or that might be affected by a change of control transaction. As it was explained in the first chapter, stakeholder concept represents any individual (whether an entity or a natural person) that can affect the achievement of a company's business purposes, or that may be affected by the achievement of those purposes. Consequently, individuals such as creditors, employees, stockholders, investors and even customers are included in the definition.

A change of control in a business entity represents a material event which affects in many ways the manner how stakeholders relate and act towards the company.

a. Creditors → This kind of stakeholders have an important interest regarding the control of the company and the way how it is managed, since a good management of the business will secure the payment of a loan, for instance. Moreover, it is common to observe change of control clauses in order to secure payment in loan

[15] Some legal tools are going to be proposed and analyzed in Chapter 4 of this paper.

agreements. In addition, a commercial relationship with a supplier could also be affected by a change in control because the supplier might not be interested to continue with the business relationship if the management of the company changes.

b. Employees → Employees are generally affected by the change of control in the business, since there is a change of employer. Even though the entity might remain to be the same, there is a change in the direction of the company and the way how it is managed, and that may affect positively or negatively the conditions of the employees.

c. Stockholders → Legal systems around the world have developed a variety of legal tools in order to protect the interest over the investments of these individuals in the company. In the end, the company exists due to the corresponding investments made by them. A traditional M&A transaction involves a process which is surrounded by several steps in order to achieve the consent and approval of shareholders, since depending upon the way how the company is going the be managed, their investment would be successful. Generally speaking, in a merger or an APA the approval of a majority of shareholders is required[16]. Regarding an SPA, shareholders might have preemptive rights, appraisal rights or stock rights as legal instruments to secure their interest in whether keep control over the business or withdraw from the company.

d. Customers → Customers are affected by the way how the management runs the company, and a change in control could certainly have an impact in business decisions. For instance, the price to be charged for the products produced by the company. These concerns are analyzed and regulated by anti-trust law.

Nonetheless, in contractual subordination scenarios, legal tools created to protect the interest of stakeholders are useless. The reason is that contractual subordination transactions suppose an unnoticed acquisition, that actually represents a change of control but there is no awareness of the takeover. Therefore, legal instruments such as shareholder's approval or stock rights are not triggered, since the signing of a commercial agreement is a business decision taken by directors and officers.

In general, shareholders, creditors or employees do not have a right to vote in the signing of a commercial contract; if the signed contract contains restrictive covenants, then a change of control occurred and they are completely unprotected because there are no legal instruments to be used prior to the consummation of the transaction, as opposed to the ones available for them in traditional acquisition methods.

- <u>Liability of the business group:</u>

[16] In Colombia, pursuant to article 173 of the Commerce Code, a merger must be approved in a shareholder meeting. Moreover, there is a process in which creditors might demand the constitutions of warranties or oppose to the transaction.

Pursuant to Colombian law, there are specific situations in which the parent company held a vicarious liability as to the activities developed by its subsidiaries. Article 148 of the Statute 222 of 1995 establishes:

> When the situation of bankruptcy or judicial liquidation has been produced by cause or due to the actions carried out by the parent company or controlling entity by virtue of the subordination and in the interest of this one or any of its subordinated entities, and against the benefit of the company in reorganization or process of judicial liquidation, the parent or controlling company will hold a vicarious liability as to the obligations of its subsidiaries. It will be presumed that the subsidiary is in that bankruptcy situation, for actions derived from control, unless the parent or controlling company or its related parties, as the case may be, show that this was caused by a different reason. Statute 222 of 1995. Article 148. Republic of Colombia.

The rule describes the situation in which the subsidiary is in bankruptcy due to the measures taken by the parent company, since it is the one that controls the management of the subsidiary and its business decisions. The statute establishes that if the assets of the subsidiary are not sufficient to satisfy the liabilities in favor of the creditors, then the latter ones can pursue the assets of the parent company in order satisfy the corresponding debts.

However, for creditors this legal instrument is useless if they have no information regarding the existence of a parent company. Keeping in mind that under the theory of contractual subordination the parent company is a shadow controller, there is no information available to creditors with respect to the existence of a business group. Therefore, contractual subordination represents a hurdle for creditors under this scenario.

- Liability of Directors and Officers:

Both in Colombia and in the United States, directors and officers are the individuals in charge of taking the business decisions and, in general, running the business. Therefore, fiduciary duties are applicable to them based on the agency relationship with the owners of the company. For the specific case of Colombia, there are three main fiduciary duties recognized by law; respectively, the fiduciary duty of acting in good faith, with loyalty and care.

Statute 222 of 1995 in its article 23 establishes the duties of directors and officers in the following terms:

> Managers must act in good faith, loyalty, and with the diligence of a good businessman[17]. Their actions will be carried out in the interest of company, taking into account the interests of its associates.

[17] The "Good businessman" is the standard of conduct created by Colombian law in order to determine whether or not there is a breach of the fiduciary duty of care in a business decision. The courts would compare if the decision was reasonable for people in a business environment. It is comparable to the reasonable person standard in the United States.

In the compliance of their function, managers must:

1. Make the efforts necessary for the proper development of the business purpose.

2. Ensure strict compliance with legal or bylaws provisions.

3. Ensure that the proper performance of the functions entrusted to the tax auditor is allowed.

4. Protect the commercial and industrial secrets of the company.

5. Refrain from misusing inside and privileged information.

6. Give fair treatment to all partners and respect the exercise of the right of inspection to all of them.

7. Refrain from participating by themselves or by an interposed person for their own personal interest or of third parties, in activities that imply competition with the company or in acts with respect to which there is a conflict of interest, unless expressly authorized by the shareholders' meeting or general assembly of shareholders.

In these cases, the manager will provide the corresponding corporate body with all the information that is relevant for making the decision. The vote of the manager must be excluded from the respective determination, if it is a partner. In any case, the authorization of the shareholders 'meeting or general shareholders' meeting may only be granted when the act does not harm the interests of the company. Statute 222 of 1995. Article 23. Republic of Colombia.

The cited provision, in its numeral 1 to 4 contemplates the duty of care, and from numerals 5 to 7 it establishes the fiduciary duty of loyalty. It is important to note that in Colombia, unlike the United States, there is no specific rule establishing the so-called business judgment rule (BJR). Unfortunately, in Colombia there is no specific statutory provision regarding the BJR, just in some cases decided by the Superintendence of Companies it has been mentioned, but it is not binding and there are no clear rules with respect to when it is applicable.

Nonetheless, partners or shareholders are able to file either direct or derivative lawsuits pursuant to article 25 of the statute *ibidem*, due to a breach of fiduciary duties. Now, in the context of contractual subordination theory (as it was previously stated) the ones who have the responsibility of taking business decisions are directors and officers, therefore the signing of a commercial contract is a decision that is within their competence. However, if the signing of the agreement represents a change of control, it seems that the decision is sufficiently material to allow shareholders to have a vote regarding the transaction, but it is not the case since in accordance with the applicable law they are not entitled to have a vote in these sort of business decisions.

Thus, the only protection shareholders have in the case of a contractual subordination scenario is to file a lawsuit whether for the breach of the fiduciary duty of loyalty (if they considered that the transaction was made against the interests of the company) or the duty of care (if the transaction was not reasonable under the standard of conduct of a good businessman). Nevertheless, it is complex from a legal perspective to prove a breach of fiduciary duties and even if a court finds it proved, the change of control would remain intact.

V. POSSIBLE LEGAL SOLUTIONS TO CONTRACTUAL SUBORDINATION CHALLENGES

The purpose of this chapter is to offer and describe some possible solutions to the legal issues and threats described above as to the theory of contractual subordination in the Colombian legal context. First of all, it is relevant to keep in mind that there is no effective *ex ante* control to an acquisition made through the signing of a contract with restrictive covenants. In analogy with the theory of piercing the corporate veil, just as it is almost impossible in advance to the constitution of a company to determine whether or not the entity is going to make use of the benefit of limited liability to defraud others, it is also impossible and inefficient for a government agency to check out every contract signed by private parties in order to determine if an acquisition occurred by virtue of the existence of restrictive covenants in the agreement.

In light of this premise, the solutions that are going to be proposed will not focus on the necessity of drafting rules providing acquisition notification requirements before government agencies, since at least in the Colombian legal system, transactions of contractual subordination are under the scope of business integration covered transactions. Instead, the core of the offered solutions is based on public policy reasons. As a result of this investigation, one of the conclusions is that the most effective way to avoid negative effects in the market and protect the rights of stakeholders is to prohibit contractual subordination clauses and impose severe sanctions to persons pursing to achieve an acquisition through this method. Consequently, in order to avoid the use of restrictive covenants which are sufficient to lead to an acquisition due to the existence of dominant influence, there are three measures that might be adopted by the law:

a. Enact and draft a rule providing an unlimited liability to directors and officers responsible for signing a contract (which main purpose was not to be an acquisition or change of control agreement) with restrictive covenants that will certainly result in a change of control situation.

b. Enact and draft a rule stating that for public policy reasons, an acquisition achieved through the contractual subordination method is prohibited and goes against the well-being of free market in the economy, due to the difficulty in the track and

analysis of the possible negative effects in the market through the consummation of this acquisition method.

c. Enact and draft a rule providing that the agreement of any restrictive covenant in a contract which purpose is to generate a dominant influence over the decision-making process and corporate governance of the other entity, is considered without any legal effect by operation of law.

Going back to the question raised by the end of chapter II, which is: Is there sufficient and effective legal instruments to prevent the formation of unnoticed business groups in the market under the Colombian legal system? The response is that, nowadays, there is no sufficient or effective legal instrument capable to avoid the formation of unnoticed business groups in the market under the Colombian legal system. However, if the lawmakers in the country recognize the importance of creating new rules that effectively prohibit the creation of shadow controllers (such as the ones proposed above), then prevention of unnoticed business groups in the market would be possible.

VI. CONCLUSIONS AND FINAL REFLECTIONS

The hypothesis raised at the beginning of this investigation is: How does the contractual subordination theory represents a threat to anti-trust/ mergers & acquisitions (M&A) regulations and stakeholders' protection rights? The outcome of this research reveals that the formation of unnoticed business groups and shadow controllers creates a variety of threats, both to the market and to stakeholders since the legal tools that were created to protect them from abuses in a change of control context are useless.

Indeed, the contractual subordination theory raises several legal issues that were described throughout this text. Furthermore, the investigation illustrates that the United States legal system has a legal gap with respect to situations of contractual subordination, since the definition of "Control" and "Covered Transactions" are not sufficiently broad to cover acquisitions achieved through the contractual subordination mechanism. By contrast, the Colombian legal system adopted a wide definition of the term "Control" and the business integration statute is drafted in such a manner that contractual subordination is covered. Due to the broadness of the definition, one government agency in the country was able in, two occasions, to declare the existence of a business group based on the fundaments of the theory.

Nonetheless, the reality is that legal tools created in Colombia in order to avoid the negative effects in the market and well-being of stakeholders are insufficient. There is no effective mechanism to control *a priori* an acquisition made by a contractual subordination method. Therefore, the most suitable way to protect a free-market environment and the interests of stakeholders, is to enact new rules that prohibits and disincentives the use of contractual subordination in order to acquire another entity and gain market power without the corresponding analysis by the anti-trust authority.

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