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The benefits and costs of controlling shareholders: the rise and fall of Parmalat

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Abstract

When Parmalat Finanziaria SpA filed for bankruptcy protection in late December 2003, it was regarded as the biggest financial collapse in European corporate history and was quickly dubbed "Europe's Enron". The collapse of Parmalat provides an ideal opportunity to examine the Italian corporate governance system. Parmalat also exhibits a particular agency problem that has received relatively little attention in the literature, namely the conflicts of interest between a controlling shareholder and minority shareholders. In the instance of Parmalat, the controlling shareholder also happens to be the founder, Chairman and CEO of the company. This paper investigates the incentives facing the controlling shareholders and the opportunistic behavior that resulted. Mismanagement, accounting irregularities and regulatory failure allowed this behavior to continue, and led to the company's bankruptcy.

Keywords: Corporate governance; Parmalat; Shareholder; Regulatory failure

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1. Introduction

When Parmalat Finanziaria SpA[2] (hereafter called “Parmalat”) filed for bankruptcy protection in late December 2003, it was regarded as the biggest financial collapse in European corporate history and was quickly dubbed “Europe’s Enron”. The US Securities and Exchange Commission called it “one of the largest and most brazen financial frauds in history”. Parmalat played a crucial role in the Italian economy, being the country’s largest food company and employing 36,400 workers in 30 countries. The collapse did not remain localized for long, quickly escalating into a global scandal by implicating several leading accounting firms and several of the world’s largest banks.

The fallout from the Parmalat collapse has been immense. Following the bankruptcy filing, the Italian government quickly approved a law making bankruptcy proceedings swifter and for large companies to restructure faster. As details of the Parmalat fraud unraveled, the Italian government rushed through a series of new bills, which attempt to reform bankruptcy proceedings, accounting standards, and the Italian financial system. How the Italian government has responded to the Parmalat scandal will not only have a significant impact on how international investors perceive risks in Italy, but also affect European Union efforts to install the Pan-European best governance practices.

This paper analyses the corporate governance failures that led to the demise of Parmalat. We trace the history of Parmalat, investigating the evolution of its ownership and organizational structure and explore the seemingly puzzling financing and investing decisions of this family-run dairy company, which had for the past 14 years undertaken more than a hundred acquisitions worldwide and visited global bond markets more than forty times. Special focus is placed on analyzing the costs and benefits of having a controlling family member in the firm. As Parmalat’s scandal unfolded amid a series of Italian governance reforms, including auditor rotation and board independence, we also examine the preventive ability of these measures in detecting and thwarting the kind of frauds like Parmalat.

The Parmalat failure shares a number of common factors with recent U.S. corporate scandals: lack of vigilance on the part of auditors and financial institutions, an ineffective board of directors, a rapid series of acquisitions, related party transactions, complex use of derivatives and aggressive and/or fraudulent accounting practices. What makes this case even more complicated is that there are many interwoven subsidiaries, shell companies, tax havens and offshore banks associated with the demise of Parmalat.

On the other hand, the breakdown of Parmalat seems especially puzzling considering the unique features of the firm. Even though it was quickly described as “Europe’s Enron”, Parmalat also seems to be distinctly different from the recent U.S. scandals.

[2] Parmalat Finanziaria SpA belongs to a pyramidal group controlled by the Tanzi family. La Coloniale SpA is the family holding company, owning 51 percent of Parmalat Finanziaria SpA (the financing company). Parmalat Finanziaria SpA, in turn, is the holding company for the Parmalat group, owning 100 percent of Parmalat SpA (the operating company). We use Parmalat as the general reference of the Parmalat group, which includes Parmalat Finanziaria SpA and Parmalat SpA.