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## Shell Companies and Government Corruption



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### Synonyms

[Dummy corporation](#); [Front organization](#); [Off-shore company](#); [Stooge](#); [Straw man](#)

### Definition

A shell company is supposedly an independent, legal business entity that is used to separate and hide the identity of its real owner. The use of shell companies can be legal when they serve as technical vehicles facilitating complicated business transactions, but they are often used for illegal purposes.

### Introduction

As the Panama Papers leak exposed in 2016, the secret world of shell companies is not a small-scale marginal phenomenon, as previously believed, but a widespread and complex network of offshore companies in remote tax havens with

the special function to cover the shady business of the global elite, including numerous senior politicians, heads of states, and dictators (Obermayer and Obermaier 2016). Yet, autocrats and their cronies extensively use shell companies, not just in tax havens but in the Western world so that they can hold their illegally accumulated wealth in the financial institutions of democratic countries (Sharman 2017, pp. 73–74). Moreover, corrupt politicians and government officials also use domestic shell companies in their home countries to facilitate illicit transactions (Jancsics 2017).

Shell companies are typically formed and maintained by Corporate Service Providers (CSPs), or intermediary law or accounting firms. Transactions and assets can be tracked back to shell companies established by a CSP but not to the actual people who indirectly and covertly exercise control over the company. Shell companies may constitute complex corporate structures in which they act as shareholders of another such company. One subcategory of shell companies, called “shelf” companies, includes organizations kept “on the shelf” for sale later on. Since financial institutions often prefer to do business with companies that have been in existence for a certain number of years, such appearance of longevity may be attractive to buyers who want to use shell companies to obtain leases, credit, and bank loans.

The use of shell companies can be perfectly legal. For example, they might be created for mergers and joint ventures by business partners

to simplify matters or to guarantee impartial legal treatment for the parties in a neutral jurisdiction. Shell companies can be also used to hold personal or family assets to facilitate inheritance or protect against attachment by creditors (Van der Does de Willebois et al. 2011). Furthermore, when buying property or land, well-known brands often hide their identity behind shell companies so they can be protected from extortive price increases by the owner (Findley et al. 2014, pp. 33). Hollywood stars also use shell companies to shield the location of their residence from the general public. Firms, still legally, can create offshore shell companies in order to lower their tax bills at home. The lucrative business of shell companies in tax havens such as Panama can be traced back to the 1920s, but their use has significantly increased since 2005 when the European Union introduced a tax penalizing interest on income earned by EU residents in tax havens (Obermayer and Obermaier 2016, pp. 13). Since the tax applies to accounts owned by only individuals not shell companies, European depositors can shift their assets to such technical vehicles.

A shell company can hold bank accounts, own assets, and engage in transactions. In many countries, shell companies are cheap and easy to establish. Confidentiality is their key advantage. Since they provide convenient vehicles for moving money secretly, even across national borders or hiding real owners of assets, they can also be used for illegal purposes such as laundering money, evading taxes, financing terrorism, busting international sanctions, and facilitating corruption. This entry chapter discusses the specific phenomenon when shell companies are used in corrupt transactions. Here the most important function that a shell company can offer for its corrupt shadow owner is providing anonymity while simultaneously guaranteeing control over the shell company and its resources.

Despite the popular conceptions that shell companies exist only in exotic tax havens such as Bahamas, Cayman Islands, Liechtenstein, or Panama, the West has a significant role in hosting illegal money via shell companies. Surprisingly the majority of shell companies are formed in non-tax haven Western countries and dictators, such as

those in Central Asia, are happy to use them to facilitate their high-level grand corruption (Cooley and Heathershaw 2017). Empirical research finds that CSPs in wealthy Western countries are the least inclined to comply with international standards (Findley et al. 2014). Domestic laws may also support such behavior. For example, the United States is among the most tolerant countries when it comes to regulating shell companies (Sharman 2017). Here CSPs are under no obligation to establish the true identity of the client who becomes the company owner. The most infamous tax haven states in the USA are Nevada, Wyoming, Delaware, and Florida. Some industries are especially vulnerable to corrupt shell company use. For instance, the US real estate industry makes less than minimal effort to examine the identity and background of property buyers behind shell companies (Cooley et al. 2018).

We can classify shell companies along two main dimensions, the location where companies are formed (offshore vs. onshore shells) and the form of operation (live vs. empty shells).

### **Location: Offshore Versus Onshore**

The main advantage of offshore shells for corrupt actors is that they are in remote tax haven countries where authorities are typically not too eager to investigate suspicious cases. Moreover, Webs of shell companies are often linked together across multiple offshore jurisdictions which makes obtaining information about them especially difficult (Van der Does de Willebois et al. 2011). The infamous Panama Papers leak in 2016 revealed the entire internal database of Mossack Fonseca, a major Panamanian law firm specializing in forming anonymous shell companies (Obermayer and Obermaier 2016). It included the records of 214,000 offshore shell companies, names of their true owners, passport scans, bank statements, and email conversations between the CSP and the owner's representatives. The leak exposed illegal money movements of several prominent figures, for example, the Nicaraguan president Arnoldo "Fat Man" Alemán, who has

been declared one of the 10 most corrupt politicians of all time by Transparency International, a global anti-corruption watchdog. Alemán used shell companies to channel almost \$100 millions of public funds into his own pocket. The Papers had serious political consequences such as the resignation of Iceland prime minister, a massive demonstration in Argentina, a small war in Azerbaijan, the block of words “Panama Papers” on the Internet by Chinese authorities, and the unpleasant confession of his late father’s decade-long tax evasion by the former British Prime Minister, David Cameron.

Onshore or domestic shell companies are typically established by corrupt actors in their home country to facilitate corruption. Despite the fact that political campaign contributions are supposed to be transparent in most democratic countries, domestic shells are frequently used by powerful corporations to get access to the political arena while keeping their identity and affiliation with politicians secret. For example, in the USA, shell companies are often registered with the sole purpose of receiving untraceable and unaccountable donations for campaigns of politicians, even presidential candidates (Findley et al. 2014, pp. 29–30). The most recent example is the shell company, Essential Consultants LLC, established by President Trump’s lawyer Michael Cohen to be able to pay hush money and receive invisible donations from companies such as AT&T and Novartis in return for “insights into the new president.”

The establishment of police foundations is a relatively new phenomenon in the USA and Canada and can be also conceptualized as a form of onshore shell company (Walby et al. 2017). These foundations operate as private nonprofit charities and amass money from private corporations. Since these organizations are not subject to Freedom of Information Act legislation and other transparency requirements that are normal in the public sector, the identity of donors and the amount of donated funds are unknown. Such secretive operations may permit transactions in dark money and potential special police treatment of donors as “insiders” in return for financial support.

Domestic shell company arrangements also enable corrupt political elites to turn public resources into private ones under a veil of complete secrecy. These actors pay particular attention to making their operations seem lawful and extract money through legal contracts that require a large number of “clean” shell companies (Jancsics 2017). Some of these cases are discussed in the next section under the category of live shells.

### **Form of Operation: Empty Versus Live Shells**

Echoing the mainstream approach of shell companies, empty shells do not have real operations, employees, infrastructure, or assets while live shells, a less researched phenomenon, are functioning entities controlled by shadow owners (Jancsics 2017). Most offshore shell companies are empty shells that have no physical presence other than a mailing address, yet onshore or domestic versions of these companies also exist. This type of shell company is often set up only for a single corrupt transaction and then left dormant. Empty shells can be established to serve a very simple function, receiving bribe cash secretly, for instance, in the form of a “consultancy fee.” Corrupt politicians who worked to benefit certain corporations with government contracts are often paid via this structure (Findley et al. 2014, pp. 100).

An empty shell can also acquire assets for a secret owner. Investigative journalists revealed that nearly half of the most expensive residential properties in the USA are now purchased anonymously through shell companies (Story and Saul 2015). For example, in 2014 at the Time Warner Center in New York City, 80% of the units were purchased by shell companies, 37% by foreigners. Among the foreign owners, we can find top government officials and their family members and businessmen with close political connections from countries such as Russia, Mexico, India, Malaysia, or China. They may not be all criminals, but such structure is perfect for hiding assets bought with corrupt money. At least 16 foreigners

in the Time Warner Center have been the subject of government inquiries, either personally or as heads of corporations. We can find a similar pattern in London where in 2015 more than 40,000 residential and commercial properties were registered to overseas companies, most of them with invisible ownership structures incorporated in secret jurisdictions such as British Virgin Islands, Jersey, Isle of Man, or Panama. Research finds that corrupt senior politicians in post-Soviet countries such as Kazakhstan and Kyrgyzstan routinely use shell companies to channel rents from state assets to the Western real estate industry (Cooley et al. 2018).

Empty shells are also used as technical vehicles to facilitate mainly domestic, corrupt transactions (Jancsics 2017). In this case, they have a switcher function. Corrupt actors allocate public resources to a shell company and then change the law which multiplies the value of the resources owned by the shell company. After that, the company can be sold to a third party for extra profit. For example, in a well-designed real estate corruption network, 26 multistory buildings were sold in an historic district in Budapest, Hungary (Jancsics and Javor 2012). The falsely undervalued old buildings were transferred by the local government to shell companies, and then secretly controlled by the mayor and his allies. After the local government removed the buildings' historic designations and issued demolition and building permits, private developers bought the shell companies, built office buildings and residential parks and then sold them at great profit.

In contrast to empty shells, live shell companies have real business operations. The main reason for their existence is that their real owners cannot openly exercise ownership in an operating firm, for example, when politicians are legally banned from having a formal position or shares in private business firms. This is usually not a one-time illegal transaction, such as is typical in the case of empty shells, but rather a long-term control over a functioning economic entity. In many live shell cases, the state distributes valuable resources, licenses, concessions, or other monopolistic market positions to a shell company that virtually guarantees profit making. Live shells can

be used to build a clientele network surrounding corrupt politicians. For example, in 2013, the Hungarian government turned the previously liberalized tobacco retail business into a state monopoly and then announced a tender for a 20-year concession of tobacco sales (Jancsics 2017). In thousands of cases, people linked to the governing party won tobacco concessions. The official owners and managers of the tender winner shell companies were family members, spouses, siblings, parents, parent-in laws, friends, or even neighbors of politicians, public servants, or politically connected oligarchs. These visible representatives of the shell company acted on behalf of their shadow principal.

### Theorizing Shell Companies

Mainly legal and financial aspects dominate the academic literature of shell companies. So far, the most comprehensive and rigorous empirical research on the topic has studied whether states and corporations comply with international financial transparency standards (Findley et al. 2014). Researchers have found that large numbers of CSPs recurrently violate international standards and surprisingly, CSPs selling shell companies from tax havens were significantly more likely to comply with the rules than service providers in rich developed countries such as the USA and the UK. However, previous research does not offer a development of a theory.

A possible way to theorize about shell company corruption is to view the phenomenon as a specific form of brokerage (Jancsics 2017; Walby et al. 2017; Van der Does de Willebois 2011). Brokerage is an informal social mechanism by which disconnected or isolated actors can interact. Here the shell company is a vehicle used to effectively navigate between legal and illegal realms. The legal action is implemented by the formal organization yet the visible but fake representative (owner or director) acts as a broker, pursuing the informal and corrupt agenda of its invisible shadow owner. This is a type of mediation where a "representative broker" is delegated by another actor, whether a single individual or a group, to

represent its interests and deal with the outside world.

The sociological aspect of the relationship between the broker and the hidden beneficial owner is an important but understudied dimension of shell companies. In the literature, the broker is mentioned by several different names such as front man, straw man, stróman, nominee director, dummy person, stooge, or patsy. Sometimes brokers are appointed by the CSP in order to appear on the public record and to sign the documents placed before them (Obermayer and Obermaier 2016, pp. 14–15). For example, Lu Zhang was, on paper, the director of SP Trading Company but actually worked as a short-order cook at a Burger King in Auckland. She supplemented her income with \$15 for each document signed by her for the company. It turned out that SP smuggled weapons from North Korea to Iran (Findley et al. 2014, pp. 1). In other cases, especially in live shell operations, brokers must be trusted which requires some level of social connection between the broker and the shadow owner. Here brokers are typically relatives, friends, current or former employees, or business partners (Jancsics 2017). We can also find unequal power relationship between these two main actors. In this case, socially marginalized people, homeless or foreign refugees are chosen as company owners and directors. They are willing to take huge risks for a relatively small amount of compensation and often fulfill the fall guy function.

## Conclusion

Using shell companies for illicit purposes is a widespread and growing phenomenon. The equivalent of 10% of world GDP is held in offshore tax havens globally. Yet, onshore or domestic shell companies are also heavily used in illegal transactions. The fact that they provide the owner with complete anonymity and at the same time control over the organization makes shell companies especially attractive for corrupt actors.

Interestingly, many countries, even those in the developed and democratic West, are reluctant to close this loophole. Scholars are behind in studying and theorizing about the shell company phenomenon. In the next few years, we need more interdisciplinary investigation in order to understand this complex and serious social problem.

## Cross-References

- ▶ [Corruption](#)
- ▶ [Globalization and Law](#)
- ▶ [Globalization and Predatory Corporations](#)
- ▶ [Political Corruption](#)
- ▶ [Public Corruption](#)

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