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BERLE AND MEANS' CONTROL AND CONTEMPORARY PROBLEMS / Tibor Tajti

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Abstract: *The best way to judge the quality of a new company law is to test it against real-life problems. This article attempts to do that by placing the concept of control in the center of its observations, posing related questions, and offering food for thought for the drafters of company laws. The concept of control in the context of corporations with highly dispersed shareholders holding atomized stakes ('quasi-public corporations') was first dissected by Adolf A. Berle (lawyer) and Gardiner C. Means (economist) in their 1932 classic The Modern Corporation and Private Property. Their conceptualization and classification of control serves as the basis for the analysis herein, even though interest in control has lately been overshadowed by novel schools of thought based on agency theory and the like. With that in mind, the central thesis of this article is that control is the ultimate 'invisible hand' of company law because it is unparalleled in importance, omnipresent, and – due to its multifaceted nature – inherently difficult to grasp, especially insofar as its precise essence or its manifestation in real life circumstances is concerned. Secondly, using examples from recent cases from Central and Eastern Europe ('CEE'), this article aims to show that the crucially important concept of control is still not fully understood. Unfortunately, but perhaps unsurprisingly, empirical evidence readily proves that simple formulas for "taming" control do not exist. Instead, eternal vigilance, as well as regular re-evaluation of governance and oversight solutions, is needed not just by the boards and corporate officers in charge of oversight, but also by shareholders if control of corporate officers is at stake. Thirdly, the article demonstrates that control plays a similarly important role for small and mid-sized businesses ('SMEs') countering a burning set of problems that SMEs are doomed to face at some point in their existence: the issues corollary to the inter-generational transfer of the control and ownership of successfully operating companies. This topic is tackled through the prism of the milestone case of Galler v. Galler from Illinois, United States (US), which gave the green light to a peculiar but flexible set of solutions to these governance-related issues. I argue that the Galler formula, or at least parts of it, could be adapted elsewhere to serve similar ends. As the case studies offered in this article will demonstrate, these are living problems, especially insofar as they concern jurisdictions which are still yet to settle on wholly-adequate solutions, such as the post-socialist states of Central and Eastern Europe, China, and other fledgling legal systems across the globe.*

Key words: *Control; Separation of ownership and control; Corporate governance; Acquisition and abuse of control; Intra-generational transfer of wealth and control; Holding companies; Company Law*

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1. BERLE AND MEANS' CONTROL EXPLAINED

1.1 Why Should One Place Control at the Centre of One's Observations?

I must start by admitting that my decision to revisit the ever-recurrent topic of control is partially borne of personal experience. As my 20th anniversary as a university professor passes by, I have been reminiscing about my experience teaching various areas of comparative commercial law and regulation (with a substantial dose of private law as well), plus the 15 years I spent as a corporate counsel and board member of a former Yugoslav company that ultimately failed to survive the Balkan wars and the privatization wave of the 1990s. I realized that these two eras of my life have a strange common denominator: the concept of *control* as understood in the context of corporate law and the law of other enterprise forms, or, as is the case in Europe, as a fundamental element of company law.

I encountered the problematics of control during the former Yugoslavia's reorganization wave which began in the late-1980s, when a novel business form borrowed from the West – the 'holding company' – became the region's top business vehicle and was promoted as some sort of magical formula for a prosperous future. In my ensuing professorial years, control yet again came into the limelight in educational contexts, firstly due to the ascendance of the new hybrid discipline of *corporate governance*, and then somewhat later, through the supplementary (or rival) discipline of *corporate finance*. These disciplines clearly grew out of company law, but went much further by covering what one could aptly describe as the 'know-how' necessary for the proper implementation of company laws, together with a focus on best practices. Both also tackle corporate strategy issues. Corporate strategy, contrary to company law, takes not only a more practical but also a more holistic approach to corporate life. For example, the issuance and sale of shares (equity) is a method of raising capital by a company (and thus is a topic for corporate finance), but it may also lead to losing control of a company (and it thereby also relates to corporate governance).

The right approach to control thus requires a combination of the two perspectives. This basic tenet should not be forgotten when reading the ensuing elaboration: no meaningful control-related analysis is based solely on the text of a company laws nor – as is the case in the United States – upon the laws regulating various business vehicles.

Consequently, my second scholarly justification for choosing to deal with control is that if one fails to comprehend it, any proper understanding, or, for that matter, proper implementation of company laws, becomes impossible. Put pithily, control should not be overlooked as an invisible and impalpable institution of company law, but should instead be emphasized as a fundamental concept and understood as part of a holistic worldview that – as indicated above – also incorporates perspectives from both corporate governance and corporate finance. In the same vein, control is the ultimate "player" in company law for the large business forms listed on stock exchanges and for SMEs alike. Contrary to Cross and Prentice, who list limited liability and corporate governance rules as the mechanisms which *"[allocate] power in the company among the shareholders, the board of directors, and corporate officers,"* (Cross and Prentice, 2007, p. 13) the claim advanced herein is that control should be placed at the center of our theoretical understanding. While admittedly the concept of control *could* be considered a subspecies of the rules regulating corporate governance, doing so would only serve to make control less visible, if not invisible, which could go on to have negative practical repercussions.

The rise of corporate governance followed the collapse of Enron, the 8th largest public (listed) corporation in the United States (US), and the contemporaneous fall of a number of other US corporations (e.g., WorldCom, Adelphia). The search for the origins of what the prestigious magazine *The Economist* called '*Enronitis*'[1] pointed to two main causes: accounting fraud and corporate sleaze. The regulatory response ensued in the form of the Sarbanes-Oxley Act 2002, which besides subjecting the accounting profession to a stricter regulatory regime and introducing numerous corporate governance rules targeting directors, further empowered the Securities and Exchange Commission (SEC) while strengthening criminal penalties for accountants and corporate officers. The Act has since been critiqued as a piece of hastily-passed legislation that amended and thereby undermined the schemes of several venerable statutes. Although initially an American affair, its spillover effects reached Europe and the rest of the developed world soon thereafter, frequently materializing in the legal sphere through the appearance of internal ethical, or codes on corporate governance,[2] which aimed to regulate the behaviour of directors. For a year or two thereafter, corporate governance became the dominant topic at conferences, among law journals' symposium issues, and in masters' theses. This, alongside a few recent cases from CEE, justify both this paper's focus on revisiting the topic of control and the idea that the problematics of control are deeply entrenched in the life of contemporary corporations.

1.2 On the Importance of Berle and Means' Monumental Work on 'Quasi-Public Corporations'

Enronitis was "culpable" for yet another important development for control. This was the re-publication of the enduring 1932 classic concerning the conceptualization of corporate control, i.e. *The Modern Corporation and Private Property* by Adolf A. Berle and Gardiner C. Means.[3] The book's relevance to the Enron scandal, corporate sleaze, and this piece's broader purpose is its ingenious analysis of what it calls 'management control', that is, control by the senior executive officers of the corporation (Berle and Means, 2004, p. 196). This form of control, one of five forms identified by Berle and Means, has resurfaced as a source of problems numerous times since the Great Depression.

Although a large part of the book has now become – to quote Weidenbaum and Jensen's introduction to the 2004 reprint – a period piece whose "*special value lies in its evocation of a historical period*," (2004, p. ix) this characterization applies primarily to the book's inclusion of abundant statistical data and case studies from 1920s US. However, the theory, fundamental concepts, and findings that form the core of the work arguably remain one of the best analyses not only of control itself, but also of another closely-related topic: the separation of ownership from control. Or, to use Weidenbaum and Jensen's formulation, "*many of the answers provided by this book have been superseded by more recent events, but the questions raised continue to be worthy of the attention of scholar and practitioner alike*" (2004, p. xviii).

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[1] The term was coined by journalists, see Enron a Year on: Investor Self-Protection (2002). *The Economist*. Available at: https://www.economist.com/leaders/2002/11/28/investor-self-protection (accessed on 10.12.2022).

[2] As put by Nina Cankar, "*the purpose of the codes [on corporate governance] has been to improve good corporate governance practice by increasing management's responsibility and promoting openness and transparency of business, thereby increasing investors' confidence in securities markets*." (2005, p. 288).

[3] Adolf A. Berle and Gardiner C. Means, The Modern Corporation and Private Property, with a new introduction by Murray Weidenbaum and Mark Jensen, Transaction Publishers, New Brunswick and London, 6th print, 2004. (hereinafter: Berle and Means, 2004). The book is the result of a commendable cooperation between a lawyer and an economist. The book is thus filled with statistical and quantitative data related to the contemporary US corporate sector, plus six tables and a chart in the appendix section.

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The book has yet another limitation: it is restricted to corporations, the largest form of business organizations in the US', both in 1932 and today. Moreover, as I have already hinted, they actually focused on a then new class of corporations, which they called '**quasi-public corporations:'** "*a corporation in which a large measure of separation of ownership and control has taken place through the multiplication of owners*" (2004, p. 5). In other words, it refers to a corporation in which the ownership of voting stock (shares) is widely diffused into the hands of hundreds if not thousands of shareholders, and while all shareholders are legally treated as the corporations' owners, actual control almost inevitably falls into the hands of either a group of minority shareholders, or of the company management (executive directors). Roe referred to this the feature of 'atomization,' or "*many shareholders owning only small stakes*" (1994, p. 6). The shareholders' powerlessness over decision-making and their consequent disinterest in the voting process makes the seizure of control by executive directors possible under certain circumstances. To illustrate, Berle and Means gave the example of the Rockefeller family's direct or indirect minority interest in several affiliates of the Standard Oil corporation. In the case of Standard Oil Indiana, a mere 14.5 per cent stake "*combined with the strategic position of its holders… proved sufficient for the control of the corporation*" (2004, p. 6).

Contemporary examples are easy to find as well. Sometimes, the old patterns described by Berle and Means resurface in an altered form, and sometimes even more-or-less unchanged. While Elon Musk holds a mere one-fifth of Tesla's single class of shares, he retains control through bylaws that impose supermajority voting (Masters, 2019, p. 26). Zuckerberg's control of Facebook rests on additional pillars: as well as being the Chief-Executive Officer (CEO) and chairman of the board, he uses a dual-voting class structure which affords him possession of 60% voting power. This is due to Facebook class B shares, 18% of which are held by Zuckerberg and a few insiders, which carry 10 votes per share (Kuchler, 2018). It is thus no wonder that in the aftermath of the Cambridge Analytica scandal (where about 87 million Facebook users' personal data was leaked) and the resulting fall of Facebook's stock value by about 10% (Kuchler, 2018), shareholders tried but failed to replace the dual class system with a 'one share – one vote' one.

Here, it is illuminating to quote from Zuckerberg's comment on the failed action of Facebook shareholders, which proves this piece's central point on the quintessential role of control in the corporate context; control is that 'invisible hand' that control-holders seek to maintain the efficiency of their control. As he put it: *"[Facebook] is 'really lucky' to be controlled by a single majority shareholder. … We are not at the whims of short-term shareholders. We can really design these products and decisions with what is going to be in the best interest of the community over time*." (Kuchler, 2018).

1.3 Control: Definition and Forms of Appearance

In the introduction to the reprint edition, it is correctly claimed that Berle and Means only "*vaguely define[d] the concept of 'the control' of the corporation*" (2004, p. xii). Indeed, control is merely *described*, among others, by the example of control by corporate *management*, which in 'quasi-public corporations' with dispersed shareholders is typically placed in the hands of purported experts (Berle and Means, 2004, p. 66), who may not even be shareholders. As they ingeniously put it, one is virtually '*forced to recognize'* (2004, p. 66) that there is 'something' hard to grasp: something that unavoidably exists in corporate life and yet it differs from both ownership and management. This control – not in the sense of the *monitoring* of any particular body or officer in a company, though including that power, too – refers extremely broadly to the possession of the powers necessary to make all important decisions for a company. This conceptualization of control is far more expansive than Weidenbaum and Jensen's, which is limited to the power to select the board of directors (2004, p. xii).

Berle and Means identified five types of control on the basis of their structural analysis of a sample group of contemporary American corporations. The *first* is complete, or near-complete ownership, which is normally the case in small-scale enterprises where ownership and control are in the same hands (2004, p. 67). The *second* group includes corporations with majority control, or control through ownership of a majority of the corporation's outstanding stock (shares). They also note that this form of control may translate into less control compared to the first group, as simple majority voting power is often not sufficient for making fundamental decisions affecting corporate life such as company dissolution or amendment of the corporate charter (2004, p. 67).

Contrasting with these relatively simple methods of control are Berle and Means' three remaining categories, which rest on more complex foundations. In their *third* type, control is maintained through various legal devices, yet without majority ownership. In this hybrid category of control, Berle and Means list pyramiding, the use of non-voting shares or shares with excessive voting rights, and the exploitation of preferred stock that affords excessively disproportionate rights to its holders. Many of these techniques were already in use by American corporations prior to the Great Depression, but only appeared in parts of Europe decades later (if at all). They also distinguished a *fourth* type, minority control, but it is their fifth category which plays a special role herein: management control (i.e., control by executive officers). This last category requires special attention, as do several extra-legal forms of control which Berle and Means mention only in passing.

1.4 Berle and Means' Disregarded Caveats concerning 'Management Control'

Berle and Means highlighted that 'management control' is probably the most subtle form of control, as it rests 'on no legal foundation' (2004, p. 82). Its existence is primarily linked to corporations with widely dispersed shareholders, in which there is no individual, or at most, only a small group of shareholders, that possess "*even a minority interest large enough to dominate the affairs of the company*" (2004, p. 78). Under such circumstances, shareholders who are aware of their position may therefore have no interest in voting, either. Or, as was the case in a number of US corporations in Berle and Means' times, such shareholders would "*sign a proxy transferring [their] voting power to certain individuals selected by the management of the corporation, the proxy committee*" (2004, p. 80). The end result is *de facto* control by the 'management,' which "*can thus become a self-perpetuating body even though its share in the ownership is negligible*" (2004, p. 82).

We know today that control may end up in the hands of executive directors and corporate officers through other means, too. Moreover, their position may be further strengthened by meaningful packages of shares or options awarded to them as rewards for their work or as incentives for meeting certain targets. Put simply, control by directors exists today in more varied forms and under more complicated sets of circumstances than in the era described by Berle and Means. They proved the existence of this form of control and hinted at some of the risks corollary to it, and thus the legacy they left to future generations ought to be acknowledged and reckoned with, at least, by introducing proper checks and balances to keep this type of control "tamed." It is a fact, however, that Berle and Means' insight is often neglected (if not intentionally disregarded) even today,

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precisely because it is not in the interest of control-holding directors, executive officers, and corporate office-holders to limit their own power.

A scandal concerning the Croatian national oil and gas company named INA,[4] which reached the media in August 2022 after going unnoticed for two years, is perfect proof of the sorts of problems that may result from the excessive concentration of control in the hands of executive directors. According to charges brought and relevant media reports (see, e.g., Bradarić, 2022), an executive director responsible for the sale of gas and empowered to sign contracts up to the value of €20m (though with the counter-signature of his deputy) fraudulently abused his position in a manner that caused damages exceeding €133m to INA. His method was simple: a small company (OMS-Ulaganje) was formed, including him and his pensioner father, as well as the President of the Croatian Chamber of Attorneys and two more individuals as the only shareholders. INA then sold gas to OMS-Ulaganje for a fixed price of €19,5 irrespective of any changes to gas prices on global markets. The small company then resold the gas at higher prices of up to €210. A bank clerk blew the whistle after noticing an attempted transfer of 500 million Kunas[5] to the executive director's pensioner father's bank account (see Bradarić, 2022). The Croatian Office for the Suppression of Corruption and Organized Crime (USKOK) subsequently initiated investigations concerning the whistleblower's allegation.[6]

What brings Berle and Means into the picture here is not only that a single executive officer found himself in the position to organize this fraudulent scheme, which in itself demonstrates the potentially excessive powers oft-possessed by executive directors, but – more pertinently – it shows that INA's entire governance and control system failed. According to the media, politics also played a role (see, e.g., Redakcijski tekst, 2022), but in this case politics can hardly be considered the sole culprit. According to the former CEO of INA, concern about the excessive power of executive directors was raised already in 2011-2012 and subsequently efforts were made – clearly unsuccessfully – to distribute the powers to conclude major contracts into "more hands." INA is one of Croatia's largest corporations, and as such has more layers of governance than most companies, including a Board of Executive Directors as well as a Board of Directors and a Supervisory Board. Moreover, as the Hungarian oil and gas company MOL holds a 49% stake in INA and consequently possesses significant governance rights, the top boards were of a mixed structure and were composed of both Croatian and Hungarian citizens. However, according to a public statement issued by MOL, they only learned about the scandal from the media in the summer of 2022 (e.g., HVG, 2022; V. B. 2022).

Under pressure from the incumbent Croatian government, the Hungarian president of the Board of Directors submitted his resignation a few days after the scandal broke out. This seems to have satisfied the Croatian side, but the harder task – i.e. finding the right legal 'checks and balances' for preventing future abuses by executive directors and establishing flexible but abuse-proof rules on contracting to this end – is yet to be achieved. It is a big question whether such a goal is achievable, especially considering that such multi-layered governance systems are inevitable in large firms with complex shareholder arrangements, and also considering the fact that these sorts of risks – which are in essence caused by 'the human factor' – seem similarly inevitable.

[4] For the history and corporate governance system of INA see INA. Available at: https://www.ina.hr/en/about-ina/profil-kompanije/povijest/ (accessed on 10.12.2022).

[5] The Kuna is the name of the Croatian national currency that will continue to be in use until 1st of January 2023, when the Euro will replace the Kuna. As of September 2022, the exchange rate is 7,51 Kunas for 1 Euro.

[6] For the English language pages of the Office see USKOK. Available at: https://uskok.hr/en (accessed on 10.12.2022).

The ultimate lesson from the recent INA case was superbly summarized by Kay: *"If we asked a visitor from another planet to guess who were the owners of a firm by observing behaviour rather than by reading text books in law or economics, there can be little doubt that he would point to the company's senior managers*" (Kay, 1996, p. 111). This description corresponds perfectly with the governance system of INA, and undoubtedly many more such large corporations in the region and beyond. Kay's comment above is ultimately what modern corporations must reckon with and what the law ought to provide checks and balances against.

1.5 Extra-Legal Control: Factual, Strategic, and Politically-Leveraged Control

Berle and Means further identified a sixth general form of corporate control, but failed to devote much attention to it. They spoke of this class as 'extra-legal in character (2004, p. 67), yet thereafter devoted little attention to this 'factual control' category. They nonetheless admit that "*[i]n the typical [US] large corporation […] control does not rest upon legal status [rather] […] control is more often factual, depending upon strategic position secured through a measure of ownership, a share in management or an external circumstance important to the conduct of the enterprise. Such control is less clearly defined than the legal forms, is more precarious, and more subject to accident and change*." (2004, p. 74).

The reason why it is important to highlight this form of control, in addition to this piece's focus on management control, is not just because these two are perhaps the most interlinked – and in practice, mutually complimentary – forms of control, but also because today – perhaps more so in CEE than in the high rule of law countries – this sixth form of control is dominant amongst large businesses. This is presumably due to the fact that throughout most the CEE, and more broadly throughout most of civil law Europe, non-voting shares or shares with excessive voting powers tend to be prohibited by law. The same could be said with regards to voting trusts, because notwithstanding the fact that an increasing number of European civil law systems have introduced versions of the trust, primarily to enrich inheritance law with more flexible legal tools (with some, such as Hungary's, being directly inspired by common law trusts),[7] few have gone as far as to expressly regulate voting trusts. There is also widespread distrust in the legal system throughout CEE, with the typical CEE businessman considering a day in court to be nothing but a waste of their time.

Last but not least, the presence of factual control is impossible not to see in case studies from CEE. The above-discussed Croatian INA saga could be taken as a paradigm case from that point of view. Particularly salient in that affair was the impact of politics on INA's business life, not just in 2022 but throughout the company's history. From both an academic and a practical point of view, an apolitical account of the governance structure of companies such as INA is impossible, and erroneous theoretical conclusions inevitably follow if politics is unduly disregarded. Particularly in cases concerning nationally important large businesses such as INA or MOL, political influence is simply the norm, not only in CEE countries but – as the Court of Justice of the European Union's judgments concerning so-called golden shares prove[8] – in Western Europe as well.

[7] On the spread of various forms of trusts in European civil law countries, see Tajti and Whitman (2016).
[8] See the cases: CJEU, judgement of 4 June 2002, Commission v. Portugal, C-367/98, ECLI:EU:C:2002:326; CJEU, judgement of 4 June 2002, Commission v. France, C-483/99, ECLI:EU:C:2002:327; CJEU, judgement of 4 June 2002, Commission v. Belgium, C-503/99, ECLI:EU:C:2002:328; CJEU, judgement of 23 October 2007, Commission v. Germany, C-112/05, ECLI:EU:C:2007:623.

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1.6 Abuse of Control

1.6.1 Simple Cases: the Northern Macedonian Smilenski Case

The fact that the concept of control is hard to pin down paradoxically makes it easy for crooks to exploit the concept's lack of clarity for malicious purposes, a phenomenon which is demonstrable with reference to numerous well-known cases. In most of these cases, a small group of individuals, often composed of friends and family members and typically with surprisingly little specialist legal knowledge, build-up a corporate façade through a byzantine system of interconnected companies while hiding their fraudulent activities behind the corporate veil.

In the small and economically weak country of Northern Macedonia, one of the successor countries of the former Yugoslavia, a series of events known as the *Smilenski* case saw a single businessman (aided by several family members) exercise full control over one such complex structure of interlinked affiliates that was built up during the transitory process of the early 1990s (Aleksandrovski, 2007, p. 141 *et seq*.). More than fifty interlinked companies (some incorporated in Austria, and some in Northern Macedonia) were controlled by Mr. Metodij Smilenski from a holding GmbH in Vienna (Austria). Exploiting the inexperience of local banks, his fraudulent scheme involved raising credit and then transferring the borrowed funds into untraceable accounts through his byzantine web of companies. The money ultimately 'disappeared'. As the only security given for these loans were the assets held by his shell companies, or the personal guarantees of Metodij, these shell companies were successively bankrupted in order to prevent the banks' collection of the debt, the guarantor disappearing from the reach of courts, too.

Empirical evidence clearly suggests that, unfortunately, this pattern of defrauding banks was frequently employed in the first transitory years in the entire region.

1.6.2 Abuse of Control: the Case of Holding Companies

Holding companies deserve special attention because in the former Yugoslavia, and some other post-socialist countries in CEE, they were seen as a model approach for the transformation of the large enterprises inherited from the socialist period into efficient business vehicles that could meet the demands of an efficient market economy. Generally considered a peculiar form of a group of companies, the holding company form seems to have become popular in Yugoslavia because there was an unspoken assumption that this form would keep economic control in the hands of the former central management, a class largely comprised of Communist-Party cadres.[9] The appeal of this particular form of ownership lay to a great extent in the fact that the overwhelming majority of Yugoslav businesses were not owned by the state, but operated under a *sui generis* form of 'societal ownership' ("*društvena svojina*"), which resembled – though differed in important ways from – cooperative ownership. The shorthand explanation is that the companies were owned by the workers they employed. Due to this *sui generis* form of corporate ownership, the state had much less direct influence over the process of economic transition from socialism to market economy than in Hungary and in other CEE countries with predominantly state-owned enterprise sectors. In other words, these Yugoslav oligarchs (not named as such initially) had freer hands in choosing and shaping the model for orchestrating their transition plans.

[9] For a more detailed description of the former idiosyncratic company ownership model prevalent in Yugoslavia and its effects on corporate governance, see Tajti (2005).

The scarce literature reveals neither the source of inspiration for the model nor the ultimate purpose of using the holding company form; relevant legislation and the few commentaries written thereon tended to present the model as virtually God-given. Most commentary only points out the law's relationship with other rules previously enshrined in the company act with little if any criticism or caveats attached. There are hardly any materials that specifically address the model's suitability for maintaining control over companies, nor are there any discussions on the role of control in secondary sources of law generally.

However, in line with the theory that this model was chosen to keep control in the hands of the experienced management of Yugoslavia's idiosyncratic socialist model, the subsequently formed holding companies employed former top executives in new, high-ranking executive positions. The tasks of those occupying these positions were limited to governance, the acquisition of stakes in new companies, and general investment, thereby excluding them from 'less comfortable' areas of activity such as manufacturing or marketing and sales.[10] However, in the absence of developed capital markets, making income from investing was normally nothing more than wishful thinking. Such holding companies would go on to possess shares in their affiliates, and sometimes subsidiary companies would also own shares in their holding company. Later, as it was realized that these Yugoslav 'holding companies' were actually just one form of the broader 'group of company' category, the designation disappeared from the legal parlance of some successor countries of the former Yugoslavia.

No quantitative data seem to exist, but several of these new holding companies collapsed soon after being created, with such companies typically facing serious governance problems even prior to the outbreak of the Balkan wars in 1991. The reasons for this included not only the burdens caused by a surplus workforce and the loss of markets, but also the teething problems corollary to the transition to capitalism, in particular, unfamiliarity with the nature of securities and other elements of the market economy, widespread distrust in an economic system that had been in constant crisis during socialism, and the lack of a litigation culture for bringing corporate disputes before the courts.

Needless to say, a misunderstanding of control's precise meaning and how it functions efficiently in the West ought to be added to this list. What I have learned from my experiences with Yugoslav holding companies is that control works where there is high respect for the law, or in modern terms, where there is a high rule of law index score, and the law is embedded in the people.[11] Where that is not the case, control by the center – the holding company – may evaporate overnight, a realization that experience thrust upon many in the transition era. In those days, the good fortune of the pearls of the national economy often depended more on political support and interference by politics than they did on good governance and management or respect for the rule of law. The brief history of holding companies in Yugoslavia is not a deeply researched subject, probably because the company form itself has largely fallen victim to oblivion. Nonetheless, history provides valuable insight into the causes of contemporary problems

[10] See, for example, section 410 of Company Act of the rump Yugoslavia from 1996, published in the Official Gazette No. 29/96.

[11] According to Krygier's description of 'social embeddedness and significance of the law' to mean that "*[t]he law must be, and must be widely expected and assumed to be, appropriate and to matter, to count, in the exercise of social power, both by those who exercise it (which should be far more than just officials) and by those on whom it is exercised*." (2001, p. 13).

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attendant to control, and may serve as an invaluable repository of utilizable empirical data.

An interesting and lesser-known point concerning holding companies that ought to be added is that holding companies were already creating problems in the US in Berle and Means' era. Berle and Means warned that "*holding companies can always be looked upon with a certain amount of suspicion; and why the investing public has always felt somewhat helpless in their presence [is because] [h]ere the control of the parent's directors over the subsidiaries' machinery is absolute; even the information disclosed may be so blind as to be unintelligible.*" (2004, p. 183).

I have already hinted that abuses of the holding company form were typically orchestrated by exploiting the pyramiding technique – i.e. multiple-layers of interlinked companies branching from a controlling holding company, much like the Smilenski case described above – combined with the use of non-voting shares, excessive voting power, and voting trusts (where existent). The ultimate aim of such structures is the maintenance of control over a group of companies by individuals or groups who do not hold the majority of the companies' shares (stock). Such practices were once a systemic problem in US public utility companies, ultimately leading to the passage of the Public Utility Company Act 1935[12] which attempted to tackle the problem. An article from 1946 described the complex, pyramid-like structures of public utility companies as follows:

"*The operating utilities […] at the base of these pyramids furnished all the revenues […] a large percentage of [which] were drained off […] by exorbitant service and construction fees charged against them by 'service companies' belonging to the parent holding company or to the individual interests who controlled the system. In such systems the companies in the super-structure were used for the purpose of retaining the insiders' control while the financial investment and risk were passed on to public investors by the floatation of myriad of holding-company securities carrying no effective power to control the management*." (Blair-Smith and Helfenstein, 1946, p. 150).

While the confines of this paper do not permit an in-depth exploration of the myriad forms that such complex holding structures may take, the questions concerning control that they raise are hardly irrelevant even today. Yet, if control and the malicious use thereof is to be observed 'in action,' then the US experience with public utility companies ought to be studied carefully.

1.7 Question to Be Asked: Should Control Be Made Visible in Company Acts?

Myriad dilemmas surround the subtle but essential concept of control. The simplest formal but hardly negligible question is: what weight is to be given to control in company law? Should it be made visible, and if so, how visible? Should control be subject to prescriptive drafting to "tame" it by carefully defining its meaning and uses wherever it comes up in company laws? Further, to tackle existing abuses of control, as illustrated also by the cases discussed herein, a parallel issue becomes: would mandatory or default rules better achieve the desired ends?[13]

The answer to most of these questions from across the Atlantic would be in the affirmative. The drafters of the General Corporation Law of Delaware, the leading authority on corporate law not only in the US but globally, found it important to define

[12] The Public Utility Holding Company Act 1935, 74-333 15 U.S.C.A. § 79 et seq.

[13] For a related discussion in the Slovakian context, see Patakyová and Grambličková (2020).

'control'[14] and to expressly regulate it in more articles. The same is done in the Model Business Corporations Act,[15] another model which provides the basis for corporate law throughout roughly half the States of the Union.

Continental European civil law systems generally do not expressly define control as conspicuously as these venerable US sources. The former Slovakian Commercial Code,[16] for example, had a distinct article on the 'Controlled and Controlling Party' and thus contained a definition of control, but this definition was extremely narrow and tailored only to the purposes of that article, thereby focusing only on voting rights. Other forms of control identified by Berle and Means – such as 'management control' – are not tackled directly in the Act, and therefore their scope and/or relevance in Slovakian law are anyone's guess. In the very few local publications on the subject, the topic of control tends to be merely hinted at during discussions concerning the separation of ownership and management.[17]

The former Hungarian Act IV of 2006 on Business Associations similarly mentioned control only in a few scattered provisions. This extremely-detailed technical statute was revoked by the new Civil Code of 2013, which deals with control as part of a relatively long article which only applies to groups of companies.[18] As opposed to the detailed and thus prescriptive Slovakian drafting, the Hungarian Civil Code is a minimalistic version of a European civilian company act that rests on the principle of 'disposivity'[19] (to wit, default regulation), meaning that the overwhelming number of company law provisions are not mandatory, but are merely models that may freely be departed from (Kisfaludi, 2013, para 3 at p. 87). The number of relevant provisions in Hungary's law have also been drastically reduced, arguably making the bypassing of legal principles surrounding control even easier.

These seemingly formalistic queries, which detractors may consider purely academic, do play an important role in warning and educating those who use the law

[14] See §203(c)(4) of Delaware General Corporation Law defines control as follows: „ [...] *"**Control**," including the terms "**controlling**," "**controlled by**" and "**under common control with**," means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting stock, by contract or otherwise. A person who is the owner of 20% or more of the outstanding voting stock of any corporation, partnership, unincorporated association or other entity shall be presumed to have control of such entity, in the absence of proof by a preponderance of the evidence to the contrary; Notwithstanding the foregoing, a presumption of control shall not apply where such person holds voting stock, in good faith and not for the purpose of circumventing this section, as an agent, bank, broker, nominee, custodian or trustee for 1 or more owners who do not individually or as a group have control of such entity*. [...]." [Emphasis added.] 8 Del. C. § 100, et. seq., as amended from time to time.

[15] See §8.60(2) of the Model Business Corporations Act providing a differing yet also express definition reading as follows: *"(2) "**Control**" (including the term "**controlled by"**) means (i) having the power, directly or indirectly, to elect or remove a majority of the members of the board of directors or other governing body of an entity, whether through ownership of voting shares or interests, by contract, or otherwise, or (ii) being subject to a majority of the risk of loss from the entity's activities or entitled to receive a majority of the entity's residual returns."* [Emphasis added.] See American Bar Association. Committee on Corporate Laws. Model Business Corporation Act: Official Text with Official Comment and Statutory Cross-References.

[16] Act No. 513/1991 Coll., section 66a. For the related commentary see Ďurica (2016, p. 299-305).

[17] For a rare English language analysis of Slovakian law, see Patakyová, Grambličková, and Duračinská (2022).

[18] A Polgári Törvénykönyvről szóló 2013. évi V. törvény [Civil Code] §§3:49-3:62. These sections took over the earlier solutions and did not add much on control. Thus, the group of companies must be registered in the company register but the group does not qualify as a juridical person. It is only those companies that qualify as controlling members which must prepare consolidated yearly financial reports.

[19] A caveat needs to be added here. Namely, reliance on default rules in the context of company laws is characteristic of other regional legal systems as well, for example in Slovakia. See, e.g., Patakyová and Grambličková (2020). What makes the Hungarian system different is the reduction of the "quantity" of provisions and in the length thereof.

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about the role of control as well as the pitfalls and potential consequences of neglecting thorough consideration of the issue. This applies *mutatis mutandis* to legal education; students are generally inexperienced in that they normally come to universities without much exposure to real life corporate challenges. Unlike practicing businessmen, they will not be able to intuitively perceive and grasp the roles that corporate governance and control play in the life of enterprises, and thus the formal transfer of theoretical knowledge on the topic ought to be considered an important pursuit in its own right.

2. INTER-GENERATIONAL TRANSFER OF WEALTH AND CONTROL IN FAMILY-OWNED FIRMS

2.1 On the Geography and Gravity of the Corollary Problems

Numerous questions, risks, and conflicts arise over the intergenerational transfer of control over successful companies. Such issues typically arise between the small business founder(s), their spouse(s), and/or their heirs when the former's retirement, death, or incapacity comes knocking at the door. This problem is presumably encountered in all legal systems, though it is perhaps more serious in less developed economies where SMEs constitute the dominant business form.

CEE is unique in this respect because in most countries of the Eastern Block, the establishment of private businesses was not possible under socialism. The exceptions were in the westernmost countries (e.g., Hungary) from the 1980s onwards, and in the former Yugoslavia, which took a less radical economic path, especially following Stalin's death in the early 1950s. In Yugoslavia, small workshops employing a small workforce were never prohibited in the post-WWII period.

Yet the true U-turn as far as CEE policy on SMEs was concerned occurred after the fall of the Berlin Wall and during the transitory 1990s, when thousands of SMEs were founded in the region. Thousands failed soon after, with most of them ending up abandoned in lieu of being led out of the market through insolvency proceedings. A considerable number of SMEs nonetheless survived, grew, and eventually became genuine success stories (e.g., the Hungarian Graphisoft).[20] While only a small number of the most outstanding ventures became hot topics in the media, and fewer still became topics of interest for legal scholars, the actual number of outstanding success stories is far from negligible.

The systemic problem for which CEE's local laws possessed no tailor-made solutions was the myriad questions that surfaced upon the retirement, death, or incapacitation of the founders of such successful enterprises. It was not just the lack of written law that caused concern, but also the lack of awareness about the dimensions of these problems and the non-existence of any societal 'know-how' necessary for dealing with them. These problems included, perhaps most importantly, questions surrounding the transfer of control.

Although quantitative figures and empirical analyses on these and related issues tend to be lacking in CEE – though this varies from country to country – some figures and pertinent publications can nonetheless be found. I was in the position to gather data primarily from post-1990 Hungary, but this data may also provide insight on the situation in neighbouring countries (perhaps with the exception of Austria). For example, the number of abandoned and liquidated companies remained high throughout the pre-COVID-19 period in Hungary.[21] One may presume that a significant number of these firms

[20] See at Graphisoft. Available at: https://graphisoft.com/hu (accessed on 10.12.2022).
[21] For a related discussion and some relevant statistical data, see Tajti (2019).

failed due to the problems inherent in the inter-generational transfer of wealth and control.

In fact, this peculiar set of problems remains one of the main contemporary challenges in the region and justifies a quest for answers from more economically advanced jurisdictions. This quest ought to include the US, a country that is often excluded as it is thought to be too divergent a system. The ensuing elaboration of the lessons that emerge from the milestone US *Galler v. Galler* case – with its balanced formula that simultaneously ensures that control is kept within the family and that the closest members of the family are financially provided for following the death of the founder-manager brothers – should also prove insightful for European civil law systems.

2.2 Why was the Galler v. Galler Case Momentous?

The case was of special importance for at least three reasons: *firstly*, it legitimized shareholders' agreements, and *secondly*, it led to the recognition that SMEs are a distinct business form which requires somewhat different rules from those applicable to large corporations. *Thirdly*, and most importantly for our purposes, its unique formula ensures that close family members are financially provided for through the future earnings of the family company upon the death of the company's founders (two brothers), while simultaneously guaranteeing the continued operation of the company under family control. Although some of points the brothers agreed upon were contested and not fully endorsed by the Supreme Court of Illinois, the pattern was eventually given a green light by it.

It is the position of this paper that this formula – notwithstanding its common law origin and the major differences between US and European company laws – may be of use to other countries including those in CEE because SMEs across many jurisdictions are burdened by very similar if not identical issues. Thus, when reading the ensuing description of the *Galler* formula, the right question is whether the law of one's home jurisdiction has sufficiently flexible arrangements in place that are tailored to addressing these common issues faced by SMEs.

2.3 Why the Galler Formula may be of Use in CEE and Other Less Developed Legal Systems

Having been directly exposed to developments in Hungary and Serbia, and indirectly exposed to developments in similarly placed jurisdictions thanks to my colleagues, students, and acquaintances from neighbouring countries, what I saw and heard was that hundreds of successfully launched SMEs typically failed due to one of two issues. Either the firm would fail once the first large deposit of money was made in the firm's accounts, or after a major problem surfaced, irreconcilable conflicts would arise between family members and/or the founders, and the business consequently ground to a complete halt. Under such circumstances, old friends or family members quickly became fierce enemies over disputes concerning the share in the profits they were entitled to, or alternatively, over who should be blamed for mistakes and ought thus suffer the liability corollary thereto.

Although obviously psychology, Fukuyama's trust (i.e. "*the improbable power of culture in the making of economic society*" – 1995, p. 1), and many other factors also play a role in such impasses, these problems are essentially corporate governance and corporate finance problems that the founders of these SMEs either lacked awareness of, or negligently – if not willingly – disregarded. Many of the failed enterprises, in other

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words, did not even reach a stage where questions concerning the inter-generational transfer of wealth arise.

2.4 The Facts of the Galler Case

The facts of *Galler* are especially educative, as they display how the problems burdening US closed corporations resemble those facing European SMEs. The Galler Drug Company was founded in 1919 by two brothers, Benjamin and Isadore Galler, who were equal partners. Shortly thereafter, in 1924, the business was incorporated under the Illinois Business Corporation Act and each of the brothers received half of the 220 shares of stock issued. For the sake of completeness, it should be added that in 1945, each brother sold 6 shares to an employee as a reward for his work, but this additional owner was not party to the dispute that arose after one of the brothers died in 1955, and his small shareholding did not affect the dispute's outcome either.

While good relations persisted between the two brothers, they concluded agreements – that is, shareholders' agreements – "*for the financial protection of their immediate families and to assure their families, after the death of either brother, equal control of the corporation*."[22] They took this step on the advice of their accountant; it is my view that analogous advice could have saved thousands of SMEs from disappearance in CEE and elsewhere. This not only provides a workable formula for the consensual transfer of wealth and control between generations that is necessary for continuing the successful operation of businesses, but also imposes a formula which disincentivizes conflicts between heirs.

Notwithstanding the existence of these shareholders' agreements, as it is usual in case of family-owned firms and generally in inheritance proceedings, one of the sides sought to have these agreements[23] quashed after Benjamin (one of the brothers) died without honouring them. Emma Galler, the widow of Benjamin, then sued for accounting and specific performance of the agreement, and the first instance court granted this relief. However, the Appellate court reversed this decision and denied Emma Galler an order for specific performance. In fact, the second instance court found the agreement void on public policy grounds because of "*the undue duration, stated purpose and substantial disregard of the provision of the Corporation Act […].*"[24] Put pithily, the agreement was highly unusual even though it was a solution fit for the purposes for which it was created.

The case became a milestone precedent because Illinois' Supreme Court did not find the obviously out-of-the-ordinary agreements unenforceable. Or, as they put it, it was not a '*corrupt scheme*' but was rather an '*[agreement] between stockholders dealing on equal terms*'[25] that would not lead to any public detriment. Two further aspects of the agreement in *Galler* were of crucial importance. On one hand, it was a "*straight contractual voting control agreement which did not divorce voting rights from ownership of stock in a close corporation [and it was not a voting trust either].*"[26] On the other hand, although its

[22] United States, Illinois, Galler v. Galler, 32 III.2d 16, 203 N.E.2d 577 (1964), p. 579.

[23] The agreement was executed by signing six copies of the terms and conditions, and the signed copies were left with the accountant for safe keeping.

[24] United States, Illinois, Galler v. Galler, 32 III.2d 16, 203 N.E.2d 577 (1964), p. 581.

[25] *Ibid*., p. 577, para 1.

[26] *Ibid*., p. 577. Voting trusts came up as a defense which the defendants attempted to plea, asking the court to apply these rules to the Galler agreement because the duration of voting trusts was limited to 10 years under a 1947 Illinois statute. *Ibid*., para 4-5, at p. 586. As the court did not consider the Galler agreement to be a voting trust and as for straight voting agreements – in use since 1870 – the defendants' defence was rejected in this regard.

duration was atypical for those times, it was not excessive because it was foreseen to continue only "*so long as one of the two majority stockholders lived*."[27]

It must also be added that at the time that the shareholders' agreements concerned in *Galler* were made, these peculiar contracts – which are simultaneously creatures of contract and company law – were novel even by the US standards. Thus, even more so in CEE, where shareholders' agreements were essentially unknown prior to the fall of the Berlin Wall. Consequently, few in CEE understood how shareholders' agreements could be used to prevent the myriad conflicts likely to arise consequent to events surrounding the inter-generational transfer of wealth and control. As shareholders' agreements typically remain confidential, years (if not decades) passed before their existence became publicly known in the region, a pattern which suggests a gradual proliferation of such arrangements in CEE. Nonetheless, it seems that shareholders' agreements have not yet been widely utilized in CEE for the specific purpose of preventing common problems associated with the inter-generational transfer of wealth and control.[28] This fact in particular justifies the re-examination of the *Galler* precedent contained herein.

2.5 The Elements of the Galler Arrangement: A Balanced Formula for Financially Supporting Close Family Members and Keeping Control in the Hands of the Family

As noted previously, it is important to stress that the brothers party to the shareholder deal concerned in *Galler* made the said agreement with two interlinked goals in mind. On one hand, they wanted to use the future profits of the company to provide financial support for their close family members after they died. Insofar as financial support was concerned, the agreement foresaw three possible sources of support for the wife (or children) of whichever brother died first; the first was a salary continuation agreement which provided that a sum double the salary previously paid to the deceased brother for work done in their capacity as a corporate officer was to be paid monthly to their widow over a five-year period, or to their widow's children if their widow was to remarry within that five-year period.[29] The *second* was the duty of the corporation to declare certain annual dividends, the figures of which were also specified in the agreements.[30] *Thirdly,* the corporation was granted authority to purchase "*so much of the stock of Galler Drug Company held by the estate [formed upon death of any of them] as is necessary to provide sufficient funds to pay the federal estate tax, the Illinois inheritance tax and other administrative expenses of the estate*."[31]

The brothers also designed their agreement to ensure that their two families would retain control of the business. The tools used to that end were technical but ingenious, demonstrating their comprehension of both the importance and characteristics of control. The first set of technical rules concerned the composition of the future board of directors. It was provided that the bylaws of the corporation shall be amended to provide for a board of four directors with a prerequisite quorum of three; clearly a measure designed to maintain the balance between the brothers' two families. Additionally, to stymie abuse of the technical rules respecting the convocation of the

[27] *Ibid*., p. 577.
[28] For the history and various uses of shareholders' agreements in Hungary in the post-1990 period, see Tajti (2018).
[29] United States, Illinois, Galler v. Galler, 32 Ill.2d 16, 203 N.E.2d 577 (1964), p. 581.
[30] *Ibid*., p. 580, para 6.
[31] *Ibid*., p. 581, para 11-12.

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board, they provided that "*no directors' meeting shall be held without giving ten days notice to all directors*."[32]

A related feature of the agreement is that it tied the hands of the heir-directors in regards to the selection of the board; the agreement simply mandated that only listed family members (Isadore, Benjamin and their wives) were to be voted for by future board members.[33] Moreover, it provided that if one brother were to die, that deceased brother's wife was to have the power to nominate a descendant to replace her deceased husband on the board.[34] The certificates evidencing the shares of the two brothers had to be printed upon a legend which subjected the transfer of shares to the terms of the already-concluded shareholders' agreements, thereby warning third-parties of the shareholders' peculiar arrangements.[35]

Obviously, some of these solutions may seem foreign – if not repugnant – to the legal systems of certain jurisdictions. Still, the *Galler* formula might be instructive elsewhere, at least for the purposes of shedding light on the sorts of problems SMEs may face during the inter-generational transfer of wealth or control as well as on potential solutions thereto.

3. EPILOGUE

Berle and Means prophesized that "*[i]t is conceivable […] that the problems of 'control' [discussed in their seminal book] may become academic within another generation.*" This particular prediction has – uncharacteristically – proved to be mistaken: control has survived, has remained equally tricky to identify in practice partly because of the novel forms it may take, and yet it has continued to generate problems similar to those tackled by Berle and Means. The daunting task awaiting drafters of contemporary laws regulating various business vehicles will therefore to a significant extent revolve around the question of what should be done with the perplexing, partially theoretical, and partially practical concept of control? As the above elaboration concerning issues connected to the inter-generational transfer of control over SMEs vividly demonstrates, control is undoubtedly a topic with concrete practical implications which are hardly of *de minimis* importance. Taking cognizance of and devoting more attention to control, the *invisible hand* of the domain, is a good start.

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[32] *Ibid.*, p. 580, para 2.
[33] *Ibid.*, p. 580, para 3.
[34] *Ibid.*, p. 580, para 4,5.
[35] *Ibid.*, p. 581, para 9.

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