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**Doctoral Thesis**

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# Control over organization

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## Control in centralized and decentralized systems

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## ABSTRACT

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This interdisciplinary research project aims analysis of modern concept and determinants of controlling person; reviews historical development of concept; discuss the ability to identify power of control; helps to uncover factual distribution of power and hierarchies; proposes methods of control and analysis of controlling network structure. The research shows that the control over organization can be full, partial, lateral, vertical but cannot be absolute.

Modern corporate law and corporate governance rules have a gap between obsolete legal rules and new network structures; legislation and social processes. There are a lot of non-standard situations where modern law is not working: VIE structures in China with indirect control; Cooperative minority Activists; and, finally, Decentralized Virtual Organizations.

The corporate law has focused on the controlling person acting alone or with its affiliates. In practice, key players often form coalitions to get a control over corporation. It could be no key players at all, but only cooperative network of minorities or stakeholders. Existing methods of control analysis don't provide parties, administrative bodies and judicial system with clear definition of control. Methods of control determination are working only in the simple cases. In respect to control by coalitions or existing in networking organizations, the definitions of control are vague and have no clear methodology. Though, the economic and social tools like Cooperative Game Analysis and Social Network Analysis can shed light on the process of formation of coalitions and create new regulations. Focusing on the best practice of the controlling shareholder regulation, minority shareholders rights protection, conflicts between minority and controlling shareholder and effectiveness of law implementation the project strengthens the existing regulation and facilitates development of new rules to enhance the effectiveness of analysis of control over excessive power of the controlling person taking into account practical aspects of law implementation.

The complimentary objective of the research is an analysis of modern determinants of control distribution over corporation, assets, transactions, and decentralized organizations on blockchain distributed network.

On the ground of analysis, the methods of determination of control in complicated coalitions and network organizations are proposed. The control in decentralized network achieved and implemented faster with low quantity of errors, therefore, control is more comprehensive and pervasive. The present research suggests ways to overcome the existing problems with more precise identification of control in coalitions, networking societies and organizations with blurred ownership structure.

The methodology is based on legal, economic, social and technological indicators. The feasible aspects of sole, shared and movable control are discussed.

Control is viewed as movable essence, which could exist separately from beneficiaries and stakeholders of controlling and controlled organization. The research underlines the importance and influence of coalitions and networking societies. The Network Control Analysis enables analysis of control distribution among coalitions.

Among others, the research is focused on: control in different branches of law (corporate, competition, tax); definition of controlling person; control of social groups over organization; methods of control determination and qualification; control over decentralized virtual organizations.

# INTRODUCTION

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The subject of the research is control over the companies and organized societies like virtual organizations. The control over the company is the key notion in many areas of law from the corporate to money laundering law. The fair determination of control of the company allows prevent breaches of the rights of minority shareholders, tax evasion, and raising competition on the market. The understanding of control nature is especially important as the change of control used in many contracts as the trigger event for acceleration or cancellation of the contract. Contractual, Network and Game theories provide new way for control determination. Appropriate analysis of information on control over the contracts can improve corporate governance of the companies.

In the research the control over companies and key indicators of control are discussed from the legal, economical, contractual, and technological point of view. Among others, the research focuses on distributed blockchain network. The blockchain industry shows tremendous growth. One of the key problems of blockchain technology is lack of control over transactions and asset on the decentralized network.

One of the purposes of the research is an analysis of modern determinants of control over companies, participants, assets, transactions, and decentralized network organizations. The main questions are: what is control over an organization; how the control over the organization can be determined and regulated.

For proper understanding control over the company and organized network societies we discuss control notions, specific relevant traits and legal frameworks of every component and factor: company, shareholders, management body, employees, and other key stakeholders; their acts and interactions.

The paper derives the effectiveness and the best practice of the regulation of control over corporations and networking organizations. On the base of the legal cases and practice the ability of controlling shareholder, directors, managers, governments, and users of crypto-communities to control the company/organization, transactions and assets will be discussed.

## **IMPORTANCE**

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The control over the company by a single person is still important factor of economic development. The aggregate share of countries with predominantly “concentrated” ownership structures in global market capitalization increased from 20% (1998-2002) to 34% (2013-2015)<sup>2</sup>. In Israel almost 75% of listed companies are controlled by family or individual. The twenty business groups (nearly all of them family-owned) controlling 160 publicly-traded companies with a 40% segment of the market<sup>3</sup>. In Belgium, about 60% of listed companies have a shareholder who, alone or in concert, hold more than 30% of the voting, which gives them de facto control of the company. In China around 75% of issuers have a dominant shareholder, an individual/family or state-owned entity, who owns 30% or more of the issued shares and remain dominated by a single state shareholder. In Russia, about 43% of 96 major listed companies have an owner or a group of interrelated owners holding 75% of company shares. Many of the largest listed companies have controlling owners. For example, in Canada about 25% of the largest 300 TSX listed firms have a controlling shareholder<sup>4</sup>.

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<sup>2</sup> OECD, Corporate Governance Factbook, (2017).

<http://www.oecd.org/daf/ca/Corporate-Governance-Factbook.pdf>. Page 11.

<sup>3</sup> OECD, Factbook, supra note 2 at 6. Page 13.

<sup>4</sup> OECD, Factbook, supra note 2 at 6. Page 12. and Clarke, Donald, (2003). "Corporate Governance in China: An Overview", China Economic Review, vol. 14, 2003, pp. 494-507.

At the same time, associated groups of stakeholders or token holders of decentralized virtual organizations can potentially change the situation with concentrated control over organization especially in respect to minority network societies.

The standard approach to control is based on voting threshold. Nowadays, a lot of stakeholders of organization, networking and pyramidal structures are widely used. It is difficult to determine control while not making investigation and thorough proper due diligence.

Determination of the control in every individual case demands a lot of time and assumes individual approach. For fair determination of the control over a company the authorities or independent judiciaries have to carry out a process of investigation like economic calculations in competition law to find out influencing party and reveal the mechanism of control. The process of control determination on case by case base demands a lot of time and efforts. This is why we need to develop common procedure for identification of control over company. We need to adopt some methodologies and develop common process for identification of control over the company.

This research is important because it contributes to knowledge on control over corporation and networking societies, develops methodology and produces the new discourse along with fresh look on control over companies and networking societies like stakeholders' communities and virtual organizations.



# 1. HISTORY AND THEORY

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## 1.1. EXCURSION INTO THE HISTORICAL DOMAIN

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To perceive the concept of control over the company we can view antecedents experience and make excursion to history of organization.

According to Harold J. Berman<sup>5</sup> (1983), **Roman law** of Justinian provided the basic legal terminology, but had not developed the idea of limited liability.

At the same time the Roman jurists had stated a variety of situations in which a group of people were to be treated as a collective unit, such as a *societas* ("partnership").

The Roman law considered the state as such (still called *populus Romanus*) and other territorial administrative units like municipalities as corporations (*universitas*; also *corpus* or *collegium*), with the right to own property and make contracts, to receive gifts and legacies, to sue and be sued, and, in general, to perform legal acts through representatives. All the rights and obligations of such corporations were regulated administratively but not by civil law.

Similarly, many private associations, including organizations for maintaining a religious cult, burial clubs, political clubs, and guilds of craftsmen or traders, were considered to be corporations, the extent of their rights depended on privileges and liberties granted by the emperor.

The Roman jurists, with their intense hostility to definitions and theories, did not address in general terms the question of the relationship of the *universitas* to the ensemble of its members. The Digest stated epigrammatically: "What is of the corporation is not of individuals," and again, "If something is owed to a

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<sup>5</sup> Berman, Harold (1983), "Law and revolution. The Formation of the Western Legal Tradition". Harvard University Press, Cambridge. Page 122.

corporation it is not owed to individuals; nor do individuals owe what the corporation owes."<sup>6</sup>

Hence, in Roman law the control over corporation held emperor and various administrative bodies. Small partnership as a form of private collective agreement was under the collective control of its members.

Germanic viewed the corporation as a fellowship with a group personality and a group will. This group had personified purposes to which property, money, land, and incorporeal rights had been dedicated<sup>7</sup>. Some form of modern networking societies and virtual organizations can survive on the same principles of the group will.

The good example of a managerial control is corporation of goods in the canon law. Bishop of Rome as the sole head of the church separate the clergy from the control of emperors, kings, and other feudal lords. The corporation was often formed under canon law (church law) in absent the permission and jurisdiction of the state and king. Under the canon law any group of persons which had the requisite structure and purpose, for example, an almshouse or a hospital or a body of students, as well as a bishopric or, indeed, the Church Universal constituted a corporation, without special permission of a higher authority<sup>8</sup>.

The canonists developed a legal device called a "foundation" or "corporation of goods" (*universitas bonorum*). A clergy hospital, or poorhouse, or educational institution, or bishopric or abbey, could be viewed not only as a corporation of persons but also as a corporation of goods. The property rights and duties connected with a clerical office, the income from economic activities adhering to the office, and all other perquisites of it was treated as a legal person, with power

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<sup>6</sup> Berman, Harold, supra note 5 at 8, page 216.

<sup>7</sup> Berman, Harold, supra note 5 at 8, pages 52, 56.

<sup>8</sup> Kenny-Greenwood, Joshua, (2014). "History of The Corporation Sole", page 1.

through its officers to conduct its own economic and legal affairs as a single entity<sup>9</sup>.

The head of corporation (a bishop, rector or governor) was authorized to act on his own authority, and had rights distinct from those of the corporation. The head of the corporation was viewed as a species of guardian or tutor, and the corporation as a kind of ward or minor. While the office of corporate held title to property, that property did not “belong” to the head of corporation personally. Rather, the head held the property in trust for the church. In this sense, the bishop was very much like a trustee<sup>10</sup>. In contrast to the rule of Roman law, canon law imposed civil and criminal liability on a corporation when a majority of its members consented to a wrongful act, but in contrast to Germanic law the wrongful acts of officers of a corporation could not be imputed to the corporation itself<sup>11</sup>.

Therefore, it can be said that under the canon law though the head of corporation didn't own the property of corporation, he was entitled the power to control the corporation. At the same time the members of the corporation have the rights to take the decisions in some cases and elect head of corporation. This organizational structure is similar to some decentralized networking organization. For example the DAO an organization created on ethereum blockchain was a networking society which jointed and managed the participants' funds.

In the eleventh and twelfth centuries the European jurists revived the Roman law to systematize and harmonize the huge network of Roman legal rules in terms both of general principles and of general concepts. In western mercantile law acquired in the late eleventh, twelfth, and early thirteenth centuries the more individualistic Roman concept of partnership (*societas*) were replaced by a more collectivistic concept in which there was joint ownership, the property was at the disposition of the partnership as a unit, and the rights and obligations of one partner survived the

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<sup>9</sup> Berman, Harold, *supra* note 5 at 8. Page 91.

<sup>10</sup> Kenny-Greenwood, Joshua, *supra* note 8, at 9. Page 1.

<sup>11</sup> Berman, Harold, *supra* note 5 at 8. Page 218.

death of the other. The individual liability of partners was replaced by joint liability of partners.

Various forms of partnerships and corporations such as commenda (a partnership for a single joint venture) and compagna (long term family association) were developed.

In contrast to compagna the commenda had the great advantage that the liability of partners was limited to the amount of their initial investment<sup>12</sup>.

The Lutheran concept of individuality recast old rules in a new ensemble. Nature became property. Economic relations became contract. Conscience became will and intent. The Catholic tradition became primarily means of controlling social and economic relations<sup>13</sup>.

The contractual arrangements and individual control over the property and economic relationships open the door to law-based individual control over jointly organized societies.

Therefore, we know that in history exist various forms of control like:

1. Administrative (Rome);
2. Contractual (partnership Rome);
3. Collective control over people and their assets (Germanic tribes);
4. Control of managers over corporation's goods (Canon law);
5. Control of partners over economic activity.

Let view how this historical form of control reflected nowadays.

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<sup>12</sup> Berman, Harold, supra note 5 at 8. Page 351.

<sup>13</sup> Berman, Harold, supra note 5 at 8. Page 29.

## 1.2. THEORIES OF CONTROL

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There are various approaches and theories to the organization and control over the companies. These theories explain and interpret various aspects of the control from economic, behavioural, and legal point of view.

The first and the most adopted is Classical firm theory. According to the Classical firm theory firms exist to coordinate and motivate specialised people's economic activity<sup>14</sup>. In the light of classical theory, the control performs over economic processes of the company and over management coordinative efforts. We can note that it is count only economic but not social activity. Besides, the weakest part of the theory is ignorance of other stakeholders. Among all stakeholders the theory views only the managers as the most important. In addition there are no fair indicators of control.

The shortcomings of the Classical theory are eliminated in the Team production theory. The Team production theory, views the corporation as a cohesive group consisting of the internal and external stakeholders of the corporation<sup>15</sup>. The cooperative network of all participants comprises the corporation. Every participant, stakeholder or shareholder, is equally important and have to make input or investment. "Party without control rights will be discouraged from making necessary firm-specific investments"<sup>16</sup>. Though, it is arguable. There are a lot of examples from creditor's activity until volunteering and charity, which don't assume any control.

From the Team production theory view the owner of the assets of the corporation is corporation itself but not shareholders.

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<sup>14</sup> Mantsaari, Petri (2012). "Organising the firm. Theories of Commercial law, Corporate governance, and Corporate law". Springer. Page 12.

<sup>15</sup> Clarke, Thomas; Branson, Douglas, (2012). "The SAGE Handbook of Corporate Governance". SAGE publications Ltd. Page 101.

<sup>16</sup> Blair, Margaret and Stout, Lynn, (1999). "A Team Production Theory of Corporate Law". Virginia Law Review, Vol. 85, No. 2, pp. 248-328, March 1999. SSRN: <https://ssrn.com/abstract=425500>. Page 272.

The same as in the Classical theory, the most powerful player within corporation is board of directors. This makes sense as the board of directors hierarchically controls all transactions, assets and players of corporation. According to Team production theory boards exist not to protect shareholders per se, but to protect the enterprise-specific investments of all the members of the corporate “team,” including shareholders, managers, rank and file employees, and possibly other groups, such as creditors<sup>17</sup>.

Team production problems are said to arise in situations where a productive activity requires the combined investment and coordinated effort of two or more individuals or groups<sup>18</sup>. The Team production theory views the control over corporation as an ability to provide substantial influence on a group of shareholders and stakeholders of the corporation to overcome production problems. It is true, in relation of companies based on intellectual property. At the same time, for companies, focusing on heavy engineering or mineral extraction, the machines, minerals and other assets are also very important.

The Team production theory pays attention to cooperative behavior but has poor explanation of economic reasons.

Transaction costs theory gives explanations of economic rationality for company to exist. According to the Transaction cost theory every company will expand as long as the company's activities can be performed cheaper within the company, than by e.g. outsourcing the activities to external providers in the market<sup>19</sup>. Though, it doesn't explain how the outcome will be distributed.

From the Transaction cost theory perspectives the control over corporation is control over the cost of corporation's activities. But who are the persons that govern corporation's activities? The next one is Incomplete contracting theory. Incomplete contracting theory is more concern about management.

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<sup>17</sup> Blair, Margaret; Stout, Lynn, supra note 16 at 12. Page 253.

<sup>18</sup> Blair, Margaret; Stout, Lynn, supra note 16 at 12. Page 249.

<sup>19</sup> Coase, R. H. (1988). *The Firm, the Market, and the Law*. Chicago: University of Chicago Press. Page 178.

Incomplete contracting theory is founded on an assumption that it is costly to write elaborate contracts. Therefore, there is a need for ex post governance of “simple” contract. In regard to corporation, the control is ongoing governance of corporation. The executive managers play significant role in control over corporation.

The role of principal and managers are stressed out in the Agency theory. Agency theory assumes that all individuals act in their own interests with the objective of maximizing their personal welfare. As a result, there are inherent costs associated with a structure in which one individual (the principal) delegates or entrusts the management and control of his assets or affairs to another (the agent), especially where the agent is armed with more information than the principal (known as information asymmetry). These costs are labelled ‘agency costs’ and comprise all negative effects of the delegation of management and control

Principal-agent models, which allow agents write contracts, characterized by *ex ante* incentive alignment under the constraints imposed by the presence of asymmetric information.<sup>20</sup> Despite the law asserting that an agent has a fiduciary duty to serve the principal’s interest, the agent will also tend to serve their own self-interests<sup>21</sup>. The controlling person loses control over management. Therefore, an agent (directors) has unlawful power to control the corporation.

Control can be viewed through lens of property rights. The property rights provide the owner with the title to own, use, get benefits and transfer it. Grossman & Hart has viewed the ownership as the power to exercise control. The property rights theory focuses on controlling shareholder as a person who has the title to own shares, use, vote, get benefits from shares and transfer it.

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<sup>20</sup> Foss, Nicolai; Lando, Henrik (1999). “The Theory of the Firm”. Encyclopedia of Law and Economics. Page 19.

<sup>21</sup> Braendle, Udo (2007) “Theories of the firm”. Lecture. Page 9.

According to Segal Ilya and Whinston Michael (2010) Roman law referred to these property rights as *usus* (the right to use), *abusus* (the right to encumber or transfer), and *fructus* (the right to the fruits)<sup>22</sup>.

The property rights over an asset can be defined as a bundle of decision rights involving the asset, which provide rights to take certain actions (“rights of access”) and to prevent others from taking certain actions (“rights of exclusion”), including the right to take the profit generated by use of the asset and to prevent others from doing so, often called “profit rights” or “cash flow rights”<sup>23</sup>.

In some cases property rights specify control rights, which grant an agent the rights to take certain actions<sup>24</sup>.

Grossman and Hart (1986) note, property rights confer residual rights of control to the owner of an asset: the owner is entitled to the use and fruits of the asset except insofar as he has contractually agreed to limits on those rights.

## **2. PRESENT REGULATION AND THEORIES**

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### **2.1. DEFINITION AND TYPES OF CONTROL**

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#### **Definition**

The common understanding of control over organization is based on static and dynamic positions. The term control as a state means power to order, limit, or rule<sup>25</sup>; power to influence or direct<sup>26</sup>; power to make decisions about how something is managed or done, the ability to direct the actions of someone or

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<sup>22</sup> Segal, Ilya; Whinston, Michael (2010). "Handbook of Organizational Economics" and "Property Rights". Page 2.

<sup>23</sup> Holmes, O.W. (1881), *The Common Law*, page 246; Segal, Ilya, *supra* note 22 at 15, page 1.

<sup>24</sup> Segal, Ilya, *supra* note 22 at 15. Page 13.

<sup>25</sup> Cambridge University Press (2013). "Cambridge Advanced Learner's Dictionary".

<sup>26</sup> OUP Oxford, 2009. "Oxford Paperback Dictionary & Thesaurus Paperback".



something<sup>27</sup>. The control as an action can be defined as an act of controlling something or someone<sup>28</sup> or act that limits, cause to do what controlling person want; direct the actions or function<sup>29</sup>.

The objects of control are something, or someone's actions or behavior<sup>30</sup> or the course of events<sup>31</sup>. Having no control means freedom to do something and independence from everyone.

In legislation the control usually defined as a possibility exercise decisive influence<sup>32</sup> or dominant influence<sup>33</sup> over management or activity of a company. Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities<sup>34</sup>.

Control is capacity to carry an ordinary resolution at a general meeting of shareholders<sup>35</sup>.

The control of company means the power to exercise a controlling influence over the management or policies of a company whether through ownership of securities, by contract, or otherwise<sup>36</sup>.

Control in case of trust means a power (whether exercisable alone, jointly with another person or with the consent of another person) under the trust instrument or by law to — (a) dispose of, advance, lend, invest, pay or apply trust property; (b) vary the trust; (c) add or remove a person as a beneficiary or to or from a class of

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<sup>27</sup> Webster, Merriam, U.S. (2014). “The Merriam-Webster Dictionary”.

<sup>28</sup> “Cambridge Advanced Learner's Dictionary”, supra note 25 at 15.

<sup>29</sup> “The Merriam-Webster Dictionary”, supra note 27 at 16.

<sup>30</sup> “Cambridge Advanced Learner's Dictionary”, supra note 25 at 15.

<sup>31</sup> OUP Oxford, supra note 26 at 15.

<sup>32</sup> Council Regulation No 139/2004. Page 7.

<sup>33</sup> Directive 2012/30/EU. Page 11.

<sup>34</sup> Commission Regulation (EU) No 632/2010 of 19 July 2010 on Accounting Standards. Page 6.

<sup>35</sup> Case Canwest Global Communications Corporation v Australian Broadcasting Authority (1997).

<sup>36</sup> Commodity and Securities Exchanges of U.S. Code of Federal Regulations (2014) (17 CFR 160.3 Title 17 Chapter 1, Part 160).

beneficiaries; (d) appoint or remove trustees; (e) direct, withhold consent to or veto the exercise of a power<sup>37</sup>.

In legal practice the standard evidences<sup>38</sup> of control are:

- control of majority of voting rights;
- rights to appoint or remove a majority of the members of the administrative, management or supervisory body;
- rights to exercise a dominant influence over an undertaking of which it is a shareholder pursuant to a contract entered into or articles of association.

In determining the power of control it is very important determine not only the factual possession but also the intention to possess (*animus possidendi*) the majority of voting rights or major part of company's gains.

### **Types of control**

Let's discuss types of control. The control over the company can be full/partial, direct/indirect, latent/active, negative/positive, horizontal/vertical, ultimate, collateral, joint, de facto/intentional and movable.

#### **Full control**

Full control is ability to control and manage total cash flow of a corporation and essential business operations.

#### **Partial control**

There is a big question could someone have a partial control over corporation.

Generally, a corporation could not be under partial control. Rather, we can use term "partial control" as an indication of full control over part of assets, contracts

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<sup>37</sup> UK Money Laundering Regulations (2007) Consultation. Article 9.2.

<sup>38</sup> Directive 2013/34/EU of the European Parliament (2013) on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC 29.6.2013 Official Journal of the European Union L 182/19. Page 21.

and processes of corporation. Partial control can be resulting in negative control over some decisions of shareholders or directors.

### **Negative and positive controls**

Negative control is more about blocking decision. Negative control is ability to control in the form of a power of veto. Any shareholder with at least a 25% shareholding in a company could be said to have control, at least through the ability to veto a change in the constitution of the company, or any other action requiring a special majority resolution. Veto powers are negative powers that provide no active control over a business. Therefore, they cannot be considered to amount to control<sup>39</sup>. Actually Negative control is not control at all but ability to influence on decision or action making by other stakeholders.

In contrast to negative the positive control is ability to take a decision and positively control the direction of the company.

### **Latent and active controls**

The partial control can be confused with latent control. As we know, control of the firm resides with the CEO and the board of directors.<sup>40</sup> In this sense, the latent control defined as ability exercise significant influence over shareholder approvals for the election of directors, mergers and acquisitions, and amendments bylaws<sup>41</sup>. The amount of voting rights is not very important. The latent control can be carried out by shareholder with a small amount of voting shares, but having control over the executive functions. For example, in the Zhongpin Inc. S'holders Litig.<sup>42</sup> case, the Delaware Court of Chancery declared that although stockholder has only 17.3% of voting shares as CEO and Chairman of the Board, the stockholder possessed latent and active control over the company. Active control is the intentional direction of the companies' day-to-day operations.

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<sup>39</sup> Keeves, John (2015). "Letter to Australian Taxation Office". Page 2.

<sup>40</sup> Conyon, Martin and Muldoon, Mark, (2007). "Ownership and Control: A Small-World Analysis". Page 2.

<sup>41</sup> Delaware Court of Chancery (2014) Case: Zhongpin Inc. S'holders Litig. Page case 19.

<sup>42</sup> Case: Zhongpin Inc. S'holders Litig, supra note 41 at page 18. Page case 19.

## **Direct and indirect controls**

Control can be fulfilled directly or indirectly. Direct control is realization of control through personal rights. A shareholding of 25 % plus one share or an ownership interest of more than 25% in the customer held by a natural person shall be an indication of direct ownership<sup>43</sup>.

Indirect control is ability to control through intermediary. A shareholding of 25 % plus one share or an ownership interest of more than 25% in the customer held by a corporate entity, which is under the control of a natural person(s), or by multiple corporate entities, which are under the control of the same natural person(s), shall be an indication of indirect ownership<sup>44</sup>.

The term “Indirect control” is very similar to notion “Ultimate effective control”, though the Ultimate effective control is a broader concept.

## **Ultimate effective control**

The ultimate effective control is situations in which ownership/control is exercised through a chain of ownership or by means of control other, than direct control.<sup>45</sup>

## **Horizontal and Vertical controls**

In theory and competition law terms Horizontal and Vertical controls are used.

Vertical control means ability to control as result of competition for control between controlling shareholder and managers.

Horizontal control means ability to control as result of competition between controlling and minority shareholders.

## **Common ownership in horizontal shareholding**

Horizontal control over the corporation should be distinguished from Horizontal shareholding over companies. Horizontal shareholding occurs in situation of common ownership where one person simultaneously controls some companies.

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<sup>43</sup> Directive (EU) 2015/849. of the European Parliament and of the Council (2015). "On the prevention of the use of the financial system for the purposes of money laundering ".Article 3.

<sup>44</sup> Directive (EU) 2015/849 supra note 43 at 19.

<sup>45</sup> Glossary to the FATF Recommendations. Page 113.

### **Joint control**

Often control is result of cooperation or joint efforts of some players. Joint control is the contractually agreed sharing of control over an economic activity.<sup>46</sup>

### **Movable control**

Control can be transfer from one stakeholder to another. Movable control reflects floating rights. Dominant influence is indicator of control moving from one stakeholder to another. It is possible to create a map of control based on influence characteristics for each group of stakeholders and shareholders.

### **De Facto control**

Finally, there is De Facto control. De Facto control can be understood as a result of, or by means of, trusts, agreements, arrangements, understandings and practices, whether or not having legal or equitable force and whether or not based on legal or equitable rights<sup>47</sup>. De Facto control can be viewed as a power to exercise control. De Facto control can be Legal or Illegal. Illegal control is control based on unlawful actions like racketeering.

## **2.2. CONTROL IN CURRENT LEGISLATION**

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Nowadays we can underline that the definition of control is highly developed though has some features and shortcomings in every country. The criteria and variables of control are quite various in different areas of law.

The term Control is highly used in Company, Competition, Anti-Money laundering, Controlling foreign company, Insolvency, Consolidated statements and Stock exchange regulations. Every area of law has own aims, rules and principles. Understanding of control in different countries and areas of law is very diverse. To illustrate the regulation of control the most ostensive examples from civil and

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<sup>46</sup> Commission Regulation (EU) No 632/2010, supra note 34 at 16. Page 6.

<sup>47</sup> Federal court decision *The News Corporation Ltd. Re and Others* (1987) 70 ALR 419. Page 2.

common law systems are chosen. The recommendations of inter-governmental organizations like FATF also are taken in account.

Let discuss it in more details and make comparative analysis of regulatory principles, effectiveness and cost in civil law system.

### **Anti-Money Laundering regulations**

In European Union the control in anti-money laundering legislation determined as ownership or control of a legal entity through direct or indirect ownership of a sufficient percentage of the shares or voting rights or ownership interest in that entity, including through bearer shareholdings, or through control via other means, other than a company listed on a regulated market that is subject to disclosure requirements consistent with Union law or subject to equivalent international standards which ensure adequate transparency of ownership information<sup>48</sup>.

According to directive of the European parliament<sup>49</sup> on money laundering and terrorist financing a shareholding of 25 % plus one share or an ownership interest of more than 25% in the customer held by a natural person shall be an indication of direct ownership; a shareholding of 25% plus one share or an ownership interest of more than 25% in the customer held by a corporate entity, which is under the control of a natural person(s), or by multiple corporate entities, which are under the control of the same natural person(s), shall be an indication of indirect ownership. There may be cases where no natural person is identifiable who either ultimately owns, or who exerts control over a legal entity. In such exceptional cases obliged entities, having exhausted all other means of identification, and provided there are no grounds for suspicion, may consider the senior managing official(s) as beneficial owner.

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<sup>48</sup> Directive (EU) 2015/849 supra note 43 at 19. Article 3.

<sup>49</sup> Directive of the European parliament and of the council on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing, 2016, 5116/15 ADD 2.

According to FATF<sup>50</sup> control refers to the ability of taking relevant decisions within the legal person and imposes those resolutions, which can be acquired by several means (for example, by owning a controlling block of shares).

Control through other means may, inter alia, include the criteria of control used for the purposes of preparing consolidated financial statements, such as through shareholders' agreement, the exercise of dominant influence or the power to appoint senior management<sup>51</sup>.

### **Control under CFC rules**

Control under CFC rules are viewed from the tax perspective. The aim of CFC rules is to prevent erosion of the tax base in the shareholder residence. According to OECD BEPS recommendations, CFC should be treated as controlled where residents (including corporate entities, individuals, or others) hold, at a minimum, more than 50% control. At the same time OECD admits that countries may set their control threshold at a lower level to achieve broader policy goals or prevent circumvention of CFC rules.

### **Germany CFC**

Germany section 7-14 of the 1972 Foreign Tax Act define control as holding more than 50% of a foreign company<sup>52</sup>.

According to sec. 7 of German Foreign Tax Act (Aussensteuergesetz), control is holding at least 50% plus one vote of the shares of the foreign corporation or of the voting rights. In the case that the foreign entity does not have nominal capital or any voting rights, the proportion of the assets of the corporation is decisive.<sup>53</sup>

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<sup>50</sup> FATF guidance on Transparency and beneficial ownership (2014). Page 8.

<sup>51</sup> Directive 5116/15, supra note 49 at 21.

<sup>52</sup> Deloitte, (2014). "Guide to Controlled Foreign Company Regimes".

<sup>53</sup> Lampert, Steffen (2013). The CFC Regime in Germany, № 1, European Tax Studies. Page 4.

## **Spain CFC**

CFC rules of Spain are principally set out in article 107 of the Corporate Income Tax Law (CITL) and article 91 of the Personal Income Tax Law (PITL). Control under CFC rules exist when the Spanish taxpayer, alone or with related parties, holds a direct or indirect participation of 50% or more in the capital, equity, results (profits) or voting rights and non-resident company tax on income is less than tax calculated in accordance with Spanish law<sup>54</sup>.

## **Russian CFC**

According to CFC rules in Russia control over company determined on the ground of share, which has to be more than 25% or more than 10% if the total share of all Russian tax residents exceeds 50 percent<sup>55</sup>; or as an ability to exercise dominant influence in relation to profit of company.

According to Tax Code of Russian Federation<sup>56</sup> individual or corporate entities should be treated as Controlling Foreign Company where:

1. Controlling Foreign Company hold more than 25% shares of controlled foreign company;
2. Controlling Foreign Company hold more than 10% of controlled foreign company and at the same time other residents of Russian Federation (with relatives in case of natural person) hold more than 50% in the such foreign company.
3. Controlling Foreign Company keep the control over the foreign company by:
  - exercising dominant influence over decisions of foreign company on distribution of chargeable profit;
  - keeping share;
  - the agreement;
  - other means.

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<sup>54</sup> Deloitte, Guide, supra note 52 at 22.

<sup>55</sup> Tax Code of the Russian Federation (1998) N 146-FZ. Chapter 3.4.

<sup>56</sup> Tax Code of the Russian Federation, supra note 56 at 23. Paragraph 3 article 25.13.



## **Finland CFC**

In Finland<sup>57</sup> according to Act on the Taxation of Shareholders in Controlled Foreign Corporations the foreign is controlled by Finnish residents if one or more Finnish residents hold together, directly or indirectly, at least 50% of the capital or voting rights of the foreign entity or otherwise be entitled to at least 50% of the profits of the foreign entity (the control requirement also is met if there is at least 50% Finnish control in each tier of the ownership chain of the foreign entity).

## **China CFC**

In China<sup>58</sup> according to Article 117 of the Implementation Rules on Income Tax control persons (1) hold directly or indirectly, 10% or more of the total voting shares, and jointly holds more than 50% of the total shares of the foreign enterprise or (2) exert substantial control over foreign enterprise in respect to shareholding, finance, sales, purchases, business.

## **Poland CFC**

Poland introduced its first CFC regime on 1 January 2015. These rules are found in article 24a and article 27.2a of the Corporate Income Tax Law, and articles 30c.6, 30f and 45.1aa of the Personal Income Tax Law.

The Polish parent company must have held at least 25% of the shares directly or indirectly for at least 30 days.

## **Sweden CFC**

Sweden's CFC rules are found in chapter 39a of the Income Tax Act.

The CFC rules apply to Swedish holders of 25% or more of the votes or the capital of a foreign legal entity considered having "low taxed income"<sup>59</sup>. The term "holding" means ownership or control, and any shares held by a person or entity

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<sup>57</sup> Deloitte, Guide, supra note 52 at 22.

<sup>58</sup> Deloitte, Guide, supra note 52 at 22.

<sup>59</sup> "Sweden Corporate Tax" (2016). ICLG <http://www.iclg.co.uk>

affiliated with the holder in question is taken into account at the computation. The holding may be direct or indirect through other foreign legal entities<sup>60</sup>.

The rules entail that a Swedish holder of a Controlled Foreign Company is taxed for its share of the CFC's income, whether distributed or not.

### **Conclusion on CFC rules**

Learning the CFC rules we can say that many countries use clear quantitative markers like voting threshold. In spite standard corporate law practice, the voting threshold for determining control under CFC rules can be lower than 50%.

The Russian law defines control for tax purpose at the twice lower level than it is accepted under company law regulation. The Russian Tax law consist very vague definition of control which doesn't provide objective criteria of control but focused on control de facto, control which can be obtained by any other means though not mentioned in law. The Spanish understanding of control for CFC purpose is based on formal criteria like voting rights and share of profit. The Finland definition of control is very similar to Spanish approach. Law of Poland establishes very interesting criteria "time". Though, the threshold is substantially lower than 50% (25% exactly), it is still not enough to have control one day or one week. The power to vote shall be retained at least 30 days to be count as control.

The lower threshold for determining control under CFC rules constitutes shifting of balance of rights protection in favour of public law.

### **Accounting rules**

The term control has separate meaning in accounting legislation.

Under accounting rules of European Union the control is a power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.<sup>61</sup>

The evidences of control in accounting law are<sup>62</sup>:

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<sup>60</sup> "Sweden Corporate Tax", supra note 59 at 24.

<sup>61</sup> Commission Regulation (EU) No 632/2010, supra note 34 at 16. Page 6.

- control of majority of voting rights;
- rights to appoint or remove a majority of the members of the administrative, management or supervisory body if at the same time shareholder;
- rights to exercise a dominant influence over an undertaking of which it is a shareholder pursuant to a contract entered into or articles of association.

Control should be based on holding a majority of voting rights, but control may also exist where there are agreements with fellow shareholders or members. In certain circumstances control may be effectively exercised where the parent holds a minority or none of the shares in the subsidiary<sup>63</sup>.

In consolidated financial statements has to be included undertakings, which are managed on a unified basis or have a common administrative, managerial or supervisory body; has a majority of the shareholders' or members' voting rights in another undertaking (a subsidiary undertaking); has the right to appoint or remove a majority of the members of the administrative, management or supervisory body of another undertaking (a subsidiary undertaking) and is at the same time a shareholder in or member of that undertaking; has the right to exercise a dominant influence over an undertaking (a subsidiary undertaking) pursuant to a contract entered into with that undertaking or to a provision in its memorandum or articles of association<sup>64</sup>.

In Spain a group of corporations may be taxed on a consolidated basis. To apply the tax consolidation regime, the controlling company of the tax group must hold a 75% or higher interest, either directly or indirectly, and the majority of the voting rights in the companies forming the tax group at the beginning of the first tax year

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<sup>62</sup> Directive 2013/34/EU, supra note 38, at 17. Page 21.

<sup>63</sup> Directive 2013/34/EU, supra note 38, at 17. Article 31. Page 24.

<sup>64</sup> Directive 2013/34/EU, supra note 38, at 17. Article 22(1) to (5). Page 22.

in which the tax consolidation regime is applied, and this interest and voting rights must be maintained during the year unless the dependent company is dissolved. The interest requirement is 70% for companies listed on a stock exchange<sup>65</sup>. In this example we can see the higher threshold of control (75%), in contrast to standard 50%+1. It is interesting how one definition of control can have diverse perception depending on area of law.

## **Competition law**

### **European Union**

In Competition law term control is rather characteristic of concentration designed to determine control of a person over market share through control over company. The same as in Tax law the Competition law definition of control is very broad, which is distinctive trait of administrative law. For example, in Merger Regulation of European Union<sup>66</sup> the control are constituted by rights, contracts or any other means which, either separately or in combination and having regard to the considerations of fact or law involved, confer the possibility of exercising decisive influence on an undertaking, in particular by: (a) ownership or the right to use all or part of the assets of an undertaking; (b) rights or contracts which confer decisive influence on the composition, voting or decisions of the organs of an undertaking. Connected undertakings are: undertakings in which a party to the agreement, directly or indirectly: has the power to exercise more than half the voting rights, or has the power to appoint more than half the members of the supervisory board, board of management or bodies legally representing the undertaking, or has the right to manage the undertaking's affairs<sup>67</sup>.

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<sup>65</sup> Deloitte Spain Highlights (2017). Page 3.

<sup>66</sup> Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings (the EC Merger Regulation) 29.1.2004 EN Official Journal of the European Union L 24/1. Article 2. Page 7.

<sup>67</sup> Paragraph 12.2 of the Commission's Notice on agreements of minor importance which do not appreciably restrict competition under Article 81(1) of the Treaty establishing the European Community (OJ C 368, 22.12.2001, p. 13).

## **Germany**

The term Control determined in the German competition rules and definition of concentration. Control constituted by rights, contracts or any other means which, either separately or in combination and having regard to the considerations of fact or law involved, confer the possibility of exercising decisive influence on an undertaking having regard to all factual and legal circumstances, in particular through<sup>68</sup>: ownership or the rights to use all or parts of the assets of the undertaking, rights or contracts which confer decisive influence on the composition, voting or decisions of the organs of the undertaking.

The control can be exercised not only by voting rights but also special or exclusive rights. Exclusive right is a right, which substantially affect the ability of other undertakings to carry out such activity<sup>69</sup>.

Though the German Act Against Restraints of Competition does not explain the terms "decisive influence" we can rely on definition of controlling influence. According to article 106a of German Act Against Restraints of Competition controlling influence exists if the person directly or indirectly owns the majority of the subscribed capital of the entity or holds the majority of the voting rights attached to the shares of the entity or can appoint more than half of the members of the administrative, management or supervisory board of the entity.

## **Italy**

In Italy also used the definition based on decisive influence. According to Section 7 of Competition and Fair Trading Act of Italy Control is acquired by the holding of rights, contracts or other legal relations which, separately or in combination, and having regard for the considerations of fact and law involved, confer the possibility of exercising decisive influence on an undertaking, in particular by: a) the ownership or right of use over all or part of the assets of an undertaking; b) rights,

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<sup>68</sup> According to article 37 of Act Against Restraints of Competition (translation of Juris GmbH, Saarbrücken, 2015).

<sup>69</sup> Act Against Restraints of Competition, supra note 68 at 28. Article 98.

contracts or other legal relations which confer a decisive influence over the composition, resolutions or decisions of the board of an undertaking.

## **Russia**

In Russian competition law<sup>70</sup> control means possibility of a physical person or a legal entity to directly or indirectly (through a legal entity or several legal entities) determine decisions made by another legal entity, through one or several following actions: 1) managing over 50% of the total number of votes falling on the voting stocks (shares) of the charter (pooled) capital of a legal entity; 2) exercising the functions of an executive body of a legal entity.

## **Conclusion on control in Competition law**

The control under Competition law is detailed but more value judgment with blurred criteria like “exercising decisive influence” or “control by other means”.

## **Corporate law**

Regulation of control in corporate law is relatively simple.

## **Germany**

The German Company law determines the term control as an ability to exert, directly or indirectly, a controlling influence or having a majority shareholding over controlled enterprise<sup>71</sup>. This term includes qualitative criteria - controlling influence and qualitative criteria - majority shareholding.

## **Spain**

In Spain the law<sup>72</sup> on consolidated group determines the control as:

- holding the majority of the voting rights;
- having the power to appoint or dismiss the majority of the members of the governing body;
- disposing, by virtue of agreements entered into with third parties, of the majority of the voting rights;

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<sup>70</sup> Article 11. The Federal Law "On Protection of Competition" (as amended in 2016).

<sup>71</sup> Article 17 of the Stock Corporation Act - Aktiengesetz 2015.

<sup>72</sup> Article 42.1. Code of Commerce of Spain 2012.

- using its votes to appoint the majority of the members of the governing body who hold office at the moment when the consolidated accounts must be drawn up and during the two business years immediately preceding.

## **Italy**

The Italian Civil Code<sup>73</sup> defines control as:

- possession the majority of the votes that can be exercised at the ordinary shareholders' meeting;
- possession enough votes to exercise a dominant influence at the ordinary shareholders' meeting;
- dominant influence by virtue of particular contractual arrangements.

## **Conclusion on regulation of control in different areas of law of civil law countries**

We can conclude that the definition of control in different areas of law in various countries of civil law system is mostly uniform. Though, the definition of control is not clearly defined so can be interpreted very wide. The decisive influence has to be proved on the ground of multiple factors and variables with large amount of evidence. Even it is proved it could not reflect the realities of control.

Regulative bodies simplified the process of control detection. The state authorities adopted the common rules for determining control by some criteria like percentages of voting shares, number of shareholders, income, listing regime etc. This means that if such criteria exist the authorities count it as evidence of control even though there is no control at all. In most of the cases we can't definitely say about existence of control until make thorough investigation and due diligence. For fair determination of the control over a company the authorities or independent judiciaries have to carry out a process of investigation like economic calculations in competition law to find out influencing party and reveal the mechanism of control. The process of control determination on case by case base demands a lot of time and efforts. This is why we need to develop common procedure for

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<sup>73</sup> Article 2359 of the Italian Civil Code.

identification of control over company. We need to adopt some approaches and develop common process for identification of control over the company.

The criteria of control under the public law rules are more developed than in private law. Criteria of control in tax law are more state authority determined. That underlines the priority of state right over companies' cash flow in opposition to the minority shareholders' rights.

Taking all above-mentioned into account, we can consider Control as ability exercise decisive and significant influence on organization's cash flow and affairs by implementation of combination of various rights including but not limited the voting rights, rights to elect management body, to manage the operational processes, and enter into a contract. To prevent inaccurate measure of control, the ability to exercise decisive influence should be subject of thorough determination on the ground of quantitative methodology.

We have made analysis of control definition in number of countries and under various areas of law of civil law countries. Let make comparative analysis of the definition of control in one country and consider the control regulation under the common legal system on the UK law ground under Tax and Corporate law.

## **Definitions of Control under common law**

### **UK Company law**

According to UK Companies Act 2006<sup>74</sup> a person "A" controls another person "B" if —

- (a) A holds a majority of the voting rights in B,
- (b) A is a member of B and has the right to appoint or remove a majority of the members of the board of directors (or, if there is no such board, the equivalent management body) of B, (c) A is a member of B and controls alone, pursuant to an

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<sup>74</sup> UK Companies Act 2006 Section 89J.



agreement with other shareholders or members, a majority of the voting rights in B, or

(d) A has the right to exercise, or actually exercises, dominant influence or control over B.

According to section 282 and 283 of UK Companies Act 2006 the majority of voting rights could be simple majority for an ordinary resolution and a majority of not less than 75% for special resolution. Simple majority meeting is passed by members representing a simple majority of the total voting rights of members who (being entitled to do so) vote in person or by proxy on the resolution. Majority of not less than 75% is passed by members representing not less than 75% of the total voting rights of the members or by proxy on the resolution.

We can note that the definition of the control has relatively easy countable explicit characteristics<sup>75</sup> like hold or control majority of voting rights, appoint majority of members of board of directors. But the definition also includes not so obvious criteria like right to exercise dominant influence.

The dominant influence<sup>76</sup> is the right to give directions with respect to the operating and financial policies of the other undertaking which its directors are obliged to comply with whether or not they are for the benefit of that.

From this definition of dominant influence is not clear in what extent the directors obliged to follow directions, how directors' fiduciary duties and duties due to dominant influence should comply,

To sum up the control under Company law is viewed as ability:

- hold or control majority of voting rights (over 50%);
- appoint majority (over 50%) of members of board of directors;
- exercise dominant influence i.e. to give directions to directors with respect to the operating and financial policies.

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<sup>75</sup> OECD defines legal and economic control as relatively mechanical test. OECD (2015), Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report.

<sup>76</sup> UK Companies Act, supra note 74 at 31. Schedule 7.

## **Takeovers and mergers definition of control in UK**

According to the UK city code on takeovers and mergers control means an interest in shares carrying in aggregate 30% or more of the voting rights of a company, irrespective of whether such interest give de facto control.

Therefore, controlling person according to UK Company law is subject control if posses majority voting rights. But in case UK Tax regulation for close companies the same person count as a controlling person if the person is owner of greater part of voting rights. Again we can see the difference between approaches in regulation state authority interests and privet interests.

Let have a look at the details of UK Tax law.

## **Corporation Tax**

According to Section 3, Article 450 of UK Corporation Tax Act 2010 control in close companies means to be entitled to acquire —

- (a) the greater part of the share capital or issued share capital of company;
- (b) the greater part of the voting power;
- (c) so much of the issued share capital of company as would, on the assumption that the whole of the income of company were distributed among the participators, entitle controlling person to receive the greater part of the amount so distributed, or
- (d) such rights as would entitle controlling person, in the event of the winding up of company or in any other circumstances, to receive the greater part of the assets of company which would then be available for distribution among the participators.

We can see from above definition that in contrast to company law regulation the control definition under tax law is more complicated. There is no majority rule. Instead, the controlling person has to have greater part of the share capital, or voting rights, or income, or assets. At the same time, the “greater part”, by itself, is not self-evident trait of control. To determine the control we need to have clear

picture of the balance of powers, understand the hidden connections and estimate pyramidal structures.

Shareholder, administrative body, court and any other interested party has to carry out complicated due diligence and analysis before can realize the real controlling person, which having a greater part.

Nevertheless to say that such control by “greater part” does not always mean an actual control over the corporation. In some cases it denotes sufficient, but not decisive influence. There can be a situation, when shareholder has a greater part of voting rights but creditor has great part of assets of the company at the same time. There is another approach to the control in UK Tax law. For purpose of recovery of unpaid corporation tax the person is treated as having control of a company if that person –

- exercises, is able to exercise, or is entitled to acquire, direct or indirect control over companies’ affairs.
- possesses or is entitled to acquire 50% of the share capital or issued share capital or 50% of the voting power in company.

This approach based on control of companies’ affairs and qualified majority rule. This approach is more like actual control, but meanwhile it has no quantitative indicators of control over assets, intellectual property, long-term relationship with employees, contracts and loans.

### **Stock-exchange rules**

According to Commodity and Securities Exchanges of U.S. Code<sup>77</sup> control of a company means the power to exercise a controlling influence over the management or policies of company whether through ownership of securities, by contract, or otherwise. Though, there is no clear indicator of controlling influence over policies of company. We can’t say where the border line is. But there is indicator of

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<sup>77</sup> U.S. Code of Federal Regulations (2014), supra note 36 at 16.

preconditions of controlling influence. According to the U.S. Code, any person who owns beneficially, either directly or through one or more controlled companies, more than 25 percent of the voting securities of any company is presumed to control the company. Any person who does not own more than 25 percent of the voting securities of a company will be presumed not to control the company.

The modern regulations are focused on counteract control over public companies. The stock exchange regulation introduces the following protections to minority shareholders from controlling shareholder<sup>78</sup>:

- Placing requirements on the interaction between a premium listed company and a controlling shareholder, where one exists, via a mandatory 'agreement'.
- Providing additional voting power for minority shareholders when electing independent directors where a controlling shareholder is present by requiring that they must be separately approved both by the shareholders as a whole and the independent shareholders as a separate class.
- Enhancing voting power for the minority shareholders where a company with a controlling shareholder wishes to cancel its premium listing.

### **UK CFC rules**

The UK CFC regime is set out in Part 9A of the Taxation (International and other Provisions) Act 2010 (TIOPA). Generally a foreign company is "controlled" if UK shareholders are able to secure that the company's affairs are conducted in accordance with controlling person wishes.

The definition of control over company under the CFC rules is broader and more detailed than in corporate law.

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<sup>78</sup> The consultation paper CP 13/15 UK. Financial Conduct Authority. (2013).

Under the UK CFC rules the control determined by reference to legal, economic and accounting standards.

Legal control is the power to secure that the affairs of controlled person are conducted in accordance with controlling person wishes. Legal control can be fulfilled by:

- holding of shares;
- possession of voting power;
- by virtue of any powers conferred by the articles of association or other document regulating controlled company.

From economic point of view control is ability of controlling person to receive directly or indirectly and whether at the time of the event or later:

- over 50% of the proceeds of the disposal, if the whole share capital were disposed.
- over 50% of the distributed amount of income, if the whole income were distributed.
- over 50% of assets which would then be available for distribution, in the event of the winding-up of controlled company or in any other circumstances.

The legal definition of control under CFC rules doesn't point out exactly the percentage of voting shares giving control. But there is separate case of control taken together - if two or more persons, taken together, meet the requirement of legal or economic control for controlling a company, those persons are taken to control the company ("the controllers").

For taken together control the 40% rule applied.

If one of the two controllers is UK resident and the other is non-UK resident and conditions X and Y are met, C is to be taken to be a CFC.

Condition X is that the UK resident controller has interests, rights and powers representing at least 40% of the holdings, rights and powers of controlled person.

Condition Y is that the non-UK resident controller has interests, rights and powers representing — (a) at least 40%, but (b) no more than 55%, of the holdings, rights and powers of controlled person.

We have to note that in spite of clear definition of control CFC charge arises also if there is a UK ‘interest holder’ that is not exempt and that (together with connected companies) holds an interest of at least 25%.

Apart from legal and economic control there is also control by reference to accounting standards. Control by UK accounting standards is control of parent undertaking with 50% condition.

The 50% condition is met at the time in question if at least 50% of the CFC’s chargeable profits would be apportioned to controlling person<sup>79</sup>.

According to FRS 102 parent is an entity that has one or more subsidiaries. Subsidiaries are controlled by parent entity. Control (of an entity) is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

Therefore, summing up TIOPA 2010 and FRS 102 rules the control, by reference to accounting standards, is the power to govern the financial and operating policies of an entity so as to obtain at least 50% of the CFC’s chargeable profits from its activities.

### **Israel CFC**

According to Israel’s CFC section 75B of the Income Tax Ordinance control arise when<sup>80</sup>:

- The shares or rights of the company are not registered for trading on a stock exchange, or less than 30% of the company’s shares are issued to the public (excluding the publicly issued shares owned by the controlling shareholder); and
- Israeli residents hold, directly or indirectly, more than 50% of one of the means

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<sup>79</sup> September 2015 FRS 102. The Financial Reporting Standard applicable in the UK and Republic of Ireland. Page 61.

<sup>80</sup> Deloitte, Guide, supra note 52 at 22.

of control, or more than 40% of one or more of the means of control are held by Israeli residents who, together with one or more “relatives,” hold more than 50% of one or more of the means of control.

The tax CFC rules of Israel triggered in case resident directly or indirectly hold:

- more than 50% of one or more of its means of control, or
- more than 40% of one or more of its means of control are held by residents, who – together with a relative of one or more of them – hold more than 50% of one or more of its means of control, or
- resident has the right to prevent the adoption of substantive management decisions in it, including decisions on dividend distributions or on winding up, and all that at one of the following times:
  - (a) at the end of the tax year;
  - (b) on any day during the tax year and on any day in the following tax year.

### **Conclusion on definition of control in common law countries**

Comparative analysis of definition of control in common law countries shows that Company law focuses on means of control like voting rights, majority of board of directors and direction of financial policies. The Tax law is more modern, highly developed and goal oriented. According to Tax law voting rights are only means to secure company affairs.

Dominant influence over operating and financial policies indicates control in Company law. In contrast to Tax law the power to govern the financial and operating policies of a company is not evidence of control under Company law. Power to govern or dominant influence is viewed as an instrument. In Company law the result is not necessary. Control exists without any realization just after the fact of dominant influence revealing.

For Tax law, as the government competes for the cash flow, the power to govern the financial policies has meaning only if giving the right to obtain at least 50% of the controlled financial company's chargeable profit. The focus is on consequences of control.

One of the traits of the UK Tax law is 40% rule which states that control appeared when the resident has interests, rights and powers representing at least 40% of the holdings, though in Company law the controlling person have to have more than 50% of voting rights.

There is a concern that the UK Tax law level of voting control is lower than level used in Company law. It is obvious that 45% of voting rights does not secure control if there is another person who holds 55% of voting rights.

Even more, the regulation 14/8 of Financial Conduct Authority (FCA) defines the person as a controlling shareholder who alone or 'acting in concert' controls 30% of votes.

Hence, the minority shareholders of non-public companies in accordance with company law have a different protection in the same conditions in contrast to the protection in accordance with the tax rules.

The definition of control in the tax law, which can happen even there is no actual control, reflects administrative and public character of relations. In contrast to the tax law, the company law based on equality of parties entering in commercial contract. The law protects government interests better than private rights.



## 2.3. APPLICATION OF INTERNATIONAL RULES

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The freedom to conduct a business in accordance with a community law and national laws and practices is recognized<sup>81</sup>.

In the case of implementation of law we have a situation where “*lex fori*”, personal legal rules of non-resident participant, mix with law of country where the company established – “*lex causae*”.

Let explore the situation in which UK company owns 40% of voting shares of a Cyprus company and a Russian company owns 40 % of voting shares of the same Cyprus company. We have to consider CFC, Double tax treaties and contract’s applicable rules to determine a conflict among all participants. The main questions are: who is controlling person and what are tax consequences.

As we already know, according to 40% rule, the UK resident is count as controlling person of Cyprus company.

At the same time, the Russian company is the controlling person as it has more than 25% of voting rights.

Between Cyprus and Russia from one side and between Cyprus and the United Kingdom from another side there are the double taxation agreements.

According to article 5 of the double tax treaty agreement between Cyprus and Russia the fact that a company, which is a resident of a Contracting State, controls or is controlled by a company, which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise) shall not of itself constitute either company a permanent establishment of the other.

Where an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or the same persons participate directly or indirectly in the management control or

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<sup>81</sup> Article 16 EU Charter of Fundamental Rights.

capital of an enterprise of a Contracting State and an enterprise of the other Contracting State<sup>82</sup>, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would have accrued to one of the enterprises, but, by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

According to Article 1186 of the Russian Civil Code the law applicable to civil legal relations involving the participation of foreign citizens or foreign legal entities or civil legal relations complicated by another foreign factor, in particular, in cases when an object of civil rights is located abroad shall be determined on the basis of international treaties of the Russian Federation, the Civil Code, other laws and usage recognized in the Russian Federation.

If an international treaty of the Russian Federation contains substantive law norms governing a relevant relation, a definition on the basis of law of conflict norms governing the matters fully regulated by such substantive law norms is prohibited.

The *lex loci contractus* - law of the place where the contract is made

Issues under consideration:

- The residence or main domicile of the signatory parties;
- The main place of business of the signatory parties;
- The state in which the business was incorporated;
- The state nominated for arbitration proceedings in case of a conflict (*lex loci arbitri*);
- The language used to write the contract;
- The format of the contract (only relevant if the contract format is unique to a state or group of states within the comity group);
- The currency in which payment for performance of the contract is specified to be paid;

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<sup>82</sup> Double tax treaty agreement between Cyprus and Russia. (1998). Article 9.

- The nation of registration of any ship involved in performance of the contract;
- The state where completion of the contract is specified to occur (*lex loci solutionis*);
- A pattern of similar contracts involving the same parties;
- The state where any third parties to the contract are located;
- The state where any insurance companies connected with the contract are located.
- The law of the place where the property is situated (*Lex loci rei sitae*).

As noted by OECD<sup>83</sup> jurisdictions with CFC rules that apply broadly may find themselves at a competitive disadvantage relative to jurisdictions without CFC rules (or with narrower CFC rules) because foreign subsidiaries owned by resident companies will be taxed more heavily than locally owned companies in the foreign jurisdiction. This competitive disadvantage may in turn lead to distortions, for instance, it may impact on where groups choose to locate their head office or increase the risk of inversions, and it may also impact on ownership or capital structures where groups attempt to avoid the impact of CFC rules. CFC rules can therefore run the risk of restricting or distorting real economic activity.

Many countries don't implement CFC rules to companies, which effective management and economic activity are proven in place in a foreign state.

For example, German legislator introduced a complementary activity test in the Section 8 par. 2 FTA. According to this test, a company that has its registered office or place of effective management or control in a member state of the European Union or the EEA that provides administrative assistance is excluded from the German CFC rules if the pursuit of an economic activity can be proven<sup>84</sup>. Several criteria have to be taken into account to produce evidence that an economic activity exists. One indication is a fixed establishment set up for an indefinite

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<sup>83</sup> OECD (2015), Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report. Page 15.

<sup>84</sup> Lampert, Steffen, *supra* note 53 at 22. Page 6.

period in the foreign state. Also, of significance are actual commercial operations and the presence of business premises and staff. Equally, a continuous participation in general economic transactions leads to the assumption of an economic activity. According to Civil Code of the Russian Federation<sup>85</sup> the personal law of a legal entity shall be deemed the law of the country where the legal entity has been founded.

In particular the following shall be determined on the basis of the personal law of a legal entity: an organization's status as a legal entity; the content of the legal capacity of a legal entity; the procedure for acquisition of civil rights and assumption of civil duties by a legal entity; in-house relations, in particular, relations between a legal entity and its founders; a legal entity's capacity to be liable for its obligations.

If the legal entity founded abroad and carries out its business activity mostly in Russian Federation the entity shareholders shall be liable in accordance with law of Russian Federation or upon choice of its creditor the personal law of the legal entity can be applied<sup>86</sup>.

Taking into account the applicable legislation and legal rules we can conclude that the Cyprus company, under control of shareholder from UK and Russia, will pay taxes on Cyprus as independent genuine legal person.

In case a Cyprus company under the UK and Russian CFC rules is not independent or fictional person the taxes have to be paid in the country of residence i.e. in UK and Russia proportionally to the share of controlling shareholders.

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<sup>85</sup> Civil Code of the Russian Federation. № 146-FZ. Part 3. Article 1202.

<sup>86</sup> Civil Code of the Russian Federation, supra note 85 at 43. Article 1202.

## 2.4. CONTROLLING PERSON

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Controlling person is a natural person having power to control.

A member of a company who holds enough shares to give a majority of votes at a general meeting has ‘control’ of the company<sup>87</sup>.

In Russia controlling person is natural or juridical person owning in a foreign company: more than 25 percent the participatory interest; or more than ten per cent, if the total participatory interest of all other Russian tax residents in such an organization exceeds 50 percent; or exercising control over company<sup>88</sup>.

The FATF uses term “Beneficial owner” to describe the controlling shareholder<sup>89</sup>. According to FATF glossary the beneficial owner refers to the natural person(s) who ultimately owns or controls a customer and/or the natural person on whose behalf a transaction is being conducted, even where that person does not have actual or legal ownership or control.

The FATF definition of beneficial owner also applies in the context of legal arrangements, meaning the natural person(s), at the end of the chain, who ultimately owns or controls the legal arrangement, including those persons who exercise ultimate effective control over the legal arrangement, and/or the natural person(s) on whose behalf a transaction is being conducted<sup>90</sup>. The ultimately refers to situations in which ownership/control is exercised through a chain of ownership or by means of control other than direct control.

However, in this context, the specific characteristics of legal arrangements make it more complicated to identify the beneficial owner(s) in practice. For example, in a trust, the legal title and control of an asset are separated from the equitable interests

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<sup>87</sup> Mendes v Commissioner of Probate Duties (Vic) [1967] 122 CLR 152 (‘Mendes’) Windeyer J. Page 8.

<sup>88</sup> Tax Code of the Russian Federation, supra note 56 at 23. Chapter 3.4.

<sup>89</sup> FATF guidance, supra note 50 at 22. Page 8.

<sup>90</sup> FATF guidance, supra note 50 at 22. Page 8.

in the asset. This means that different persons might own, benefit from, and control the trust depending on the applicable trust law and the provisions of the document establishing the trust (for example, the trust deed). In some countries, trust law allows for the settlor and beneficiary (and sometimes even the trustee) to be the same person<sup>91</sup>.

In UK<sup>92</sup> the beneficial owner notion depends on the type of the controlled object. The beneficial owner means any individual who ultimately owns or controls (whether through direct or indirect ownership or control, including through bearer share holdings) more than 25% of the shares or voting rights in the body; or as respects anybody corporate, otherwise exercises control over the management of the body.

In the case of a partnership (other than a limited liability partnership), beneficial owner means any individual who ultimately is entitled to or controls (whether the entitlement or control is direct or indirect) more than a 25% share of the capital or profits of the partnership or more than 25% of the voting rights in the partnership; or otherwise exercises control over the management of the partnership. Any shareholder who is not controlling should be viewed as independent.

The independent shareholder is any person entitled to vote on the election of directors of a listed company that is not a controlling shareholder of the listed company<sup>93</sup>.

In the case of a trust, beneficial owner any individual who is entitled to a specified interest in at least 25% of the capital of the trust property; as respects any trust other than one which is set up or operates entirely for the benefit of individuals, the class of persons in whose main interest the trust is set up or operates.

In the case of a legal entity or legal arrangement which does not fall within other definition the beneficial owner<sup>94</sup> means, where the individuals who benefit from

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<sup>91</sup> FATF guidance, supra note 50 at 22. Page 8.

<sup>92</sup> UK Money Laundering Regulations, supra note 37 at 17.

<sup>93</sup> FCA “Handbook on Listing Rules” UK (2017). Chapter 9. LR 9.2.

the entity or arrangement have been determined, any individual who benefits from at least 25% of the property of the entity or arrangement; where the individuals who benefit from the entity or arrangement have yet to be determined, the class of persons in whose main interest the entity or arrangement is set up or operates; any individual who exercises control over at least 25% of the property of the entity or arrangement.

In the case of an estate of a deceased person in the course of administration, “beneficial owner” means —the executor, original or by representation, or administrator for the time being of a deceased person.

In any other case, “beneficial owner” means the individual who ultimately owns or controls the customer or on whose behalf a transaction is being conducted.

According to U.S. Code of Federal regulation any person who owns beneficially, either directly or through one or more controlled companies, more than 25 percent of the voting securities of any company is presumed to control the company. Any person who does not own more than 25 percent of the voting securities of a company will be presumed not to control the company<sup>95</sup>.

In European Union the controlling person is the natural person(s) who ultimately owns or controls a legal entity through direct or indirect ownership of a sufficient percentage of the shares or voting rights or ownership interest in that entity, including through bearer shareholdings, or through control via other means, other than a company listed on a regulated market that is subject to disclosure requirements consistent with Union law or subject to equivalent international standards which ensure adequate transparency of ownership information<sup>96</sup>.

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<sup>94</sup> Probably, this definition could be used in respect of decentralized network organization.

<sup>95</sup> U.S. Code of Federal Regulations (2014), supra note 36 at 16.

<sup>96</sup> Directive (EU) 2015/849 supra note 43 at 19. Article 3.

In Italy the controlling person<sup>97</sup> a) are holders of the rights or beneficiaries under the contracts or are parties to the other legal relations; b) while not being holders of the rights or beneficiaries under the contracts or parties to such legal relations, have the power to exercise the rights deriving therefrom.

The managers can be viewed as a controlling person even there is no direct evidence of control.

According to Article 3 of preamble of Directive (EU) 2015/849 on money laundering there may be cases where no natural person is identifiable who ultimately owns or exerts control over a legal entity. In such exceptional cases the senior managing official may be considered as the beneficial owner.

According to Title 13 Part 108 Subpart B 108.50 US Code of Federal Regulations (2014) Control Person means “any Person that controls a NMVC (New Markets Venture Capital) Company, either directly or through an intervening entity. A Control Person includes:

- A general partner of a Partnership NMVC Company;
- Any Person serving as the general partner, officer, director, or manager (in the case of a limited liability company) of any entity that controls a NMVC Company, either directly or through an intervening entity;
- Any Person that:
  - Controls or owns, directly or through an intervening entity, at least 10 percent of a Partnership NMVC Company; and
  - Participates in the investment decisions of the general partner of such Partnership NMVC Company;
  - Any Person that controls or owns, directly or through an intervening entity, at least 50 percent of a Partnership NMVC Company or any entity described above.”

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<sup>97</sup> Competition and Fair Trading Act of Italy.



According to Corporation Tax Act 2010 UK a person is treated as having control of a company if person —

1. exercises, is able to exercise, or is entitled to acquire, direct or indirect control over companies' affairs.
2. In particular, person is treated as having control of company if person possesses or is entitled to acquire—
  - a. the greater part of the share capital or issued share capital of company,
  - b. the greater part of the voting power in company,
  - c. so much of the issued share capital of company as would, on the assumption that the whole of the income of company were distributed among the participators, entitle person to receive the greater part of the amount so distributed, or
3. such rights as would entitle person (except a loan creditor), in the event of the winding up of company or in any other circumstances, to receive the greater part of the assets of company which would then be available for distribution among the participators.

Delaware Court of Chancery<sup>98</sup> decisions have emphasized that a stockholder must exercise actual control over the board of directors to be a controlling stockholder<sup>99</sup>. There are number of other terms related to controlling person, which explain types of relationship and help understand the control nuances.

### **Other terms related to controlling person**

The most ancient term is Amicitia - friendship or relationship of equal persons. Amicitia provides the ground for the trust, cooperation and company formation. Many money laundering schemes are based on Amicitia nowadays.

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<sup>98</sup> In re KKR Financial Holdings LLC S'holder Litig., In re Crimson Exploration Inc. S'holder Litig., and In re Sanchez Energy Derivative Litig. (2014).

<sup>99</sup> Paul, Weiss; Rifkind, Wharton & Garrison LLP. ( 2014). "Client Memorandum" www.paulweiss.com, page 3.

Another ancient definition, which relate to control, is Patronage. Patronage means relationship of non equal persons. Patronage (*clientela*) was the distinctive relationship in ancient Roman society between the “patronus” and their “cliens”. The relationship was hierarchical, but obligations were mutual. The “patronus” was the protector, sponsor, and benefactor of the client<sup>100</sup>. One of the major spheres of activity within patron-client relations was the law courts, but *clientela* was not itself a legal contract, though it was supported by law from earliest times<sup>101</sup>.

In UK law we can meet definition of Peoples with Significant Control (PSC). PSC are individuals who meet anyone or more of the following conditions in relation to a company<sup>102</sup>:

- Directly or indirectly holding more than 25% of the shares;
- Directly or indirectly holding more than 25% of the voting rights;
- Directly or indirectly holding the right to appoint or remove the majority of directors;
- Otherwise having the right to exercise, or actually exercising, significant influence or control;
- Having the right to exercise, or actually exercising, significant influence or control over the activities of a trust or firm which is not a legal entity, but would itself satisfy any of the first four conditions if it were an individual.

Peoples with Significant Control are followed by Substantial shareholder.

Substantial shareholder means<sup>103</sup> any person who is entitled to exercise, or to

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<sup>100</sup> Quinn, Kenneth, “Poet and Audience in the Augustan Age” *Aufstieg und Niedergang der römischen Welt* II.30.1 (1982). Page 117.

<sup>101</sup> Twelve Tables 8.10; Dillon and Garland, *Ancient Rome*. Page 87.

<sup>102</sup> Department for Business, Innovation and Skills, UK (2016). “Guidance on the register of people with significant control over companies, Societates Europaeae and Limited Liability Partnerships”. Page 11.

<sup>103</sup> Handbook on Listing Rules (UK), [www.handbook.fca.org.uk](http://www.handbook.fca.org.uk). Page 184.

control the exercise of, 10% or more of the votes able to be cast on all or substantially all matters at general meetings of the company (or of any company which is its subsidiary undertaking or parent undertaking or of a fellow subsidiary undertaking of its parent undertaking).

Simple shareholding constitutes participation.

Participator<sup>104</sup>, in relation to a company, means a person having a share or interest in the capital or income of the company.

In particular, participator includes —

1. a person who possesses, or is entitled to acquire, share capital or voting rights in the company,
2. a loan creditor of the company,
3. a person who possesses a right to receive or participate in distributions of the company or any amounts payable by the company (in cash or in kind) to loan creditors by way of premium on redemption,
4. a person who is entitled to acquire such a right as is mentioned in paragraph (c), and
5. a person who is entitled to secure that income or assets (whether present or future) of the company will be applied directly or indirectly for the person's benefit.

The other terms like Related party, Relative, Linked, Connected or Associated person describe individuals who are connected to controlling person.

Related party<sup>105</sup> is

1. A person or entity that is related to the entity that is preparing its financial statements

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<sup>104</sup> Corporation Tax Act 2010 UK. Article 441.

<sup>105</sup> Commission Regulation (EU) No 632/2010, supra note 34 at 16. Page 6.

2. A person or a close member of that person's family is related to a reporting entity if that person:
  - (i) has control or joint control over the reporting entity;
  - (ii) has significant influence over the reporting entity; or
  - (iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.
  
3. An entity is related to a reporting entity if any of the following conditions applies:
  - (i) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).
  - (ii) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).
  - (iii) Both entities are joint ventures of the same third party.
  - (iv) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.
  - (v) The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.
  - (vi) The entity is controlled or jointly controlled by a person identified in (a).
  - (vii) A person having control or joint control has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).

A provider of finance is not necessarily related party.

The government departments and agencies, simply by virtue of their normal dealings with an entity (even though they may affect the freedom of action of an entity or participate in its decision-making process) are not necessarily related party.

UK Listing rules<sup>106</sup> has other definition of related person. According to the Listing rules related party means:

- (1) a person who is (or was within the 12 months before the date of the transaction or arrangement) a substantial shareholder; or
- (2) a person who is (or was within the 12 months before the date of the transaction or arrangement) a director or shadow director of the listed company or of any other company which is (and, if he has ceased to be such, was while he was a director or shadow director of such other company) its subsidiary undertaking or parent undertaking or a fellow subsidiary undertaking of its parent undertaking; or
- (4) a person exercising significant influence; or
- (5) an associate of a related party.

Relatives play important role in control over company due to trust relationship.

According to Corporation Tax Act 2010 UK<sup>107</sup> relative means —

- a spouse or civil partner,
- a parent or remoter forebear,
- a child or remoter issue, or
- a brother or sister.

Close members of the family of an individual are those family members who may be expected to influence, or be influenced by, that individual in their dealings with the entity. They may include<sup>108</sup>:

1. the individual's domestic partner and children;
2. children of the individual's domestic partner; and
3. dependants of the individual or the individual's domestic partner.

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<sup>106</sup> Handbook on Listing Rules (UK), supra note 103 at 49. LR.11.

<sup>107</sup> Corporation Tax Act, supra note 104 at 50. Article 1122.

<sup>108</sup> Commission Regulation (EU) No 632/2010, supra note 34 at 16. Page 6.

Some relative can be counted as connected persons.

According to UK Taxation (International and Other Provisions) Act 2010 two persons are connected with each other if one of them is an individual and the other is —

- (a) the individual's spouse or civil partner,
- (b) a relative of the individual,
- (c) a relative of the individual's spouse or civil partner, or
- (d) the spouse, or civil partner, of a person within paragraph (b) or (c).

Two persons are connected with each other if one of them is a trustee of a settlement and the other is —

- (a) a person who in relation to that settlement is a settlor, or
- (b) a person who is connected with a person within paragraph (a).

In this section — “relative” means brother, sister, ancestor or lineal descendant (you can see that for International taxation the spouse is not relative as it is in corporation taxation).

Control can be fulfilled not by natural person but by linked company.

Two companies are linked<sup>109</sup> if —

- (a) one is under the control of the other, or
- (b) both are under the control of the same person or persons.

The companies could be not linked but just active in concert.

Companies acting in concert or under arrangements if

1. each of two or more close companies makes a payment,
2. each of those payments is made to a person who —
  - (i) is not a participator in the company making the payment, but
  - (ii) is a participator in another of those companies, and

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<sup>109</sup> Article 217. Taxation (International and other Provisions) Act 2010 (TIOPA).

3. the companies are acting in concert or under arrangements made by any person.

There is a common term for relatives, partners and linked person. They all are associates.

According to Corporation Tax Act 2010 UK<sup>110</sup> Associate in relation to a person means —

1. any relative or partner of the person,
2. the trustees of any settlement in relation to which the person is a settlor,
3. the trustees of any settlement in relation to which any relative of the person (living or dead) is or was a settlor,
4. if the person has an interest in any shares or obligations of a company which are subject to any trust, the trustees of any settlement concerned,
5. if the person — (i) is a company, and (ii) has an interest in any shares or obligations of a company which are subject to any trust, any other company which has an interest in those shares or obligations,
6. if the person has an interest in any shares or obligations of a company which are part of the estate of a deceased person, the personal representatives of the deceased, or
7. if the person — (i) is a company, and (ii) has an interest in any shares or obligations of a company which are part of the estate of a deceased person, any other company which has an interest in those shares or obligations.

Associated company<sup>111</sup> —

1. one of them has control of the other, or
2. both are under the control of the same person or persons.

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<sup>110</sup> Corporation Tax Act, supra note 104 at 50. Article 448.

<sup>111</sup> Corporation Tax Act, supra note 104 at 50. Article 25, 271. Page 25.

Affiliated persons being natural persons and legal entities, capable of exerting influence on the activities of legal entities and/or natural persons pursuing entrepreneurial activities<sup>112</sup>.

The affiliated person term is used in some countries to describe almost every person having connection with controlling person.

As affiliated persons of a legal entity appears<sup>113</sup>:

- a member of the Board of Directors (supervisory board) or another managerial body thereof, a member of the executive body as well as a person discharging the powers of the sole executive power thereof;
- persons belonging to the same group of persons to which the given legal entity belongs;
- persons having the right to control more than 20 percent of the total number of votes falling on the voting shares or constituting the authorised or aggregated capital of the participation of the given legal entity;
- a legal entity in which the given legal entity has the right to control more than 20 percent of the total number of votes falling on the voting shares or constituting the authorised or aggregated capital of the participation of the given legal entity;
- if the legal entity is a participant in a financial-industrial group, its affiliated persons shall also include the members of the Board of Directors (supervisory board) or other managerial bodies, executive bodies of the participants in the financial-industrial group as well as the persons discharging the powers of sole executive bodies of the participants in the financial-industrial group;

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<sup>112</sup> Article 4. Law of the RSFSR No. 948-1, 22 (1991). "On Competition and Limitation of Monopolistic Activity in Commodities Markets".

<sup>113</sup> Law of the RSFSR On competition. No. 948-1, supra note 112 at 55. Article 4.



As affiliated persons of a natural person pursuing entrepreneurial activity appear<sup>114</sup>:

- persons belonging to the same group of persons to which the given natural person belongs;
  - a legal entity in which the given natural person has the right to control more than 20 percent of the total number of votes falling on the voting shares or constituting the authorised or aggregated capital of the given legal entity.
- The provisions of the present law applying to economic entities shall also extend to groups of persons.

### **There is a special participator of the company - loan creditor.**

Loan creditor, in relation to a company, means a creditor<sup>115</sup> — in respect of any debt, or in respect of any redeemable loan capital issued by the company.

A person who is not the creditor in respect of any debt or loan capital, but has a beneficial interest in that debt or loan capital, is, to the extent of that interest, treated as a loan creditor. A person carrying on a business of banking is not treated as a loan creditor in respect of any debt or loan capital incurred or issued by the company for money lent by the person to the company in the ordinary course of that business.

At the same time, according to Section 4, Article 450 of UK Corporation Tax Act 2010 rights to get income from the company that any person has as a loan creditor are to be disregarded and do not count as a control. Therefore, the regulative bodies don't view the creditors of the company as a controlling person.

In fact, the creditors of company can take control over company through bankruptcy procedures. The creditors are one of the most important stakeholders of

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<sup>114</sup> Law of the RSFSR On competition. No. 948-1, supra note 112 at 55. Article 4.

<sup>115</sup> Corporation Tax Act, supra note 104 at 50. Article 453.

the corporation. The creditors, as a rule, have no influence on short term strategy of the company, but they have substantial influence on existence of the company and long term strategy. Creditors impact on the agency costs of debt, their interventions may jointly benefit creditors and equity-holders by limiting managerial inefficiency<sup>116</sup>. Shareholders are only liable to the company to pay up their share capital. In other words, they are sharing the company's profits, but they are not responsible for all of its losses. Limited liability, so the argument goes, shifts the risk of business failure from the company's shareholders to its creditors<sup>117</sup>.

The creditors have substantial informal influence on corporation. Creditors can apply non-contractual control over violating firms via behind-the-scenes advice on how best to "manage through" the performance problems that caused the violation<sup>118</sup>. Creditors can have a contractual control over corporation. A violation of a covenant is considered an event of default, giving the creditor the right to demand immediate repayment of, or accelerate, the entire loan balance. In practice, creditors rarely accelerate the loan, opting instead to use the acceleration right to initiate a renegotiation of the credit agreement. These renegotiations can lead to both changes in the terms of the loan and increases in monitoring by lenders. The nature of behind-the-scenes negotiations makes it difficult to document the informal role of creditors on corporate governance<sup>119</sup>. Firms in violation of a covenant in a private debt agreement change senior management, become more conservative in their financial and investment policy, and thus improve performance. Given the well-documented set of control rights given to creditors following a covenant violation, we interpret the evidence as suggesting that

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<sup>116</sup> Goergen, Marc; Renneboog, Luc, (2008). "Contractual corporate governance". Page 8 and Nini, Greg; Smith, David and Sufi, Amir, (2011). "Creditor Control Rights, Corporate Governance, and Firm Value". *The Review of Financial Studies*. Vol. 25, No. 6 (June 2012). Published by: Oxford University Press. Page 25.

<sup>117</sup> Braendle, Udo, supra note 21 at 14. Page 10.

<sup>118</sup> Daniels, Ronald; Triantis, George. (1995). "The Role of Debt in Interactive Corporate Governance". *California Law Review* 83:1073–11. Page 6.

<sup>119</sup> Nini, Greg; Smith, David and Sufi, Amir, supra note 116 at 57. Page 10.

creditors serve a corporate governance role that helps increase the value of the firm. These changes occur despite the fact that violators are not on the verge of bankruptcy or payment default; creditors play an important corporate governance role, even outside of payment default states<sup>120</sup>.

To sum up, creditors can have contractual and non-contractual control over company. Creditors can obtain full control over company in process on bankruptcy.

Let view the contractual control in more details.

## **2.5. CONTROL AND CONTRACTS**

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Company or firm is a principal legal mechanism which operates in a market. From an economic point of view the firm is an organization engaged in the production of goods and/or services. To do this it combines physical, human and virtual assets, with a view to realizing a surplus<sup>121</sup>. That is true but the economic understanding of the company is often do not take into account the specific for each country "rules of game" established by local legislation, which affect every connection and relationship of the company. The contractual theory of the firm does not present the company as a community, but views it as the networks of contractual exchanges<sup>122</sup> or as an entity founded in private contract<sup>123</sup>.

We can agree with this feature, which in contractual theory is focused on contract-links. At the same time, the theory doesn't take into account the participants but their interactions. The contractual theory gives attention not merely to contract, but

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<sup>120</sup> Nini, Greg; Smith, David and Sufi, Amir, supra note 116 at 57. Page 32.

<sup>121</sup> Clarke, Thomas; Branson, Douglas, supra note 15 at 12. Page 115.

<sup>122</sup> Boatright, John and Schuck, Michael. (1997) "The Contractual Theory of the Firm as a Normative Business Ethic and its Relationship to Roman Catholic Social Teaching on Economic Life". Page 9.

<sup>123</sup> Butler, Henry (1989). "The Contractual theory of the corporation". George Mason University Law and Economics Research Paper Series 12-19. Page 24.

to the group of contracts or various binding interconnections, which form nexus or a bundle of contracts, i.e. the bundle of rights and obligations organized to written and unwritten contracts and statutory documents with different role of authority from recognition until enforcement depending on the state policy.

According to Henry Butler,<sup>124</sup> the role of the state is limited to enforcing contracts. In this regard, we can note that state merely recognizes the existence of a "nexus of contracts" called a corporation. Legal personality of company often depends on recognition of public authority and not given since the establishment. Signing an article of association without state registration of the company doesn't lead to personality. Though, in some cases like establishing a branch or subsidiary of non-resident company the preliminary permission of state authority is obligatory. Hence, the bundle of contracts and state authorization are conditions of the organization's existence. The bundle of contracts can be viewed as a test of the legal personality of the company in court proceedings on piercing the corporate veil. The company without the bundle of contract is a fake. Especially this is important in anti-avoidance tax regulation as helps reveal tax avoidance schemes. Therefore, the company can be conceptualized as a nexus of contracts – an interconnected network of explicit and implicit agreements among those who constitute and interact with the corporation, i.e. internal and external corporate stakeholders<sup>125</sup> or a private arrangement negotiated between actors, some of which take the form of recognizable legal contracts, such as the contract of employment, other which take the form of principal-and-agent relations.

From a legal point of view the company is an entity, which has some traits like legal personality, limited liability and perpetual existence. The core element of the company as a nexus for contracts is what the civil law refers to as 'separate

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<sup>124</sup> Butler, Henry, *supra* note 123 at 58. Page 3.

<sup>125</sup> Clarke, Thomas; Branson, Douglas, *supra* note 15 at 12. Page 100.

patrimony'. This involves the demarcation of a pool of assets that are distinct from other assets sets owned, singly or jointly, by the company's shareholders<sup>126</sup>.

This pool of assets formed by a bundle of contracts can be transferred to someone else, but only if it is transferred together<sup>127</sup>. In fact that is right, legal personality of the company facilitates the transition of contracts as a whole. At the same time, I doubt that contracts can be transferred only as a bundle. There are a lot of cases of assets, technology or personnel substitution, which cannot be viewed as transfer of company.

This is not change the standard form of company transfer, which happens in a form of shares transfer. In UK and other countries the shares or other interest of any member in a company are transferable in accordance with the company's articles<sup>128</sup>.

In relation to contractual theory, the most suitable for explanation of control is definition of connected undertakings given in the European Commission's Notice<sup>129</sup> as it provides the quantitative details of control along with vague criteria such as control over company's affairs.

The control over the company can be determined as:

- The power to exercise more than half the voting rights, or
- The power to appoint more than half the members of the supervisory board, board of management or bodies legally representing the undertaking, or
- The right to manage the undertaking's affairs.

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<sup>126</sup> Reinier, Kraakman (2009). "The Anatomy of Corporate Law A Comparative and Functional Approach". Page 6.

<sup>127</sup> Kenneth, Ayotte; Hansmann, Henry (2015). "A nexus of contracts theory of legal entities". United States International Review of Law and Economics 42 (2015) Page 1.

<sup>128</sup> UK Companies Act, supra note 74 at 31. Section 544 (c.46).

<sup>129</sup> Commission's Notice, supra note 68 at 28. Paragraph 12.2.

In most countries, there are only three management bodies that manage with undertaking's affairs and can approve the deals with company assets: General meeting shareholders; Session of board of directors; Executive director.

As a rule, the competence of general meeting of shareholders includes appointment and dismissal directors, amendments to articles of association and bylaws, capital increasing, acquisition, spin-off, dissolution<sup>130</sup>. In Spain the competence of general meeting of shareholder may include intervention in the management work in the form of instructions for management body or authorization of agreements and decisions adopted by management body<sup>131</sup>.

The directors are responsible for the management of the company's business<sup>132</sup>. Management of the company fulfils the management of day-to-day operations and control company's affairs. CEO has active control over the company's day-to-day operations because it stated that the company heavily relied on the CEO for the management of the business and that his departure would have a material adverse effect on the Company<sup>133</sup>. Of course, no doubt those executive managers of company have substantial influence on the company business. But control on operational level doesn't mean the control over the whole company yet. It is especially important in companies with large number of executive managers and directors, where rights and responsibilities are blurred.

The executive directors of a corporation can take part in company management in two-tier board system. Though, one-tier boards are most common (in 19 jurisdictions out 47), but a growing number of jurisdictions (12) offer the choice of either single or two-tier boards<sup>134</sup>.

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<sup>130</sup> The article 160 of "The corporate enterprises act" Spain. Official State Journal (BOE) No. 161, 3 July 2010. and UK Companies Act, supra note 74 at 31.

<sup>131</sup> "The corporate enterprises act" (Spain), supra not 130 at 61. Article 161.

<sup>132</sup> The UK Companies (Model Articles) Regulations 2008 No. 3229.

<sup>133</sup> Weiss, Paul (2014). "Delaware M&A Quarterly" Page 3.

<sup>134</sup> OECD, Factbook, supra note 2 at 6. Page 90.

In some countries the CEO could be the member of chairman of board of directors and influence on board of directors decision. Though, in nearly two-thirds of the jurisdictions with a one-tier board system requires or encourages the separation of the board chair and the CEO<sup>135</sup>.

From this perspective the control over the contracts of company can be viewed as hierarchy of: Control over voting rights by Shareholders; Control over directors and management by General meeting shareholders; Control over company's affairs and executive managers' deals by Board of directors; Control over company's affairs (including contracts) by executive managers.

Within the corporation, control over those assets is exercised by an internal hierarchy whose job is to coordinate the activities of the team members, allocate the resulting production, and mediate disputes among team members over that allocation<sup>136</sup>.

Blair and Stout<sup>137</sup> have assumed that at the peak of this hierarchy sits a board of directors whose authority over the use of corporate assets is virtually absolute and whose independence from individual team members. I suppose, this is true, if there is no controlling shareholder in the corporation. I presume that there can be a shared control over voting rights, director's election, and conditions of contracts. The ultimate control over the whole company is not achievable. The ultimate control over the company can be denoted as an ability to determine all the rights and obligations of the company, manage cash flow and assets of the company, elect the directors, appoint executive manager, enter into the contracts and bargain all sufficient conditions of contracts independently.

I suppose that ability independently determine or influence on sufficient conditions of contracts means having control over the contracts. If the company is not independent in determining conditions of companies' contracts this company

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<sup>135</sup> OECD, Factbook, supra note 2 at 6. Page 97.

<sup>136</sup> Blair, Margaret; Stout, Lynn, supra note 16 at 12. Page 6.

<sup>137</sup> Blair, Margaret; Stout, Lynn, supra note 16 at 12. Page 6.

doesn't control the company's affairs. Hence, such the company under control of the person who can determine the sufficient conditions of the company's contracts whatever is this person another contractual party or creditor.

In the light of the contractual theory the company is the nexus of contracts.

Therefore, from this point of view the control over the company means control over the bundle of contracts.

One of the important traits of the control over company is separation of control over company by voting and control over company through the bundle of contracts. The controls by voting and by contracts are in competition with each other and can occur at the same time.

The control over company by the voting rights is fulfilled by shareholders.

But control by the contracts carried out by company (managers) and other contracting parties jointly as conditions of the contract are determined by both parties.

There are numbers of legal theories which explain the contract from the principles of promise, consent, reliance, or efficiency<sup>138</sup>. Generally, the contract is promise to do something in return for a consideration. In common law, there are three basic essentials to the creation of a contract<sup>139</sup>: (i) agreement; (ii) contractual intention; and (iii) consideration.

In deciding whether the parties have reached agreement, the courts will apply an objective test. Corporate law enables the participants to select the optimal arrangement for the many different sets of risks and opportunities that are available in a large economy<sup>140</sup>.

Control is composed by number of influences, which can be count separately. The ensemble of separate influences composes a decisive influence. This ensemble can

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<sup>138</sup> Bix, Brian, (2006). "Contract Law Theory". Research Paper No. 06-12. Page 24.

<sup>139</sup> Allen&Overy "Basic principles of English contract law". Page 3.

<sup>140</sup> Easterbrook, Frank; Fischel, Daniel (1989), "The Corporate Contract" Columbia Law Review. Page 1418.



be viewed as a bundle of contracts among all stakeholders of company and company by itself.

From an economic perspective, a contract is everything which pictures observable states, or, to put it in other words, an instrument which facilitates an exchange of property rights<sup>141</sup> or mechanism for achieving efficient allocation of resources<sup>142</sup>.

There could be a contract between divisions of company but from legal perspective those contract don't exist as a division of company is not a separate legal entity and has no legal personality.

For better understanding of the control over the bundle of contracts we can investigate and categorize every separate contract or group of contracts. We should take into account not only quantitative characteristics, like number of valid contracts and volume, but qualitative characteristics too. It is important to determine type of contracts, type of contractor, type of enforcement, specific terms and ability to substitute the product or other contracting party. For fair estimation of control over company the especial focus should be on contracts among shareholders, company and shareholders, company and board of directors, and company and executive managers.

The procedural issues like approval and enforcement by shareholders' meeting, disclosure of information etc are very important for contract validation. The contract should be properly accepted and approved by both parties of agreement. Validation and approval of contracts first of all depend on directors and executive manager of the company who are trying to keep all companies' contracts in equilibrium in sense of rights-duties and profit-loss.

The nodes of contracts of the company can be categorized by type of contractor as: external - between company and external contractor, which regulate external

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<sup>141</sup> Braendle, Udo, supra note 21 at 14. Page 8.

<sup>142</sup> Cane, Peter; Kritzer, Herbert, (2010). "The Oxford Handbook of Empirical Legal Research" OUP Oxford. Page 132.

affairs; internal - between company and internal stakeholders, which regulate internal affairs.

The company's contracts could have a form of: commercial and labor agreements, bylaws and articles of association.

If the contractual party gets control over the whole conditions of bundle of external contracts, the party gets control over the company affairs but at the same time can't get control over the management bodies, determine conditions of new contracts, and take decision on company dissolution. Therefore, control over the external contracts can't provide ultimate control over the company.

Partial control over conditions of external contracts substantially influences management rational decisions. This is not legal control over management but rather influence, which can predetermine management decision.

There are number internal contracts of the company: contracts between company and employees; contract between company and executive manager; contracts between company and board of directors, including contracts with members of board; contracts between company and shareholders. Let discuss them in more details.

### **Contracts between company and employees**

The labor contracts with employees are substantially important for companies in which personal is the key company resource especially in software, consulting or scientific organizations.

The collective labor agreements can be viewed as an instrument for mitigating the risks between company and various collective labor associations and bodies.

No jurisdiction prohibits publicly listed companies from having employee representatives on the board. Twelve EU countries plus China have established legal requirements regarding the minimum share of employee representation on the

board, which varies from one member to half the board members, with one third being the most common<sup>143</sup>.

In France<sup>144</sup> and Germany<sup>145</sup> the employees have expanded rights with ability to participate and vote in the sessions of board of directors and could have double voting rights at the shareholder meeting. These privileges can be viewed as partial control over management bodies. The labor force, integrated in labor unions by shareholder voting rights have the substantial influence on the company especially through shareholder activism by calling shareholders meeting, voting, public discussions and other collaborative actions.

There are also rules which give employees who are minority shareholders the rights to influence the company. The law of Australia gives the right to one hundred or more shareholders to require call of company shareholder meeting<sup>146</sup>. This rule widely used by the trade unions. Trade unions have begun to pursue workers' interests within the confines of the shareholder primacy paradigm of corporate governance<sup>147</sup>. Trade unions spur changes in governance characteristics that lead to shareholder wealth improvement<sup>148</sup>. I would rather view it as one of example of total change of balance between shareholders and stakeholders, which cooperative actions manifest substantial influence of stakeholders on companies affairs.

Another internal type of contract is contract between directors and management.

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<sup>143</sup> OECD, Factbook, supra note 2 at 6. Page 100.

<sup>144</sup> Article L.2323-7-2 of the Labour Code (France).

<sup>145</sup> Mandatory in companies with over 2000 employees. Mitbestimmungsgesetz (Codetermination Act) of 1976, Germany.

<sup>146</sup> Corporations Act of Australia (2001), Article s249D.

<sup>147</sup> O'Connor, Marleen (1997). "Organized Labor as Shareholder Activist: Building Coalitions to Promote Worker Capitalism" University of Richmond Law Review, Vol. 31, No. 5, 1997. Page 1366.

<sup>148</sup> Prevost, Andrew; Ramesh, Rao; and Williams, Melissa, (2002). "Labor Unions as Shareholder Activists: Champions or Detractors". Page 22.

According to Corporation Tax Act (UK) Director<sup>149</sup>

- A person occupying the position of director of the company, by whatever name called,
- A person in accordance with whose directions or instructions the directors of the company are accustomed to act, and
- is a manager of the company or otherwise concerned in the management of the company's trade or business, and
- is — (i) the beneficial owner of, or (ii) directly or indirectly able to control at least 20% of the ordinary share capital of the company.

### **Contracts with directors and management**

The Board of director's rights is based on law, internal regulations like approved by shareholders article of association and bylaws. As a rule every member of board of director concludes a contract with the company, which is the labor contract by nature. The most important issue in contract with director is remuneration.

In many countries remuneration policy should be discussed on meeting of shareholders. In UK in the listed companies shareholders have a binding vote on a resolution to approve the directors' remuneration policy<sup>150</sup>. In Spain the directors' remuneration policy shall be adjusted in accordance with the remuneration system established in the by-laws and shall be approved by the shareholders' general meeting at least every three years as a separate item on the agenda<sup>151</sup>.

Although shareholders can and should vote on the selection of corporate directors and on investment questions and other policy matters, it appears that return on investment is the governing criterion in the relationship between them and management.<sup>152</sup>

Apart from standard contract there are internal regulative statutory documents – article of association and bylaws. Bylaws include clauses on directors' duties,

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<sup>149</sup> Corporation Tax Act, supra note 104 at 50. Article 452.

<sup>150</sup> UK Corporate Governance Code (2014).

<sup>151</sup> Corporate Enterprises Act of Spain. Official State Journal (BOE) No. 161, 3 July 2010 with amendments 2012. Article 529.

<sup>152</sup> Boatright, John; Schuck, Michael, supra note 122 at 58. Page 8.

competence and scope of obligations. The directors are bound by the article of association and bylaws in the time of election and, therefore, the two parties, company and director, entered into a formal contract.

The directors or managers can breach contracts.

The company acts through its agents. The executive manager or another specially authorized person acts on behalf of company and have an authority to enter in contracts. This ability of executive manager transact the business of the company, bargain the contract's conditions and therefore control the company affairs through the bundle of contracts rises concerns on competition between managers and shareholders for control over the company. Breaching by directors or managers of the company its agent, loyalty and fiduciary duties can lead to losing control over companies' contract.

The shareholders lose the control over the company when executive manager doesn't work as an agent of shareholder but as principal. In this case manager can control substantial part of contracts, though the ability of manager approve the deals and determine contract conditions restricted bylaws and statutory documents of the company.

There are also competition among controlling shareholder, board of directors, executive manager and stakeholders for control over conditions of contracts. This competition may arise or exacerbated in conflict situation with labor union or with other dominant shareholder.

Through contracting, any constituency or stakeholder group could become the beneficiary of the firm's wealth-creating powers or the fiduciary duties of management; this is what happens when corporations become employee-owned or customer-owned<sup>153</sup>.

One of the most well-known conflicts between directors and shareholders is self-dealing. Self-dealing is transactions between the director and the director's

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<sup>153</sup> Boatright, John; Schuck, Michael, *supra* note 122 at 58. Page 3.

company. The principal-agent conflict in such transactions is particularly striking because the director acts on both sides, thereby the director in a position in which he has an incentive to shape the price and the contractual conditions in his own interest to the detriment of the shareholders<sup>154</sup>.

### **Articles of association as a contract**

The contracts among shareholders can also be viewed as part of internal contract system. The shareholder's rights and obligations are regulated by articles of association and shareholder agreements. In addition, the regulation on controlling shareholder<sup>155</sup> describes possibility of contract between company and its controlling shareholder. One of the most important constitutional document setting up governance structure, management and shareholder rights is articles of association (in term of United Kingdom's law), Articles of incorporation (USA), Gesellschaftsvertrag (Germany), Estatutos (Spain), Ustav (Russia). The articles of association include clauses on management duties, competence and scope of obligations.

UK Court of Appeal views the articles of association as a contract (case *Cream Holdings Ltd & Ors v Davenport* [2008] EWCA Civ 1363). A company's articles of association creates a contract between the company and each of its members in their capacity as members<sup>156</sup>. The provisions of a company's constitution bind the company and its members to the same extent as if there were covenants on the part of the company and of each member, which can limit shareholders' ability to amend the governing documents of the corporation<sup>157</sup>.

Therefore, the articles of association binds company and shareholders as parties of contract. Shareholders accept the provisions of articles of association in time of

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<sup>154</sup> Davies P; Hopt K. J.; Nowak R.; Solinge, eds., (2013). "Corporate Boards in European law: a comparative analysis". Oxford University Press 2013. Page 54.

<sup>155</sup> Consultation Paper CP13/15 Financial Conduct Authority November 2013. Page 64

<sup>156</sup> Chaney, Samantha (2010). "Articles of association are like any other contract". Page 6.

<sup>157</sup> UK Companies Act, supra note 74 at 31. Section 33 (1) and Gompers, P., L. Ishii, and A. Metrick, 2003, "Corporate Governance and Equity Prices" Quarterly Journal of Economics 118, p. 107-155.

purchasing company shares. The changes of articles of association require the consent of 75% of shareholders<sup>158</sup>. That means that having 75% of voting rights the person can have control of the most sufficient provisions of articles of association as a contract. Though in France<sup>159</sup> to change the articles of association the majority of 2/3 is enough. In Spain amendments to the articles of association demand response from over half of the votes associated with the stakes into which the capital is divided<sup>160</sup>.

### **Shareholder's contracts**

There are number of contracts that, although not included in a bundle of contracts of company, affect the control over the company. Some of them have intersection rules with the articles of association. The most important contract, where the company is not a party, is shareholder agreement.

The main task of shareholder agreements is regulation of control over the company, voting rights, conflict situations, transfer of interest and election of management. From the contractual theory perspectives the shareholder agreement regulates the shareholder's rights and transfer of control over the company's bundle of contract.

The shareholder agreement is one of contract influencing the company governance and rules to running the company. In contrast to articles of association the shareholder agreement is not public document. It should be noted that in UK the provisions of the articles of association normally prevail over shareholder agreements<sup>161</sup>.

An additional contractual instrument of contractual system of company is relatively new special agreement between shareholder and company. To be admitted to a Premium listing FCA requires that a company have to enter into a

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<sup>158</sup> UK Companies Act, supra note 74 at 31. Section 25.

<sup>159</sup> Article L233-3 of French commercial code.

<sup>160</sup> "The corporate enterprises act" (Spain), supra not 130 at 61. Article 199.

<sup>161</sup> UK. Dear and Griffith v Jackson (2013) case EWCA Civ 89. Article 43.

binding agreement with the controlling shareholder. The agreement has to contain undertakings<sup>162</sup>:

- (1) transactions and arrangements with the controlling shareholder (and/or any of its associates) will be conducted at arm's length and on normal commercial terms;
- (2) neither the controlling shareholder nor any of its associates will take any action that would have the effect of preventing the new applicant or listed company from complying with its obligations under the listing rules; and
- (3) neither the controlling shareholder nor any of its associates will propose or procure the proposal of a shareholder resolution which is intended or appears to be intended to circumvent the proper application of the listing rules.

Where a company has a controlling shareholder, cancellation also requires the approval of a majority of the votes of the independent shareholders voting on the resolution.

### **Sufficient influence and loss of control**

The control over company's contracts can be lost. One of the most serious consequence of losing control over the company's' contract is lost of control over the whole company. The contractor of company can influence on the management of the company through negation of various conditions of contract. But this influence is limited by time, amount of contract and penalties or other sanctions for breaching the contract. One of the main reasons why the party of contract can't control the bundle of contract is ability of company to replace the contracting party or contract. At the same time, this situation can drastically change if there is no ability to replace the contractor or cancel the contract as it the case of monopolistic power.

Contractor monopolist can have control over the company due to its monopolistic position, ability determine conditions of companies' contracts. Let test this hypothesis and consider the situation when the provider supply rare earth metals.

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<sup>162</sup> Handbook on Listing Rules (UK), supra note 103 at 49. Article 6.1.4BR (1).



Let assume that there are no other substitutes so the provider completely control conditions of the agreement between company and provider. In this situation the company is not under control of the provider yet. The company does not able barging the contract conditions or declines it. Rejection or inability to fulfill it leads with high probability to bankruptcy of company and replacement of shareholder. During the bankruptcy a creditor can take control over the company. When corporations are in distress, creditors take control from shareholders, and the creditors' interests become primary until the firm recovers<sup>163</sup>. Though, this statement sums up different groups of stakeholders as creditors. It doesn't count difference in interests of the groups.

There is a link between controlling creditor power and company assets. Person controls the company if he or she possesses or is entitled to acquire such rights as would, in the event of a winding up or in any other circumstances entitle him or her to receive the greater part of the assets which would then be available for distribution among participators<sup>164</sup>. Therefore, the influence of monopolist and creditors, as the contractual parties, on company is very high.

The sufficient influence to the company or partial control over the company's affairs carried out by contractor can be converted to ultimate control over the company if the conditions of the contract entitle the contractor receive 50% of the assets of the company.

It emerged from understanding that the control has different implication under various theories and legal regulation. Refraining some legal principles and approaches I have reviewed the contractual relationship existing in the company and the contractual parties for determining control balance in it. It can be stated that contractual theory provides new way for control determination. Appropriate

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<sup>163</sup> Boatright, John; Schuck, Michael, supra note 122 at 58. Page 4.

<sup>164</sup> The House of Lords' judgment in the case of R v CIR ex parte Newfields Developments Ltd 73TC532.

analysis of information on control over the contracts can improve corporate governance of the companies.

Every company can be viewed as number of assets, resources, and rights, which are subject of contracts among stakeholders of the company. The ability of stakeholders to fulfil the control over the contracts determines the ability of the participants and assets be consolidated as an organized entity, which are legalized by the state authority as a company, or exist as unregistered association. The object of control over contract is to make the risk of company dissolution lower and profit higher in the long run.

We can conclude that the current regulation of control is based on non-indicative criteria. At the same time the most resent law evolution employ new approaches to control determination. The modern stakeholder, contract and agency theories create a solid base for the further development of law on control over organization.

### **3. PROBLEMS OF CONTROL**

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#### **3.1. LEGISLATION PROBLEMS**

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There is assumption that ownership and full control is the same things. According to Clarke and Branson dominant shareholders owned controlling positions in the corporation, resulting in no actual separation of ownership and control<sup>165</sup>. At the same time, according to European Parliament draft of resolution on the Shareholder rights directive<sup>166</sup> shareholders do not own corporations, which are separate legal entities beyond their full control<sup>167</sup>.

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<sup>165</sup> Clarke, Thomas; Branson, Douglas, supra note 15 at 12. Page 99.

<sup>166</sup> Draft European Parliament legislative resolution on the proposal for a directive of the European Parliament and of the Council amending Directive 2007/36/EC.

<sup>167</sup> It was rejected finally.

This is amendments of the Shareholder rights directive are in line with the modern stakeholder theory, which implies that the corporation is a set of relationships among stakeholders having a stake in or claim on the corporation. The corporation has to count the rights of all affecting or affected parties<sup>168</sup> like shareholders, employees, customers, suppliers, and communities<sup>169</sup>.

The draft of resolution on the directive affirms that the shareholders do not have a full control over the corporation. Is this true? What does it mean full control?

There are a lot of different approaches to definition of control on the ground of voting rights, assets, power etc. The first question - is the full control absolute? Absolute means be completely free from restrain, having no exception<sup>170</sup>. Full means not lacking in any essential<sup>171</sup>. Hence, the full control should not be viewed as absolute control.

We determine the full control as an ability to manage total cash flow of a corporation, companies' affairs and essential business operations, including rights to distribute profits. Of course no one shareholder can control day-to-day business decisions and operations. In other words the absolute control over the corporation is not attainable.

So, why the cash flow and business operations are important for the full control?

We assume that every stakeholder is interested in managing revenue and distributing profit in its own favour. The local community is interested in finance for ecological environment. The managers are interested in higher bonuses, the employees in high salary and the minority shareholders in dividends.

At the same time, controlling shareholder has different approaches to company development depending the phase of a long-term strategy.

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<sup>168</sup>Freeman Edward, "Managing for Stakeholders". (2008). Page 12.

<sup>169</sup> Freeman Edward , (1984). "Strategic Management: A Stakeholder Approach", Pitman Series, Harpercollins College Div. Page 144.

<sup>170</sup> "The Merriam-Webster Dictionary", supra note 27 at 16.

<sup>171</sup> "The Merriam-Webster Dictionary", supra note 27 at 16.

In 1916, the Dodge Brothers sued Henry Ford for keeping the company's cash, nearly \$60 million and not distributing it to shareholders. Something like that was happened with Apple in 2012. Apple has nearly \$100 billion in cash just sitting on its balance sheet but didn't pay dividends<sup>172</sup>. This illustrate that as a rule, the firms with controlling shareholders have lower payout ratios<sup>173</sup>.

Consequently, in practice the controlling shareholder is not interested in short-term payoff, but in company dynamic development, which demands higher expenditures.

Furthermore, controlling shareholders prefer to avoid pro-rata distributions of profits, where all shareholders are treated equally<sup>174</sup>.

The control over cash flow is the key to full control over the corporation. In most countries the law allows the controlling shareholder to control the cash flow through shareholder's meeting. In Germany, UK, Spain, China, Russia and many other countries annual financial statements, distribution of profit and loss recovery plans must be approved by shareholder's meeting. The shareholder's meeting also takes decision on substantial deals. For example, in China decision on sale of any substantial assets by a listed company or the provision of guarantee exceeds 30 percent of the total asset value of the listed company within a given year, shall be made by the general meeting of shareholders<sup>175</sup>. Therefore, money, at large, is in hands of shareholders.

But in interim period the funds are under the run of the board of directors and executive managers. Election of board of directors is critically important for all stakeholders as recommendations on profit distribution, approval of the major transactions usually are in the hands of board of directors of corporation.

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<sup>172</sup> Forbes "Can Apple Investors Sue For a Dividend?" 17.02.2012. Page 1.

<sup>173</sup> Sáez Lacave, Maria Isabel and Gutiérrez Urriaga, María, (2014). "Dividend Policy with Controlling Shareholders" Law Working Paper N°250/2014. <http://ssrn.com/abstract=2412588>. Page 6.

<sup>174</sup> Sáez Lacave, Maria Isabel and Gutiérrez Urriaga, María,, supra note 173 at 75. Page 26.

<sup>175</sup> Companies Law of the People's Republic of China. (2013). Article 121.

The determination of the dividend policy is in practice left to the firm insiders (controlling shareholder and directors)<sup>176</sup>.

In Germany<sup>177</sup> the management board submits proposal for appropriation of distributable profits. The annual financial statements have to be approved by the supervisory board. Though, the management board and the supervisory board can resolve that the annual financial statements are to be approved by the shareholders' meeting<sup>178</sup>. In China the board of directors formulates the annual financial budget plans and final accounts of the company<sup>179</sup>.

Hence, the full control can be obtained directly by taking decision on shareholder's meeting or indirectly by election and control of directors.

To elect and get the majority on board of directors the controlling shareholder needs at least 50% +1 voting rights. At the same time, the controlling shareholder not only influences on board of directors but also can change rules of the game.

To make amendments to article of association in most countries the controlling shareholder needs at least 75% of voting rights. In UK controlling shareholder may amend its articles by special resolution (majority of not less than 75%)<sup>180</sup>.

In China any resolutions made at a shareholders' meeting on the amendment of the company's articles of association, increase or decrease of the registered capital and on the merger, division, dissolution, or conversion of the company, shall be adopted by the shareholders representing more than two thirds of the voting rights<sup>181</sup>.

Hence, for full control the controlling shareholder has to have at least 75% of voting rights. Without any doubt the full control exists if the controlling shareholder has 100% voting rights. At the same time, full control is not equal

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<sup>176</sup> Sáez Lacave, Maria Isabel and Gutiérrez Urriaga, María,, supra note 173 at 75. Page 33.

<sup>177</sup> German Stock Corporation Act (Aktiengesetz). § 170.

<sup>178</sup> German Stock Corporation Act § 172, supra note 177 at 76.

<sup>179</sup> Companies Law of the People's Republic of China , supra note 175 at 75. Article 46.

<sup>180</sup> UK Companies Act, supra note 74 at 31. §21.

<sup>181</sup> Companies Law of the People's Republic of China , supra note 175 at 75. Article 43.

ownership of corporation because it can't be absolute as stated above. There are always other stakeholders, which able to influence on corporation business activity. The absolute control is not achievable.

Therefore, the European Parliament draft of resolution on the Shareholder rights directive is wrong. The legal entity can be under full control but cannot be under absolute control.

This example points out modern but at the same time problematic approach of legislators to the definition of control.

### **3.2. UNBALANCED SUPREMACY**

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As we already stated above the criteria of control in tax law are determined by state authority. There is a difference in control regulation in tax (public) and company (private) law. As a rule, the company law used more simplistic approach to control definition in a group of companies' regulation for accounting purpose and in regulation of the privet controlling person as a participant of public limited liability companies.

The government authority plays dual conflicting roles in relationships with corporation as a participator and regulator. The government displays many characteristics of an equity claimant (shareholder) and many characteristics of a fixed claimant (lender), but it has certain "rights" (legal privileges assumed as a matter of power) not shared with other claimants on a firm's cash flows.<sup>182</sup>

The definition of control in the public law is indicator, which used to determine the person who should share the profit with government. Normative regulation of the control under the tax law aims preventing profit shifting and protects public social interest.

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<sup>182</sup> Frankel, Paul Ellen; Miller, Fred; Jeffrey, Paul, (2006). "Taxation, Economic Prosperity, and Distributive Justice". Volume 23, part 2. Cambridge Universtity Press. Page 256.

The state wishes the enterprises to be run efficiently, not solely for the purpose of wealth maximization, but to maintenance of urban employment levels, direct control over sensitive industries, or politically motivated job placement. One of the examples is a state policy in China and Russia, where the state authority has a special voting and/or veto rights. This creates monitoring difficulties and sets up a conflict of interest between the state as controlling shareholder and other shareholders. Of course, government, like other financial claimants on firms' cash flows, has to affect the behavior of the firms in which they invest. The key point here is that the interests of different claimholders are both varied and conflicting.<sup>183</sup> Public institutions are given privileges and powers normally denied to "private" institutions-the right to confiscate resources forcibly ("taxation" and "condemnation")<sup>184</sup>. In using its control for purposes other than value maximization, the state exploits minority shareholders who have no other way to benefit from their investment.<sup>185</sup>

Since government is a claimant on firm's cash flows, it should not be able to engage in conduct that is prohibited to other investors.<sup>186</sup>

In a system of optimal constitutional design, government actors will be constrained, and will be unable to impose sub-optimal or inefficient rules on people and business subject to their taxing authority<sup>187</sup>. Unfortunately, the present legal system is not optimal. The interests of participants are not balanced. There is supremacy of one of stakeholders' group.

Supremacy of one or group of shareholders can't be substituted by disorganization, where stakeholders take part in governance without responsibility. Under threat of the tragedy of the commons the controlling shareholder have to take the full

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<sup>183</sup> Macey, Jonathan, (2006). "Government as Contractual Claimant: Tax Policy and the State". Page 4.

<sup>184</sup> Barnett, Randy. "Four Senses of the Public Law-Private Law Distinction", Foreword to the "Symposium on the Limits of Public Law". Page 272.

<sup>185</sup> Clarke, Thomas; Branson, Douglas, supra note 15 at 12. Page 502.

<sup>186</sup> Frankel, Paul Ellen; Miller, Fred; Jeffrey, Paul, supra note 182 at 77. Page 256.

<sup>187</sup> Macey, Jonathan, supra note 183 at 78. Page 3.

responsibility for the corporation taking into account opinions' diversity of all interested parties.

Paraphrasing the H. Berman<sup>188</sup>, said that “law may protect the collective against a dominant individualism or the individual against a dominant collectivism”, the corporate governance rules and laws have to protect the stakeholders against a controlling shareholder and the controlling shareholder against the stakeholders. Good corporate governance infrastructure should ideally combine large investor involvement with legal protection of minority investors.<sup>189</sup>

The legal regulation of control over company should take into account a positive influence of controlling person on principal-agency problem that arises from the separation of ownership and control.

A large shareholder may have better police management than the standard panoply of market-oriented techniques but at the same time the agency problem arises between controlling and non-controlling shareholders, which produces the potential for private benefits of control. The two facets of the agency problem present a trade-off<sup>190</sup>.

From economical point of view the presence of a controlling shareholder reduces the managerial agency problem, but at the cost of the private benefits agency problem. Non-controlling shareholders will prefer the presence of a controlling shareholder so long as the benefits from reduction in managerial agency costs are greater than the costs of private benefits of control<sup>191</sup>.

With the imminent problem of free riding, i.e. each shareholder wants to avoid the costs of control by hoping that the other shareholders are exercising the necessary control, this leads to a collective action problem. Each of the shareholders is acting

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<sup>188</sup> Berman, Harold, *supra* note 5 at 8. Page 43.

<sup>189</sup> Vermeulen, Erik. (2012). “Beneficial ownership and control: a comparative study Disclosure, information and enforcement”. Page 16.

<sup>190</sup> Gilson, Ronald and Gordon, Jeffrey (2003). “Controlling Controlling Shareholders”. Page 785.

<sup>191</sup> Gilson, Ronald and Gordon, Jeffrey, *supra* note 190 at 79. Page 61.



rational, when not exercising control. But this leads to a situation where nobody controls the management at all<sup>192</sup>.

Large investors with significant voting and cash-flow rights may encourage long-term growth and firm performance. The accumulation of control in one or more shareholders may very well benefit minority investors by making management more accountable. Hence, legitimate majority shareholding should not be deterred from taking an active role in monitoring management in listed companies. At the same time controlling beneficial owners with large voting blocs may have incentives to divert corporate assets and opportunities for personal gain at the expense of minority investors<sup>193</sup>.

Control is not only privilege but instrument of protection of investor.

In the legal articulation of the contractual theory, the norm of maximizing shareholder wealth is defended on the grounds that having corporate control is a protection that is of greater value to residual claimants than to other constituencies. Shareholders, therefore, are more willing to pay for the privilege of having their interests be the objective of the firm, whereas bondholders, employees, and other stakeholders rationally prefer different contractual arrangements.<sup>194</sup> We may note that while shareholders pay for privilege, stakeholders rely on contracts; the governments prefer use administrative power. All parties try to utilize their power through difference channels.

### **3.3. CONTROL WITHOUT VOTING**

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There are number of cases, which are proves the control without voting power.

This non-voting control is reflected in law poorly.

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<sup>192</sup> Braendle, Udo, supra note 21 at 14. Page 11.

<sup>193</sup> Vermeulen, Erik, supra note 189 at 79. Page 3.

<sup>194</sup> Boatright, John and Schuck, Michael, supra note 122 at 58. Page 3.

Let's consider the Burda ultimate control case<sup>195</sup>. Burda case shows a way to keep control over company without voting power.

In Russia was adopted a law, which prohibits foreign person to hold more than 20% of mass media company. The German concern Hubert Burda Media controlled Burda and Playboy magazines in Russia. To fulfill the law but doesn't lose control the Burda concern separated functions of management from editorial board. The editorial board and Burda magazine company, as set out in law for mass media, is governed and controlled by Russian editors. At the same time the Hubert Burda Media still keep control over the management company. The management company controlled income from distribution, ad sales, licensing of titles and advertising of Burda magazine.

This case shows that there are number of ways, apart from voting by shares, to avoid restrictions of law and have control over the company cash flow, business operations and affairs.

Another case is touching the VIE structures.

In China there are some categories of domestic industries, which have restrictions or prohibition on foreign investment. These restrictions include prohibition on direct control over Chinese domestic companies by foreign companies.

To avoid restrictions by professional lawyers and managers were created Variable Interest Entity (VIE) structures. VIE composing of foreign offshore pyramidal companies and Chinese Wholly Foreign Owned Enterprise (WFOE). The WFOE is directly controlled by foreign offshore companies through shareholding.

The key feature of WFOE is that the WFOE has a contractual control over Chinese domestic company.

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<sup>195</sup> Bloomberg. (2015). "Russian Publisher of Playboy Said to Stay as Media Squeezed" <https://www.bloomberg.com/>.

WFOE can have (1) contractual arrangements with a shareholder of Chinese domestic company, which grant WFOE voting rights; (2) collateral control over affiliated managers of domestic company; and (3) contractual control as set of contractual arrangements with the Chinese domestic company.

The set of contracts includes license, service, consulting, voting rights, option and pledge agreements. This makes possible to control the Chinese domestic company and consolidate the financials of the domestic company into the group's common financial statements.

As a result, a foreign company has indirect and active control over day-to-day operations of Chinese domestic company by VIE structure. Implementation of the VIE structures especially effective in virtual, software and internet industry where there is no tangible assets.

What is new in this structure? First of all, the main goal is to avoid formal legal rules, which prohibit direct control via share ownership. Secondly, the agreements between WFOE and Chinese domestic company provide full control over cash flow and assets of the domestic company.

Current legislation has focused more on standard situations. Control is viewed as result of share ownership or right to appoint manager but not as lateral contractual control. This is one of the main problems of the relevant law. It is focused on wrong indicators of control and erroneous methods. The role of control, which described in current legislation as “control by other means” is increased.

In some sense, the VIE structure helps to form a collaborative network in spite of legal rules. Escaping of state control is the major trend of modern society. This one the reason and driver of high popularity of blockchain based projects.

### **3.4. CONTROL OVER DISTRIBUTED ORGANIZATIONS**

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The networking groups like associations of stakeholders or decentralized network organizations become a powerful self-assembling dynamic system force. There are

similarities between action of minority activists and activists of decentralized communities. They are based on joint and coordinated efforts of a large number of participants.

The blockchain and smart contract technology enables individuals to initiate and participate in organized societies and networking groups. New virtual communities and distributed network organizations spread all over the world. The Initial Coin Offering of decentralized network organization based on blockchain technology starts to be the major competitor of the traditional IPO for attracting financial capital for start-ups companies. The question on control of networking societies is raised.

At the same time the distributed ledger technology and cryptography provide the new way of distant interaction and organization with higher speed, security and cooperation. The transactions executed on distributed ledger are more reliable. These make the organization to be more independent from authorities shifting from one jurisdiction to other. Poor regulation doesn't abolish control over substantial financial resources, which are in the hand of founders and participators of decentralized organizations.

Internet networking groups are very simplistic yet. Their governance system is very primitive. Decentralized network organizations have historical analogy. The societies on distributed network are in the earliest stage of development and can be compared to historical analog in the ancient Rome. The process of the groups' formation on the blockchain is spontaneous and similar to the practice of establishment of ancient Roman associations. According to the Roman law of the Twelve Tables,<sup>196</sup> the first associations were rural communities, professional and religious associations. They had freedom of action and could exist in any form. First Roman associations acted on the base of simple communities' statutes and

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<sup>196</sup> Conant. E. B. (1928). "The Laws of the Twelve Tables". Page 236.

have no duty of registration. They were the same simplistic like the contemporary decentralized organizations on blockchain, which, in most cases, act only on the ground of a white paper and program code.

Later the “*lex Iulia de collegiis*” at the time of August<sup>197</sup> were determining the certain types of associations, which were allowing to exist. The creation of associations was subject to the authorization of the Senate or the Emperor (*ex senatus consulto coire licet*).

The Gai<sup>198</sup> described the types of permitted association: farmers (*societates vectigalium publicorum*), fishermen (*pistorum*), sailors (*naviculariurum*).

On this historical example, we can observe the process of society formation and its regulation from total freedom to total regulation. It took four centuries to restrict the freedom of association. But now everything happens faster. We should expect that the decentralized network organizations based on the blockchain will be also classified and restricted in every possible way in number of countries.

The other historical example is church regulation. According to Harold J. Berman (1983)<sup>199</sup>, the corporation was often formed under canon law (church law) in absent a permission of the state authorities the same like decentralized network organizations, which could exist without any authorization. Under the canon law any group of persons, which had the requisite structure and purpose, for example, a hospital or a body of students, as well as a bishopric, constituted a corporation without special permission of a higher authority.

It can be said that under the canon law, though the head of a corporation (church) didn't own the property of the corporation, the head was entitled the power to control the corporation. The members of the corporation had the rights to take the decisions in some cases and elect the head of a corporation. The same governance structure can be met in some decentralized autonomous organizations. Participants

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<sup>197</sup> Dozhdev, Dmitry (1996) “Roman Law”. Moscow, Infra-Norma. Page 307.

<sup>198</sup> “Gai, Institutiones”, translation and commentary by the Post Edward. (1904).

<sup>199</sup> Berman, Harold, supra note 5 at 8. Page 576.

of organization can vote and take certain decisions. The founders control the assets of the organization.

## **Blockchain network**

Blockchain network has number of features.

### **Code dependence**

First of all the network is code dependence. The whole distributed ledger network is based on the logic of a few lines of code. Every block in the blockchain is a software-generated container that bundles together the messages relating to a particular transaction.

### **Anonymity**

The blockchain technology provides privacy and anonymity to users though the information about transactions is publically available. Blockchain public address hide personality. It is just the strings of random characters. At the same time, the blockchain is transparent so everyone can see the information on transactions, which is included in a block. Using a block explorer you can find out: block number, a hash of transaction, the address of the sender, the address of the recipient, the value of the transaction, and balance. Therefore, we can say that investments in decentralized network organization are “pseudonymously” i.e., an individual’s or entity’s pseudonym was their blockchain address<sup>200</sup>.

The pseudonymously is a challenge to the state authority to exert effective control over the blockchain transactions. To determine the person on the blockchain a Cluster Analysis (location of addresses) and a Big Data Analysis can be used, but it is still complicated process.

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<sup>200</sup> Securities and Exchange Commission. Release No. 81207 / July 25, 2017 “Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO”.

## **Immutability and Irreversibility**

All transactions on the blockchain network are immutable. The history of transactions is built on distributed ledger layer by layer. The chain of blocks can't be tearing up. The key implication is that every mistake on blockchain is fatal. Once a mistake is made it cannot be revised or fixed.

## **Distributed jurisdiction**

Due to the intersection of a large number of users and providers on the distributed network, there is substantial uncertainty about applicable law and jurisdiction. The jurisdiction is shared by many participants in every single case.

Distributed Jurisdictional means necessitate governance from within the blockchain technology itself to effectively address the problems inherent in blockchain-based smart contracts<sup>201</sup>.

## **Reputation**

The blockchain is the trustless system. Most interactions in the blockchain communities are fulfilled remotely and in the absence of recommendations of traditional communities. In contrast to common opinion, the Blockchain doesn't provide trust. The Blockchain is the trustless system due to cryptographic technology. Smart contracts guarantee an execution of transaction regardless the personal relationship or trust. The cryptographic technology ensures the execution but not relationship. The relationships among users on the decentralized network are based on reputation.

The fairness among members of the blockchain network community is possible on the ground of shared reputation. Publically available profile, the openness of historical data, and absence of legal rules are the foundation of all transactions on blockchain network. In the system where the rule-code in blockchain applications

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<sup>201</sup> Kaal ,Wulf; Calcaterra, Craig. (2017). "Crypto Transaction Dispute Resolution". Page 34.

is unclear even for experienced users and legal rules do not work the reputation is the most important assets.

### **Natural law**

Natural law prevails on the decentralized network.

The justice and culture are based on morality and traditions<sup>202</sup>, especially on blockchain network. The positive law, as the law actually adopted by proper authority, doesn't work in communities based on the blockchain technology due to the decentralized character of the network. At the present time, the balance between positive and natural law in blockchain industry is broken in favor of natural law.

Though, the many state authorities are going to take revenge to control the processes and assets existing on distributed network.

### **The cohesion of users**

There is cohesion among users. The users of blockchain network are linked to each other on the ground of individual interest to get benefits. At the same time, participants of the decentralized network organization are focused not only individual benefits but also common tasks, which are dedicated to the specific project of the decentralized organization. The cohesion of members of the network increases proportionally to the members' input to the project.

### **Control on individual level**

The control over a network society or decentralized organization starts from the control of the asset belonging to the users and transactions with this asset. The user has to manage a wallet, store private key, make transactions through ambiguous intermediaries by confusing algorithms, which functioning principle is unclear.

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<sup>202</sup> Bidzina, Savaneli "The Coexistence of Public Positive Law and the Private Normative Order". Page 8.



There is a special definition of control for blockchain industry. According to the Uniform Law Commission (US), the control means, when used in reference to a transaction or relationship involving virtual currency, the power to execute unilaterally or prevent indefinitely a virtual currency transaction<sup>203</sup>.

In the respect of distributed network, we can define control on an individual level (technical control), organizational level (control over networking groups); and system level (government control).

The most challenging is to keep control over the technological features and processes, which are even not fully comprehensible.

The control over the cryptocurrency wallet can be lost due to user's mistakes, carelessness, software problems, and hardware failure. As a result, more than 25% of bitcoins are lost forever<sup>204</sup>.

### **Control of Code. Program code vulnerability. The Parity case**

As the blockchain technology based completely on code rules, the understanding of the program script is very important for successful management of assets. Even experienced developers can't guarantee the code security.

One of an example of code based attack was a Parity case in 2017<sup>205</sup>. An unknown hacker has used vulnerability in an Ethereum wallet client to steal over 153,000 Ether, worth over \$30 million dollars on the date of attack. The hack was possible due to a flaw in the Parity Ethereum client. The coding patterns were implemented not effectively and securely. Hacker was a call to *initWallet and moves* the constructor logic into a separate library then makes all functions available publicly.

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<sup>203</sup> National Conference of Commissioners on Uniform State Laws, (2017). Uniform Regulation of Virtual Currency business act. Page 10.

<sup>204</sup> Sparkes, Matthew. The Telegraph, (2015). "The £625m lost forever - the phenomenon of disappearing Bitcoins". [www.telegraph.co.uk/](http://www.telegraph.co.uk/)

<sup>205</sup> Techcrunch. (2017). "A major vulnerability has frozen hundreds of millions of dollars of Ethereum". <https://techcrunch.com>

Hacker transferred 10 000 Ethers to each of seven addresses. As all addresses are available on distributed ledger we can trace all transactions.

The last address 0x96fC4553a00C117C5b0bED950Dd625d1c16Dc894 is Cryptocurrency exchange *changelly.com* that works as a mixer, where sender and recipient could be different person / addresses but use the same wallet.

Most of the hackers' funds were transferred through intermediaries' addresses to changelly.com a mixer from the Czech Republic.

### **Control of program. Fatal program-program interaction case**

The mistake can be derived not only from user-program interaction, but also program-program interplay. We assume that a program works properly, but their interaction could be fatal for users.

For example, to make transactions on blockchain you need to get private key for the account. This is automatic process. The seemingly simple action can lead to unexpected result. In non-English-speaking countries often use Google Chrome with automatic translation of websites. While you are going to get private key the Google Chrome automatically translate the private key from English to a foreign language. The translated private key can't be used. Access to the account and cryptocurrency is lost.

To illustrate this fatal program-program interaction I have choose a bitcoin online wallet <https://bitwala.com/> The wallet can produces a private key, encrypted with the wallet password (Appendix 1).

Let imagine that user from China entering to online wallet and use the Google translate, which is built into Chrome, to understand the content. User creates an original private key by wallet. Simultaneously the Google translate the private key. After translation the original private key got some additional spaces, capital letters, hieroglyphs, and new signs. Any attempt of recovery by backward translation of

the wrong key produce wrong result. Reverse translations from Chinese to English by Google translate doesn't create the original private key.

User can't get right private key back. Without the correct private key the user can't get access to the wallet. The cryptocurrency are lost.

This case illustrates the technological manifold problems that could hinder the control over the crypto assets.

Hence, the participant's control over assets on blockchain means having control over:

- Own action,
- Software,
- Program language that used for making software,
- Executable codes and smart contracts,
- The process of user-program and programs-program interactions.

Let's view decentralized organization in more details.

### **Control over the decentralized network organization**

The decentralized network organization is new form of cooperation or partnership. There are a lot of names of decentralized network organization. It can be called virtual organization, distributed computing system, decentralized autonomous organization, autonomous community, group of users, association of individuals, partnership, or company.

We can definitely say that regardless a title the decentralized network organization is an entity based on blockchain technology with unlimited number of participants. The functions and legal status of the decentralized network organization depend on many factors, including how code is used, where it is used, and who uses it.

If the users of a decentralized network organization are shareholders, the virtual organization turns into the registered corporate entity.

The Securities and Exchange Commission aware that virtual organizations and associated individuals and entities are using distributed ledger technology to offer and sell instruments such as tokens to raise capital<sup>206</sup>.

Investors who purchased DAO Tokens were investing in a common enterprise and reasonably expected to earn profits through that enterprise when they sent ETH to The DAO's Ethereum Blockchain address in exchange for DAO Tokens.

The decentralized network organization can take every form of legal organization or associated relationship existing in the real world. In most of the cases the decentralized organization is the result of the interplay of the group of founders and group of token holders.

Control over the decentralized organization depends on organizational structure.

There are three general organizational models of decentralized network organization: Club of purchasers; Organization with Membership; and Trust.

As the blockchain network is a collection of anonymous users, it is reasonable to implement social, economic and technological indicators for determining a control over users' assets and the whole system.

### **Club of purchasers**

Decentralized organization as a club of purchaser has two main groups: society of founders and society of token holders. Founders of decentralized network organization are the separate entity. Token holders group is a club network with informal communication. If the decentralized organization is established as club there is no control over the crowd except contractual conditions.

Features of control over club:

- The process of group formation initiated by founders.
- Founders organize but do not control the crowd.
- The founders and users have no common assets.

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<sup>206</sup> Securities and Exchange Commission. Release No. 8120, supra note 200 at 83. Page 10.

- Transactions are code depended.
- Free flow of members.

In most cases, there is no need to control a club of users. The tokens' emission carried out by founder's company i.e. company, which established by the founders of the decentralized organization. All digital assets and technology belong to the founders' company. As noted by Securities and Exchange Commission, the pseudonymity and dispersion of the token holders made it difficult for token holders to join together to effect change or to exercise meaningful control<sup>207</sup>.

### **Single organization with membership**

The society of founders of decentralized network organization and society of token holders can form a single legal entity. A single group is based on formal corporate rules and governance system. The token can be viewed as a share, which grants the members a right to vote and take a decision on fund allocation. Token holders are stockholders of the company.

Features:

- Pseudonymity of some shareholders.
  - Problems with the register of shareholders.
  - KYC/AML problems as an identity cannot be checked in real life.
- The corporate rules of single organization may not comply with the corporate law.

The control over the organization as a single entity can be determined on the ground of the corporate rules implemented in documents or code.

### **Trust**

Founders of decentralized network organization can establish a managing or trust company, which operate the assets of the decentralized organization.

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<sup>207</sup> Securities and Exchange Commission. Release No. 8120, supra note 200 at 83. Page 14.

The assets are placed in a decentralized organization by a settlor. The token holders are beneficiaries. The problem of this structure is anonymity of token holders and inability to keep a register on beneficiaries.

The founder could not be considered as a controlling person of the entity if the founder meets the all next conditions:

- has not right to get directly or indirectly an income from the entity;
- can't dispose the income of the entity;
- has not right on assets, which was irrevocably transferred to the entity.
- has no control over the entity.

### **Control over network by government authorities**

The state's authorities deeply concern over the money laundering and criminal activities on blockchain network and seek a new way to design the control and regulation of the market behavior by tailoring legal norms to blockchain features. The Committee on Economic and Monetary Affairs and Committee on Civil Liberties, Justice and Home Affairs of European Union pointed out that the terrorist groups are able to transfer money into the Union's financial system or within virtual currency networks by concealing transfers or by benefiting from a certain degree of anonymity on those platforms<sup>208</sup>.

Competent authorities start to monitor the use of virtual currencies and seek ways to obtain control over the distributed blockchain network system or in other words to get a power to exercise controlling influence over the network's transactions and network's participants. It is a difficult task due to anonymity. Technically only pool of miners is able to have a partial control over the separate cryptocurrencies in exceptional circumstances.

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<sup>208</sup> Draft European Parliament Legislative on the proposal for a directive of the European Parliament and of the Council amending Directive (EU) 2015/849.

The intention of states' authorities to control is in permanent contradiction with rights to privacy and freedom. At the same time, the blockchain technology creates a problem for participants too. The users cannot restore the situation, remove information about transactions on blockchain and have a right to be forgotten as all information about transactions is immutable. A lot of questions arise on compliance with know your clients policy and transfer of personal data<sup>209</sup> from a state or intermediaries to a third country or intermediary with an inadequate level of data protection.

The blockchain technology makes it possible to hide information and personality inside the network. But there is a borderline. The anonymity and pseudonymity can be partially overcome by control of Entrance-Exit Nodes (EEN) of the network system. EEN is a node of the blockchain network, which simultaneously interacts with other nodes of the blockchain network, whose legal status is determined. EEN is a node between decentralized and centralized systems. Usually, the EEN is virtual currency exchange platform or custodian wallet provider, which the European parliament views as a threat of money laundering<sup>210</sup>.

The U.S. Financial Crimes Enforcement Network investigated the operations of money transmitter BTC-e, which is involved in money laundering. Mr. Vinnik, who is an operator of BTC-e, was tracked and discovered by links between his cryptocurrency account and an account on WebMoney payment system<sup>211</sup>.

This case shows that focus on WebMoney as an Entrance-Exit Node can reveal the identity of the user on the blockchain network.

The control over EEN only partially addresses the problem of control over the network, users, and criminal transactions. As noted by European authorities the

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<sup>209</sup> European Parliament and Council Directive 95/46/EC.

<sup>210</sup> Draft European Parliament Legislative, supra note 208 at 93.

<sup>211</sup> Adelstein, Jake (2017). "The World's Most Infamous Billion-Dollar Bitcoin Launderer Nabbed at Last?" Page 3.

strict regulation of virtual exchange platforms and custodian wallet providers will not entirely address the issue of anonymity attached to virtual currency transactions, as a large part of the virtual currency environment will remain anonymous because users can also transact without exchange platforms or custodian wallet providers. To combat the risks related to the anonymity, national Financial Intelligence Units (FIUs) should be able to associate virtual currency addresses to the identity of the owner of virtual currencies<sup>212</sup>.

We can state that the blockchain decentralized organizations are structured and managed the same simplistic like the first Roman communities. The improvement of network organizations regulations is similar to the development of ancient communities and moving forward along a path of complication. Though, there is a difference. For the ancient communities the regulations were invented, but for the virtual organizations, the existing regulation is implemented.

Realization of control on blockchain network is a difficult task for every participant including state authorities and users. At the same time, the founders of decentralized organization can effectively attract and fulfill the control over the accumulated funds. The anonymity of the decentralized network participants and peculiarities of technology prevent governments from efficient control over the network. Only goodwill of their participants to disclosure information and willingness to pay taxes or in other words high morality of the participants can confirm the governments' authority.

Let observe the various methods of control determination.

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<sup>212</sup> Draft European Parliament Legislative, supra note 208 at 93.



## 4. ANALYSIS OF CONTROL

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### 4.1. APPROACHES TO CONTROL DETERMINATION

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The most popular is threshold approach. Control over the company may be exercised through ownership of interests/shares. FATF, OECD and many countries developed recommendations and legal norms based on threshold approach where control starts from owning more than a 25% of the company<sup>213</sup>. Both in the ex-ante and ex-post framework, mandatory takeover bids are most commonly triggered by a 30-33% ownership threshold where the calculation regularly includes all affiliated parties in the sum<sup>214</sup>.

For example the UK Takeover code (2013) determine the control as an interest in shares carrying in aggregate 30% or more of the voting rights of a company, irrespective of whether such interest give de facto control.

In Italy, the law differentiates the mandatory triggering threshold according to the size of companies, where small & medium sized companies may establish in the bylaws a threshold in the range 25%-40% of voting rights, while for the others the threshold is 25% of voting rights provided that no other shareholder holds a higher stake<sup>215</sup>.

In this sense the power of control has some thresholds too.

The threshold approach implies that there could be more than one controlling person. For example, two persons who have 25% of voting share each. Therefore, controlling power can be shared among shareholders.

#### **Social approach**

The social approach to control is more focused on natural person. As network is more about human than assets, the ability to direct the actions of employees or

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<sup>213</sup> The FATF Recommendations do not specify what threshold may be appropriate.

<sup>214</sup> OECD, Factbook, supra note 2 at 6. Page 55.

<sup>215</sup> OECD, Factbook, supra note 2 at 6. Page 78.

network community denotes control over the organization. Trade unions are a good example of application of controlling power by networking stakeholders.

### **Economic approach**

Economic approach is often implemented in regulation of financial issues.

Economic indicators of control can be grounded on the base of tax and other similar legislation. From an economic point of view defined in the Taxation Act<sup>216</sup> control is the ability of controlling person to receive directly or indirectly and whether at the time of the event or later:

- over 50% of the proceeds of the disposal, if the whole share capital were disposed.
- over 50% of the distributed amount of income, if the whole income were distributed.
- over 50% of assets which would then be available for distribution, in the event of the winding-up of controlled company or in any other circumstances.

### **Technological approach**

Technological approach to control is important in high tech industries. Inability to manage and appropriately use program code and software leads to loses of information, crypto assets and communication channels within community.

Expected spreading of Artificial Intelligence technology will shift the operational processes from human hands to software. Control over technology and a technological process means control over organization.

### **Asset approach**

Under the Asset approach the control viewed as result of assets control. This kind of control is more typical for industrial organizations or companies under bankruptcy procedure.

### **Exclusive approach**

Exclusive rights approach assumes some special rights possessed by stakeholder.

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<sup>216</sup> TIOPA (UK), supra note 109 at 53. Part 9A.

The exclusive rights can be positive (additional voting power) or negative (veto rights). This type of control is often implemented by government as a golden share to keep influence on meaningful companies.

### **Contract approach**

The contractual theory of the firm does not present the company as a community, but views it as the networks of contractual exchanges<sup>217</sup> or as an entity founded in private contract<sup>218</sup>. Company is nexus of contracts. Under Contract approach control over company is control over company's contracts. Therefore, the main task is identification of the major or the most important contracts of the company.

### **Independent approach**

There is a special Independent approach for public companies. The Listing Rules published by the UK Financial Conduct Authority (FCA) set out certain basic conditions, which must be satisfied for a company's securities to be eligible for admission to the Official List. One of this conditions, published in the FCA guidance, is ability of company demonstrate that it will be carrying on an independent business as its main activity - the "independence test". One of the factors of independence test include situations where the majority of revenue generated by the company is attributable to business conducted directly or indirectly with a controlling shareholder of the company; where the company does not have strategic control over the commercialization of its products and/or its ability to earn revenue; where the company cannot demonstrate that it has access to financing other than from a controlling shareholder; or, where the company's business consists principally of holdings of shares in entities that it does not control, including entities where it is only able to exercise negative control<sup>219</sup>.

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<sup>217</sup>Boatright, John and Schuck, Michael, *supra* note 122 at 58. Page 9.

<sup>218</sup>Butler, Henry, *supra* note 123 at 58. Page 3.

<sup>219</sup>Clifford Chance LLP (2014). "Initial Public Offers: A guide to the UK listing regime". Page 32.

Independent approach is the most modern and advanced understanding of indicator of control: direct dependency between controlling person and commercialization of product, revenue and access to finance.

## **4.2. MEASURING VOTING POWER**

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Faccio Mara and Lang Larry<sup>220</sup> (2000) proposed that the definitions of ownership and control rely on cash-flow and voting rights respectively. These two measures may differ because of the use of dual-class shares, pyramiding structures, and cross-holdings.

Faccinno and Lang assume that if a family owns 15 percent of Firm X, which in turn owns 20 percent of Firm Y, then we would say that the family owns 3 percent of the cash-flow rights of Firm Y - the product of the two ownership stakes along the chain- and controls 15 percent of Firm Y.

It is looks like their position is wrong. The family can't control the process of proxy voting in the Firm Y and surely doesn't control executive managers of Firm Y. Hence the real controlling person of the Firm X will appoint the executive manager of the Firm X, define dividend policy and participate in appointment of an executive Manager of the Firm Y. The controlling person of the Firm Y will appoint the Executive manager of the Firm Y and define the dividend policy of the Firm Y. In this situation control depends on number of connection and cooperative game. In public company with diffusion of shareholder rights and great number of minority shareholders the controlling person can have only 10% to control the company. But if the minority shareholders are highly connected to each other, organized and cooperative they can hold control over the company by collective voting power.

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<sup>220</sup> Mara, Faccio; Lang, Larry, (2000). "The Separation of Ownership and Control: An Analysis of Ultimate Ownership in Western European Corporations". Page 10.

The modern law can't detect collective control due to lack of appropriate criteria. This situation of minority collective control can be described and understood by Network Control Analysis and Cooperative Game Analysis quite well.

### **4.3. CONTROL OVER CONTRACTS IDENTIFICATION**

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To determine the control or the shifting of control over company three flags concept can be employed. The three flags concept indicates changes in control on the base of assets and contracts.

Appearance of one of the next means loss of control over the company contracts:

- one person or group acting in concert controls the contracts with aggregate volume more than 50% of total assets of the company;
- one person or group acting in concert controls the contracts, loss of which will lead to company dissolution;
- one person or group acting in concert controls the contracts which can't be substitute.

For determination of control by three flag concept the calculations of influence on contracts characteristics approach can be used. The approach determines how many contracts and conditions of contracts are under control of the one person. Prerequisite of the control is sufficient influence.

Let make definition of sufficient influence.

The sufficient influence is right, which with high probability lead to changing control over the company. To provide sufficient influence over the company the contractor has to control sufficient conditions of number of contracts solely.

For determining sufficient influence the contract threshold method can be implemented. Reframing the idea that effective control over company can be defined in terms of the threshold of certain percent of voting rights, I propose to determine influence over the contract in terms of thresholds too.

In most countries<sup>221</sup> in corporate law exercising or holding more than 50% voting rights considered de facto as the control. Therefore, by analogy the sufficient influence over the company (pre control situation) can be determined as a control over conditions of contracts, which total volume is more than 30% of the company assets or more than 30% of total money volume of contracts.

In this case, the 50% of total assets viewed as sufficient assets, which guarantee sufficient influence for its contractor. The same the major creditor and monopolistic provider also can be viewed as sufficient influencer.

This three flags concept can be implemented as a test of control by contracts in legislation. The appropriate regulations and requirements for early determination of control shifting and tax avoidance schemes should be adopted by regulative authorities.

#### **4.4. ABILITY TO SUBSTITUTE**

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The relations between stakeholders and shareholders are very important for successful development of corporation. Without any doubt, the stakeholders of a corporation are able to influence on the corporation. But what could we say about control over corporation? Having in mind that control over corporation means control over the cash flow and company's affairs; could we state that the stakeholders have a minimal control, part of control, temporary control, or joint control over the corporation? In other words can the stakeholders control the cash flow and affairs of the company? We expect that this can happen if there is no active controlling shareholder. I believe that in every game/interaction of stakeholders the most important is ability to exclude another player from the game. The major obstacle for stakeholders' capacity to control the corporation is ability of controlling shareholder to substitute the stakeholders. The employee or director

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<sup>221</sup> German Foreign Tax Act; Spain Corporate Income Tax Law; Anti-Monopoly Law of China.

can be substituted for the equally professional employee or director. At the same time in public corporation the stakeholders can't substitute the shareholder for other shareholder.

I believe that the main feature and advantage of controlling shareholder over stakeholders is the ability to substitute every stakeholder at the table of corporation, except the minority shareholders (we are not take into account dilution cases). The ability to substitute every stakeholder ensures the power to control the corporation by controlling shareholder. The full control over corporation is still possible even there is no control over every coalition of company or all stakeholders of corporation.

To determine the control we need to find the equilibrium of ability to influence on corporation, which exist between controlling shareholder and stakeholders of corporation. Corporate law enables the participants to select the optimal arrangement for the many different sets of risks and opportunities that are available in a large economy<sup>222</sup>. The appropriate balance of rights and obligations in corporate governance enforced by law can prevent shareholders from misuse of the ability to substitute. At the same time, the right balance will prevent stakeholders from the ability to minimize the cash flow of the corporation by inappropriate action.

To determine ability to substitute we can view controlling shareholder through prism of the Game Theory and discuss the controlling shareholder's rights. The Game Theory provides the instrument determining the best arrangement implying the ability of controlling shareholder to substitute stakeholders of corporation. The Game Theory is quite suitable to examine cooperative and non-cooperative game. It can be scalable to the organization with high number of participants, stakeholders and coalitions.

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<sup>222</sup> Easterbrook, Frank; Fischel, Daniel, supra note 140 at 63. Page 1418.

The modern law consider control as a power of a single person and its affiliates, though in modern theory and in practice shareholders can't control a company without cooperation with stakeholders. Below we will discuss the control as result of coalition's formation.

### **Ability to substitute in Non-Cooperative game**

Let consider the Non-cooperative games, which are focused on individual interactions of players.

From the Game theory point of view, corporation is a centre of interactions of the number of players-stakeholders and their coalitions. Stakeholders and controlling shareholder (the players) are always in competition for the revenue (payoffs) generated by corporation.

Controlling shareholder in competition for higher payoff has a lot of instruments to influence on corporation like election of members of board of directors, amendments of statutory documents<sup>223</sup>, approval of substantial property transactions, reorganization<sup>224</sup> and distribution of profit.

Though, in non-cooperative games the controlling shareholder acting individually and separately has not a lot of choices to influence on corporation. The ability to manage/win game of exchange depends on ability: to control the rules (law) of the game; control resources everyone needs (creation of power dependence relation); control over preferences or identities (creation of demands for recourses)<sup>225</sup>.

The most important individual strategy of controlling shareholder is directly "dominates the company through control over the board of directors"<sup>226</sup>. If the shareholders are displeased with the action of their elected representatives the powers of corporate democracy are at their disposal to turn the board out.

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<sup>223</sup> UK Companies Act, supra note 74 at 31. § 21.

<sup>224</sup> Companies Law of the People's Republic of China , supra note 175 at 75. Article 43.

<sup>225</sup> McFarland, Daniel, (2017). "Organizational Analysis", Stanford university.

<sup>226</sup> Bainbridge, Stephen. (2002). "Corporation Law and Economics". Page 229.



Shareholder power to replace directors is supposed to supply a critical safety valve, preventing directors from straying from shareholder interests<sup>227</sup>. The board of directors will take decision in interest of corporation in accordance with explicit or implicit instructions of the controlling shareholder.

Therefore, the power to control based on ability directly substitute disloyal directors and managers, which is derived from legal rights to elect and remove the members of board of directors and executive managers.

In most countries to elect majority of board of director is enough simple majority. Controlling shareholder can elect and remove directors by ordinary resolution (a simple majority) in UK<sup>228</sup> and Spain and by a majority of not less than three-fourths of the votes cast in Germany<sup>229</sup>.

To prevent an excessive influence of controlling shareholder on board of directors there is institute of independent directors. Most jurisdictions' definitions of independent directors (76%) include requirements that they be independent of substantial shareholders, the shareholding threshold of substantial shareholders ranges from 2% to 50%, with 10% to 15% the most common<sup>230</sup>.

Remuneration of the members of board of directors is another instrument for shareholders to influence on member of board of director. In Germany remuneration of supervisory board may be determined in the articles or set by the shareholders' meeting. If the remuneration is determined in the articles, the shareholders' meeting can, by simple majority, resolve on an amendment of the articles by which such remuneration is reduced<sup>231</sup>.

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<sup>227</sup> Bebchuk, Lucian (2003). "Why Shareholders Must Have More Power". Financial Times October 22, 2003. Page 1.

<sup>228</sup> UK Companies Act, supra note 74 at 31. § 168.

<sup>229</sup> German Corporation Act (Aktiengesetz). §103.

<sup>230</sup> OECD, Factbook, supra note 2 at 6. Page 98.

<sup>231</sup> German Stock Corporation Act § 113, supra note 177 at 76.

## **Determining control through ability to substitute in Non-Cooperative game**

We can determine the power to control through the ability to substitute. To exemplify we can analyze the conflict between controlling shareholder and board of directors. Let consider the case based on situation with Viacom in 2016. The company has delivered weak annual results, and its share price has fallen about 35 percent for the year<sup>232</sup>. Redstone's National Amusements Inc, which controls Viacom, had removed five members of Viacom's board of directors and appointed new five independent directors. By replacing five directors, the Redstone's National Amusements Inc. gets a majority on the 11-member board and forms a coalition with the board.

We can consider the interactions among shareholders and stakeholders as a non-cooperative zero-sum game with opposite interests. Gains or losses of each player are balanced by gains or losses of the other players (Appendix 3).

To solve the game we employ Sub game Perfect Nash Equilibrium. This is a strategy profile that specifies the Nash equilibrium in every subgame with backwards induction, taking into account sequential rationality.

Controlling shareholder nominates and elects the board of director. The members of board of directors in turn have to take a certain decision.

Analysing payoffs of players at the end of game we determine that the profile **10 – 10** is the subgame perfect equilibrium.

The key element here is the decisions of the board of directors. They can make decision in line with the controlling shareholder's vision (Sbd1) or confront to the controlling shareholder (Sbd2). Let assume that the both decisions are equally relevant and reflect interests of corporation though by different means.

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<sup>232</sup> Bostonglobe. "Five Viacom directors are replaced" (2016).

The analysis shows that the board of directors will realize strategy Sbd1 as this is the only strategy, which brings maximum payoff (higher bonus) to the board of directors.

As the game is sequential the controlling shareholder will take the next step, which is Scs2.

In case the board of directors for any reason choose confrontational strategy Sbd2, the controlling shareholder will escape permanent conflict situation, which gives the lowest payoff 3, and implement strategy Scs3 with the better payoff 5.

Strategy Scs4 is realization of power to control through the ability to substitute, which reflected in legal rights to elect and dismiss members of board of directors. The backward analysis shows that controlling shareholder as an individual player can directly substitute members of board of directors. This can expand the scope of decisions under control of controlling shareholder though can't ensure full control over the corporation.

Controlling shareholder still can't directly substitute employees and other stakeholders, therefore has no full control over the corporation.

Let analyze the cooperative game among stakeholders of the corporation.

### **Ability to substitute in Cooperative games**

Cooperative games examine interactions among coalitions of individual players. Individual player is a natural person or body of corporation. In this sense, board of directors and member of board of directors can take part in different coalitions. The corporation from the cooperative game point of view is a grand coalition composed by stakeholders and shareholders (players). Inside the grand coalition stakeholders and shareholders can form some smaller subcoalitions. Every player periodically enters in new coalitions and interacts with other players.

As we have learnt from non-cooperative games the board of directors and managers easily form a coalition with controlling shareholder because they are

totally depend on controlling shareholder. In corporation, where the controlling shareholder can elect all members of the board of directors, the board of directors undoubtedly represents interest of controlling shareholder. “The board and management are mere puppets of their shareholders”<sup>233</sup>.

Entering in coalition with controlling shareholder the board of directors represent interest of the controlling shareholder<sup>234</sup> in spite of the legal constraints existing in some countries like independence, duty of loyalty (to corporation) and representation of employees<sup>235</sup>.

The ability to substitute members of board of directors and managers directly is the reason and means for the existence of the coalition among controlling shareholder, board of directors and managers.

Coalition between controlling shareholder and members of board of directors enforced by ability to substitute, which blurs the line between two independent players – board of directors and controlling shareholder.

If controlling shareholder and board of directors jointly act as one person the board of directors can be viewed as a “dummy player” and excluded from the game. In this case the controlling shareholder can be viewed as a shadow director i.e. the person in accordance with whose directions or instructions the directors of the company are accustomed to act<sup>236</sup>. Moreover, the controlling shareholder may not provide mandatory advice, but still be count as shadow director because it has feature of guidance<sup>237</sup>. In this sense the influence of the board of directors on management is minimal as all decisions are taken by controlling shareholder. It is recommended to include the concept of controlling shareholder as shadow director in corporate governance rules and regulations. Controlling shareholder’s

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<sup>233</sup> Dai, Sophia; Helfrich, Christian, “The Structure of Corporate Ownership and Control” (2016). Page 19.

<sup>234</sup> Moscow Cyril (2012) “Corporate Governance. The Representative Director Problem” Page 1.

<sup>235</sup> Weinberger v. UOP, Inc. 457 A.2d 701 (Del. 1983).

<sup>236</sup> UK Companies Act, supra note 74 at 31. Section. 251(1).

<sup>237</sup> Secretary of State for Trade and Industry v Deverell [2001] CH 340.

obligations and responsibilities have to match to obligations and responsibilities of member of board of directors with duties to disclosure information and liabilities for the company's criminal behaviour, incurred damages and insolvency.

### **Control in cooperative games**

I argue that the control in cooperative games is ability of a player exercise decisive influence on subcoalition and ability of this subcoalition exercise decisive influence on corporation (the grand coalition). In other words, to get the full control over the corporation the controlling shareholder has to form a subcoalition with directors and managers so subcoalition can exercise decisive influence on stakeholders. Only coalition of controlling shareholder with board of directors and managers (controlling coalition) based on ability to substitute any other stakeholder can impose cooperative behaviour of the other stakeholders (controlled coalitions) and enforce stakeholders join to the grand coalition (corporation). Hence, controlling shareholder can indirectly control other stakeholders. Ability to substitute ensures decisive influence of controlling shareholder on corporation. Control of one subcoalition over other subcoalitions and at the same time cooperation among coalitions inside corporation emphasizes dual nature of cooperative behaviour of shareholders and stakeholders. All stakeholders are bound with each other in spite of occurring conflicts as they all in minor position. Possibilities of controlling shareholder to substitute other stakeholders of corporation are restricted by law and statutory documents of the corporation. At the same time personal composition of each type of player can be changed by controlling shareholder or controlling coalition. Every type of stakeholders of corporation can be substituted wholly or partially and directly or indirectly.

## **Analysis of coalitions**

To analyse coalitions let consider the alliance of shareholder, board of directors, executive managers and employees. Grand coalition of the corporation is composed by all stakeholders and shareholders of the corporation.

The shareholder as a founder and investor is a key participant of the coalition. Controlling shareholder may not actively participate in the coalitions but be able to get payoff - dividends and yield of shares. Passive controlling shareholder doesn't participate in the shareholder meetings or adapt decision totally based on third-party recommendations.

Other stakeholders to be able to get payoffs have to participate in the corporate business actively. Members of board of directors, managers, employees can't get money from corporation in case they stop their legal relationship with the corporation. Therefore, the payoffs of the every single player, except the shareholder, outside the grand coalition are equal to zero.

### **The payoff for each player inside grand coalition.**

Due to superadditivity the payoff of every player participating in coalition is greater than zero. If payoff is equal zero the player are excluded from coalition. We assume that the payoff of each player inside coalition is a sum of money obtained by player during a year from corporation under normal conditions. We don't count the payoff as the distribution of the cash flow among players but as a number of individual outcomes for each group of players.

Payoff of employees is salary; for shareholders it is dividends and yield of shares, for members of board of directors it is salary and bonuses.

The cost of shares does not count as payoff of shareholder. We consider the cost of shares is irrevocable investments, which the corporation can't totally compensate by itself. Price for shares is the price for right to be a shareholder but not the payoff.

All shareholders and stakeholders participating in corporation get all payoffs of the corporation.

At the same time every stakeholders of a smaller subcoalition can get more than sum of individual payoffs.

Let find a Core of the game - a set of payoff allocations.

The payoffs of every player in grand coalition are distributed among players in the certain proportion. Let suppose that payoff of every stakeholder and controlling shareholder is 0,1 out of 1. Taking into account the key role of shareholder and zero payoff of every stakeholder outside coalition, the Core of the game shows that corporation are stable if the payoff of controlling shareholder tends to one (100%) and the payoffs of other stakeholders tend to zero. It doesn't mean that the corporation will successful on a market, but it is mean that inside corporation will no conflicts.

Controlling shareholder is able to influence on profitability of stakeholders and put pressure on the stakeholder's payoffs making it lower. Changes in game's vector and intentions of stakeholders to get a higher payoff will disrupt the balance.

The most often the scenario of demanding higher payoff is requirement of employees to increase the salary. Let consider employees' coalition and substitution.

The employees as player can't be totally excluded from grand coalition but personal composition can be changed therefore employees can be substituted.

We suppose that the substitution of employees will result in the same output as the employees perform the same standard work in this corporation.

The employees are the symmetric players.

In this case the controlling shareholder, board of directors and managers are the only permanent elements of the first coalition.

As permanent players the controlling shareholder, board of directors and managers can form new or second coalition. This means that the controlling shareholder, board of directors and managers can get all or most part of payoff of first coalition. The controlling shareholder can substitute other stakeholders and get all or most part of the payoffs until substitution is not reducing cost of the shares.

The precondition is that the cost of shares may reduce if the controlling shareholder abused the right to substitute.

If the set of employees is substituted for other employees the total payoff will be lower as integration of new employees will demand more fund and result in a lower output.

Another iteration of employees will make the payoff lower again.

Let view the situation where the stakeholders in turn decide to control corporation. Let analyze the possibility of the stakeholders' control or influence the corporation. The grand coalition without shareholder has no sense as a corporation can't exist without shareholder/investor.

All coalitions inside corporation compete with each other for a higher payoff.

Hardly ever the controlling shareholder will participate in two coalitions, which have different interests. The controlling shareholder rather chooses the coalition, which can bring the higher payoff in the long run.

The other subcoalitions can exist without shareholder but vector of their payoff will tend to zero.

To prevent unfair distribution of profit and break the tendency of reducing income of minors coalitions the coalition with controlling shareholder have to include every stakeholder of corporation. This can be achieved by new regulation preventing shareholder from entering in controlling coalitions and binding the controlling shareholder enter into coalition with every stakeholder. The problem is that controlling shareholder doesn't conclude direct agreements with stakeholders.



To fix this I propose to adopt the rules that legally bind controlling shareholder enters into direct agreement with employees (labour unions), local communities (municipalities) and other stakeholders. The subject of agreement should be obligation of stakeholders to not commit any act with the aim of reducing the cash flow of corporation and obligation of controlling shareholder to not commit any act in order to minimize the stakeholders' payoff.

### **Startup features of cooperative interaction of stakeholders**

New economy breaks standard model of control existing in traditional companies. There are some special features of cooperative interaction of stakeholders in startup companies:

- The startup is an open system, where every internal stakeholder enters in coalitions as much as can. Number of external coalitions in contrast to traditional corporations is substantially higher.
- The controlling shareholder can be substituted by choice of stakeholder during startup funding rounds.
- The relationships in coalitions are very dynamic. Personal composition of players is very labile. Investors and freelancers come and go very fast.
- Power to control and ability to substitute are tuned and restricted by number of private contracts like shareholder agreement, share purchase agreement, option contract etc.
- Types of players in grand coalition of startup are less than in public corporation as one player can combine function of shareholder, employee and manager. Therefore, there are few coalitions inside startup.
- The payoffs of players are not obvious and future-oriented.

These features should be taken into account with adoption of new legislation for small companies and big corporations.

## **Conflict of Controlling shareholder and Employees**

Let consider another conflict situation between controlling shareholder and employees. Shareholders and employees are both claim for the part of the revenue. Employees directly affect corporation profitability. But the employees in most countries do not take part in the sessions of board of directors and shareholders' meetings so can't influence on distribution of profit.

What if the controlling shareholder decides in spite the common practice to pay dividends and at the same time the employees insist on a higher salary. We assume that the obligation of controlling shareholder to take decision to pay dividends is based on certain provisions of shareholder's agreement and must be fulfilled under threat of contractual penalties.

How will behave the board of directors to satisfy all stakeholders? What is the role and influence of controlling shareholder? We can give answer to these questions by using the backward analysis of the Game Theory.

We use again the Sub game Perfect Nash Equilibrium.

The major role in this game plays expectations of every stakeholder and finite horizons.

Let view the game in which participate the controlling shareholder, board of directors and employees.

Preconditions:

- Corporation is in maturity stage. Shareholders wish to get dividends. Controlling shareholder decides to fix the profit.
- Decision on dividends depends on Board of directors.
- Decision on dismissal of employees depends on Board of directors.

- Board of directors is elected by shareholders. The 50% of voting shares are enough to elect majority of board of director. The employees demand to increase the salary or threaten a general strike.
- The sum of dividends is reduced by wage of employees.
- The corporation is able to replace the personal.
- The sum of money for dividends or for salary can't be split between shareholders and employees as every group of stakeholders wishes to get the whole sum of money.
- The goal of directors is to choose the appropriate strategy for long term corporation development and get an additional remuneration/bonus for every member of board of directors.
- Result of every stakeholder's decision is transparent.

Let's view the game tree and outcome profiles (Appendix 4).

Profile 8 – 9 – 1 Dividends – Strike – Personal replacement

- Board of directors makes decision to pay the dividends in the interest of the controlling shareholder to maximize shareholder value. Shareholders will get dividends.
- The Board of directors will be not replaced by controlling shareholder as it has taken the decision in interest of controlling shareholder.
- The members of the Board of directors get additional bonus.
- Employees go on strike. They have no choice as consider the current salary unfair.
- There is growing expenditures on personal replacement
- Controlling shareholder elects the controlled Board of directors. Most of the members of the Board of directors working for the benefit of the controlling shareholder.
- Board of directors will dismiss and replace the staff.
- The corporation encounters the difficulty due to downtime. Expenditures on hiring and training are rising, which makes future income lower.

The shareholders and board of directors can't get higher payoffs (the highest payoff is 10) as the income is decreasing. At the same time, expenditures are increasing too.

Profile 5 – 4 – 2    Dividends – Strike – No replacement of personal

- Permanent strike
- Shareholders get dividends
- No Board of directors replacement
- No bonus for Board of directors
- Personal get lower salary due to strike
- Corporation get lower revenue
- In a long run corporation will get bankruptcy

Profile 10 – 10 – 4    Dividends – No strike – BD bonus

- No strike. Employees save jobs with the same salary
- Shareholders get dividends
- No Board of Directors replacement
- Board of directors get additional bonus

Profile 1 - 1 – 10    No dividends – BD replacement

- Shareholders don't get dividends
- Board of Directors total replacement.
- No bonus for BD
- Employees get higher salary
- No strike

Profile 1 – 5 – 10    No dividends – BD replacement

- New attempt of controlling shareholder to elect controlled Board of directors.
- Board of directors get standard bonus

- Employees get higher salary due to new labour policy approved by Board of directors.

Using backward induction in sequential games with perfect information for analyzing profiles we can make conclusion that players will choose profile 10-10-4 (Dividends – No strike – BD bonus) as subgame perfect equilibrium.

It should be noted that the Game theory don't take into account cultural differences and irrational behavior.

### **Extended game with employees**

If we take an additional step of sub games and look at the decision of controlling shareholder we can note that all decisions can be repeated by controlling shareholder until achievement of equilibrium or bankruptcy.

Controlling shareholder replace members of board of directors and employees until new configuration of stakeholders allow achieve equilibrium.

This is happens only due to ability of controlling shareholder to replace all other stakeholders. The controlling stakeholder always can substitute (directly or indirectly) other players and start the game again.

“Controlling shareholder can easily extract private benefits that otherwise would have been shared with other shareholders”<sup>238</sup>.

### **Conclusion on cooperative and non-cooperative games**

We can conclude that the ability to substitute is the main and the most striking characteristic of the controlling shareholder. The controlling shareholder, in contrast to board of directors and over stakeholders, can replace all other stakeholder directly or indirectly, even though this can have a devastating effect and lead to bankruptcy of corporation.

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<sup>238</sup> Aymen, Jebri (2013). “The Effect of Large Controlling Shareholder’s Presence and Board of Directors on Firm”. Page 181.

The controlling shareholder can exercise full control over the corporation in the long run due to the fact that controlling shareholder by himself or by controlled board of directors and management can make decision to:

- substitute the employees by hiring new staff;
- substitute the local stakeholders and authorities by changing the place of domicile;
- substitute the debt holders, banks, creditors by new one;
- manage cash flow and revenue distribution.

The stakeholders can have decisive influence on corporation by reducing cash flow of corporation.

The shareholder can be viewed as controlling shareholder if the shareholder has such number of voting shares that it gives the rights to substitute the majority of the board of directors and change provisions of memorandum and article of association. In every country there is different legal configuration.

In non-cooperative games the controlling shareholder acting alone can't get the full control over the corporation. The cooperative games analysis shows that cooperative behavior of controlling shareholder provides greater control over the corporation. We suppose that there is only one coalition, which can be controlling in relation to one corporation

#### **4.5. NETWORK CONTROL ANALYSIS**

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Canyon Martin and Muldoon Mark<sup>239</sup> (2007), assume that most of the important features of the agency model can be articulated in a single hierarchical relation between a single principal and a single agent. Interconnections between firms can be ignored. The such approach hides a lot of information from analysis. Many

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<sup>239</sup> Canyon, Martin and Muldoon, Mark, supra note 40 at 18. Page 6.

stakeholders participate in interconnections and interactions. The control can shift with a great speed and be distributed among large number of connected participant. At the present time, to describe control in legal terms we have to use the terminology with blurred criteria and vague formulation. By using correct methods and unambiguous approaches we can enact new precise definitions and refine the existing one. We need to know all the network system variables to determine all possible influencers, players to predict future control system. Early the jurisprudence already adopted a law with economic approaches like Herfindahl-Hirschman index, which is measuring market concentration by calculating market share. The measuring mechanism of Controlling Person power can be helpful instrument of control determination.

As control often realized through network structures for the purpose of control identification I propose to employ Social Network Analysis (SNA) to measure the distribution of control and develop Network Control Analysis (NCA). It helps to investigate all aspects of Network control, which can be understood as the sum of economic gains of directly controlled firms obtained by all direct and indirect network powers. The Network Control Analysis is the method of investigating interactions and impacts through the use of network and graph analysis.

It sticks together frameworks for the personalization of private law across different regulatory tools such as disclosures, anti-money laundry and financial policies.

By application of network analysis techniques, laws can be tailored to individual characteristics of addresses.

It is not always obvious, who is the most powerful controlling person in a group of affiliates, especially, if they are hidden behind a trust, nominee holder, VIE structure or virtual organization. But Network Control Analysis with historical projection can cast the light on the real beneficial owner and controlling person. For this purpose we can be described every network structure as a number of nodes connecting with each other.

To understand all aspects of the corporate and organizational relationships, part of which lead to control, the proper disclosure of information should be applied. It is especially important for distributed networks based on blockchain.

In European Union the corporate governance framework is all based on the “comply or explain” approach which allows Member States and companies to create a framework that is in line with their culture, traditions and needs<sup>240</sup>.

“In June 2016, the UK government started publishing the PSC ('People with Significant Control') Register, the world's first open data register of the real owners and controllers of companies – known as 'beneficial owners'. It is a big step forward for transparency in this country and a potential treasure trove of information – but we need to make sense of it first”<sup>241</sup>.

Starting from 6 April 2016 the companies, Societates Europaeae (SEs) and Limited Liability Partnerships (LLPs) in UK, must keep a register of individuals or legal entities that have control over them and deliver this information annually to the central public register at Companies House<sup>242</sup>. This is in addition to keeping other information, such as a register of members, a register of directors<sup>243</sup> and beneficiaries of trust.

European Commission proposes to bring anonymous currency exchanges and wallets under the control of competent authorities by extending the scope of the fourth Anti-Money Laundering Directive to bring them under supervision.

On the basis of conclusion made above and for appropriate estimation we make some assumptions:

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<sup>240</sup> Proposal for a Directive European parliament amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement <http://eur-lex.europa.eu/>

<sup>241</sup> ICSA (2017) “UK: The End Of Anonymous Ownership”

<sup>242</sup> UK Companies Act, supra note 74 at 31. Part 21A of and Schedules 1A and 1B.

<sup>243</sup> Department of Business (UK). Guidance, Page 5, supra note 102 at 49.



- Ability to control is control even without realization or intention to fulfill it de facto.
- Control over company is control over economic gains.
- Power of control with different origin can be summarized on the ground of economic gains.
- Power of control depends not only on rights of controlling shareholder but relationship among all players and rights of every stakeholder.
- Control over the company cannot be absolute. Control always sharing with stakeholders.
- The higher number of players between controlling person and controlled entity in pyramidal structure the lower power of control.
- Control is roll over process. The power of control changing constantly. The control changed in time when the companies' governing body (shareholder's meeting, board of directors' session and executive managers' session) or external influencer taking a decision.

Stages of Network Control Analysis:

1. Transferring qualitative, quantitative characteristics, legal rights and obligations of the network to countable data and graph.

For network analysis all contracts and non legal connection have to be represented as figures. Thorough transferring the legal aspects of relationships, rights and obligations to quantitative figures define the credibility of Network Control Analysis.

2. Analysis of the data and graph.
  - a. Graph partitioning.
  - b. Clustering coefficient analysis.
  - c. Network analysis.
3. Representation
  - a. Graph.

b. Adjacency matrix.

### **Graph partitioning**

By the Graph partitioning we can define the strong links and the group to which the controlled persons belong.

Methods of partitioning<sup>244</sup>:

- divisive methods - focusing on the connections at their boundaries, removing bridges and weak links between groups.
- agglomerative methods – focusing on the most tightly-knit parts of the network finding nodes that are likely to belong to the same region and merge them together;

### **Clustering coefficient analysis**

To identify specific groups on network the clustering coefficient analysis can be implied.

Among participants there are strong ties and weak ties indicate the strength of the relationship. One of the general principles in social networks is that strong ties, representing close and frequent social contacts, tend to be embedded in tightly-linked regions of the network, while weak ties, representing more casual and distinct social contacts, tend to cross between these regions<sup>245</sup>.

We can analyze the controlling network by finding on the stakeholders' and companies' landscape the structural holes where weak link together distant group with the strong link.

We can define three types of links: the first the Collaborational links, which

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<sup>244</sup> Easley, David; Kleinberg, Jon, (2010). "Networks, Crowds, and Markets: Reasoning about a Highly Connected World". Cambridge University Press. Page 69.

<sup>245</sup> Easley, David; Kleinberg, Jon, supra note 244 at 121. Page 580.

connect the equal participants, the second the Influential links, which organize compelled participants, and the third the Informational links, which enable exchange of information. Every of these types of links can be strong or weak.

To define the probability that two randomly selected participants of player are strongly connected with each other we can use the Clustering Coefficient. Clustering coefficient is a degree of connections of node's neighborhoods.

$$C_i = \frac{2L_i}{k_i(k_i - 1)}$$

Denotations

L - Total number of links.

Geodesic – the shortest path between two nodes.

K - Degree/number of links of a node.

The Clustering coefficient shows how much the persons, linked to one node, connecting to each other.

In general, the clustering coefficient of a node ranges from 0 (when none of the node's friends are friends with each other) to 1 (when all of the node's friends are friends with each other)<sup>246</sup>.

The central node can be viewed as a leader of a certain group if Clustering coefficient of such node is high.

## **Network analysis**

The key characteristics of network are Node (participants), Links (connections) and Degree (number of connections).

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<sup>246</sup> Easley, David; Kleinberg, Jon, supra note 244 at 121. Pages 49; 65.

## **Network participants**

Network participants are identified on the base of formal and informal relationship:

1. Controlling Person:

Controlling Person (Natural person); Controlling Shareholder; Inside Shareholder (Family business); Outside Shareholder (Investor); Beneficial owner.

2. Controlled Company or Group of companies.

3. Affiliated:

Informal Relationship Participants; Family members (spouse or person considered as spouse, children, parents); Friends; Partners; Other close associates.

4. Stakeholders:

Formal/Contractual Relationship Participants; Collaborative shareholders; Employees; Members of Local communities; Contractors; Loan provider; Customers.

5. Service providers:

Trust; Shell companies; Depositary; Counselors; Auditors; Intermediaries (Natural person); Directors; Secretary; Nominee; Settler of trust; Protector of trust; Power of attorney holder / agents; Person arranging service for creation of network.

We can sum up all information and identify four main types of participant:

1. Controlling participant.
2. Controlled.
3. Transferring the power of control.
4. Neutral.

Groups of participants are identified on the base of formal and informal relationship with strong links among them.

Number of participants between Controlling Person and controlled company determine the quality of transferred information and governance. The more intermediaries are in the chain, the lower controllability and awareness of facts.

## **Criteria**

To implement the Network Control Analysis we can use a criteria corresponding to social network analysis.

The criteria<sup>247</sup>:

1. Global patterns of network: degree distribution, path length.
2. Segregation patterns: node types, node homophily.
3. Local patterns: Clustering, Transitivity, Support.
4. Position in networks: Neighborhoods, Centrality, Influence.

There are a number of variables which can be used for determining control power like:

1. Participants;
2. Links;
3. Distance between players;
4. Number of paths between Controlling Person and company;
5. Types of communication.
6. Types of players;
7. Network diameter – how close nodes to each other;
8. Degree –how many neighborhoods has a node.
9. Frequency of contacts.

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<sup>247</sup> Jackson, Matthew (2016). "Social and Economic Networks: Models and Analysis". Page 99.

One of the key characteristic of network is links. Links is a connection between nodes/participants. By understanding relationship among participants we can identify the distribution of power of control. The person having a lot of links is a Hub - the largest node with the largest degree and most important influencer at the network.

We can identify the weak and strong links depending on quality of relationship. To be more precise we can assign to every link unique weight to shape the weighted networks.

$L_{ab}=1$ , one link between “a” and “b”

Total number of links can be determined by the formula:

$$L = 1/2 \sum_{i=1}^N k_i$$

Denotations:

N - Total number of nodes/participants.

L - Total number of links.

K - Degree/number of links of a node.

The basic notions governing the structure of social network is homophily — the principle that one tend to be similar to others.

We assume that every pyramidal network has a homophily, which includes beneficial owner, legal services officer, secretary service provider, accountant, trust manager. To predict the future network shape we can use triadic closure principle – if two participants of the network (companies) have a strong links/ties

with other player one common partner (shareholder), then there is an increased likelihood that participants will establish connection / form a new link with each-other (become a members of a common alliance) in the future.

For example, a junior partner entering in alliance with a senior partner with high probability will establish new connection with service provider of senior partner.

Another characteristic is diameter.

The diameter is the average path length<sup>248</sup>.

We can understand: how close are players; how fast instructions and information spread. Network diameter is the largest distance recorded between any pair of nodes. The more network diameter the more risk of losing control over the company.

Direction of communication is very important for determining influencer.

The Controlling network interacts in both directions<sup>249</sup>. Controlling person has to have mutual or maintained communication.

Types of communication:

- Mutual communication.
- One-way communication.
- Maintained communication - the participant get information about the other participant at the other end of the link, whether or not actual communication took place.

### **Types and models of control under Network analysis**

Network analysis employs two types of control: voting (making transaction) and nonvoting (no transaction). Let consider direct voting.

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<sup>248</sup>Jackson, Matthew, supra note 247, at 124. Page 85.

<sup>249</sup>Barabási, Albert-László (2016). "Network Science". Cambridge University Press; 1 edition, August 5, 2016.

Stefania Vitali<sup>250</sup> determines three model of direct control: the linear model (applying the one share-one-vote rule), the threshold model and the relative control model. In linear model there is no deviation between ownership and control, thus the direct control matrix coincides with the ownership matrix,  $L_{ij} = W_{ij}$ . In threshold model control over a company is assigned to the actor holding a number of shares higher than a predefined threshold (usually 50%+1). The relative model control is based on the relative fraction of ownership shares that each shareholder has (one 20% and others 1% each).

Relationships on network depend on trust. Trust is the decision to rely on another party (person, group, organization) under a condition of risk.<sup>251</sup> The trust among participants highly depends on culture, which impacts on organizational structure, implementation of law in personal contacts.

Four of the ten countries with trust radiuses less than 50% (more related to in-group family or familiar trust than out-group generalized trust) are from Asia: Thailand, China, South Korea, and Vietnam. The remaining six countries with trust radiuses under 50% are all classified as low-income or middle-income by the World Bank: Morocco, Burkina Faso, Romania, Ghana, Jordan, and South Africa<sup>252</sup>.

I believe that the corporate structure is positively related to form of trust and close relationship. Claessens<sup>253</sup> showed that more than two-thirds of East Asian firms are controlled by a single shareholder, which often turns out to be a family. For these firms, the controlling shareholder is often a top manager of the firm. Pyramidal structures are very common.

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<sup>250</sup> Stefania, Vitali; Glattfelder, James and Battiston, Stefano, (2011). "The Network of Global Corporate Control". Plos One journal. Page 4.

<sup>251</sup> Bachmann, Reinhard and Zaheer, Akbar, (2006). "Handbook of trust research".

<sup>252</sup> Bower, Thomas; Wilson, Paul, (2015). "Trust over Time and Space: A Research Note". Departmental Working Paper of University of Arizona. Page 12.

<sup>253</sup> Claessens, S., S. Djankov, J. Fan, and L. Lang, (2002), Disentangling the Incentive and Entrenchment Effects of Large Shareholdings," *Journal of Finance* 57, p. 2741-2771.



Another important characteristic of network is time. I assume that the long lasting connection is evidence of trust. If trust-building actions are taken the level of trust stays roughly constant, if neither party takes actions that erode trust.<sup>254</sup> (Appendix 2).

The Network Control Analysis approach assumes that the power of control can be measured. Finding a specified percentage shareholding or ownership interest will not automatically result in finding the beneficial owner; it is one evidential factor among others to be taken into account.<sup>255</sup> So it is important to know the instruments which used by Controlling Person for exercising control. The control can be exercised by financial contracts, close relationships, company managers, and other formal and informal contracts and acts.

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<sup>254</sup> Bachmann, Reinhard and Zaheer, Akbar, *supra* note 251 at 127. Page 239.

<sup>255</sup> Directive (EU) 2015/849 *supra* note 43 at 19.

## 5. CONCLUSION

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Having considered the law of various countries we are able to conclude that understanding of control is based on perception of control as a form of sole shareholding and governance by affiliated persons or institutional shareholders. In most cases of modern regulation control is viewed as a static dominant position of restricted groups of players and result of share ownership with right to appoint managers but not as lateral contractual control.

Generally, in the law control is ability to exercise decisive and significant influence on organization's cash flow and affairs by implementation of combination of various rights including but not limited the voting rights, rights to elect management body, to manage the operational processes, and enter in contract. The research shows that the control over organization can be full, partial, lateral, vertical but cannot be absolute. Control is always shared with the stakeholders of organization.

Contemporary trend in corporate governance is shareholder activism and complicated collective actions. The minority shareholders can hold control over the company by collective voting power and coordinative actions due to high connectivity and cooperativity with each other.

There is a problem with regulation of state authority domination in some countries. The government authority plays dual conflicting roles in relationships with corporation as participator and as regulator. To determine control many countries use clear quantitative markers like voting threshold. In spite standard corporate law practice, the voting threshold for determining control under CFC rules can be lower than 50%. The lower threshold for determining control under CFC rules constitutes shifting of balance of rights protection in favour of public law. The regulation of shareholder under the company law is less detailed than under tax law. Criteria of control under the public law rules are more developed than in private law. Criteria of control in tax law are more state authority determined. This

underlines the priority of state rights over companies' cash flow in opposition to the minority shareholders' rights.

Escaping of state control is the major trend of modern society. This one the reason and driver of high popularity of blockchain based projects.

The relationships among participants of organization start to be more complicated due to network character and widely used technology. The organizational forms shift from traditional corporation to vast networking societies with stakeholders-users-supporters as the main source of finance and the main beneficiary.

Lastly the decentralized networking organizations and simple joint companies have appeared. All those substantially change the corporate landscape and control over organization.

Control over virtual organized society can be viewed as control over organization's affairs. Founders of virtual organization just shape the network, manage but don't control dynamic of development. In decentralized network organizations, based on blockchain technology, information and processes are spread more rapidly. This mean that the control in decentralized network achieved and implemented faster with low quantity of errors, therefore, control is more comprehensive and pervasive.

The distributed ledger technology and cryptography provide the new way of cooperative distant interaction with higher speed, security and proven transactions. The pseudonymously is a challenge to the state authority to exert effective control over the blockchain transactions. To determine the person on the blockchain a Cluster Analysis (location of addresses) and a Big Data Analysis can be used, but it is still complicated process.

Realization of control on blockchain network is a difficult task for every participant including state authorities and users. At the same time, the founders of decentralized organization can effectively attract and fulfill the control over the accumulated funds and assets. The anonymity of the decentralized network participants and peculiarities of technology prevent governments from efficient

control over the network. Only goodwill of their participants to disclosure information and willingness to pay taxes or in other words high morality of the participants can confirm the governments' authority.

The control in decentralized network carried out by founders and intermediaries are often based on reputation. The positive law, as the law actually adopted by proper authority, doesn't work in communities based on the blockchain technology due to the decentralized character of the network.

Even there is properly given definition of the control, we still have problems with methods of analysis. One of the main problems of modern legislation is that the definition of control is based on non-indicative criteria. Rising activism, fast spread of information and emergence of distributed networking technology allocate control among wide range of players. The number of players/stakeholders has substantially increased. It could be not thousands of shareholders but millions of stakeholders, which can jointly get control. The control itself starts to be transitory and multivariate. Control permanently slide from one group of influencer to other. The power to control is changed constantly in moment of planning, taking decision and execution.

Hence, new regulation has to be adapted to these changes by creating new mechanism of identification of control and adjusting it to the stakeholders needs. The modern stakeholder, contract and agency theories create a solid base for the further development of law on control over organization. The new approaches to control measuring can be based on economic, social and technological indicators like Network Control Analysis and Game theory. To prevent inaccurate measure of control, the ability to exercise decisive influence should be subject of thorough determination on the ground of quantitative methodology.

In the light of the Contractual Theory the company is nexus of contracts. Every company can be viewed as number of assets, resources, and rights, which are subject of contracts among stakeholders of the company. The ability of stakeholders to fulfil the control over the contracts determines the ability of the

participants and assets be consolidated as an organized entity. Therefore, the control over the company means control over the bundle of contracts.

The bundle of contracts is dynamic characteristic formed by internal company policy and external market conditions. The intention of stakeholders determines the dynamic of control distribution and establishes the basis for the future control.

Analysis of company from the Game Theory perspective makes it evident that the coalitions of stakeholders and shareholders play vital role in control over company.

The ability to substitute is the main and the most striking characteristic of the controlling shareholder. Controlling shareholder, in contrast to over stakeholders, can replace all other stakeholder directly or indirectly. The shareholder can be viewed as controlling shareholder if the shareholder has such number of voting shares that it gives the rights to substitute the majority of the board of directors and change provisions of memorandum and article of association.

In non-cooperative games the controlling shareholder acting alone can't get the full control over the corporation. The cooperative games analysis shows that cooperative behavior of controlling shareholder provides greater control over the corporation.

The method of Network Control Analysis could be employed to determine connections among stakeholder of pyramidal structures of companies, in networking societies and virtual communities. Network Control Analysis helps to develop a framework for the personalization of private law across different regulatory tools such as disclosures, anti-money laundering and financial policies. By application of network analysis techniques, laws can be tailored to individual characteristics of addresses.

Network control can be perceived as a sum of economic gains of directly controlled firms obtained by all direct and indirect network powers.

All these methods and instruments create a supporting framework for further development of law to achieve the fair balance between private and public needs.

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# APPENDICES

## Appendix 1

### The Original private key

```
{ "iv": "6htm0TUYJhEQNwXIcVWJgA==", "v": 1, "iter": 10000, "ks": 256, "ts": 64, "mode": "ccm", "adata": "", "cipher": "aes", "salt": "skziDA4LN9M=", "ct": "9d3cyR546SDOwvufxpcncqGpLjBKufwS+XVDvqw1s5peeVDH4zIle9G4fxtbXt1tw6B9/WoIjxHhWhVu5fyYX7p8arKE8tbDRIfftp3NqUHCAlydnk3hsl36izwYO2FG5Gf5VTMCEquTXmYBltNhtf4RFmgeMOhk=" }
```

On this picture the private key is translated to traditional Chinese.

It has got some additional spaces, capital letters (green), hieroglyphs (yellow), and new signs (blue).

```
{ "IV" : "6htm0TUYJhEQNwXIcVWJgA ==", "V" : 1, "ITER" : 10000, "KS" : 256, "TS" : 64, "模式" : "CCM", "ADATA" : "", "密碼" : "AES", "鹽" : "skziDA4LN9M =", "CT" : "9d3cyR546SDOwvufxpcncqGpLjBKufwS XVDvqw1s5peeVDH4zIle9G4fxtbXt1tw6B9 / WoIjxHhWhVu5fyYX7p8arKE8tbDRIfftp3NqUHCAlydnk3hsl36izwYO2FG5Gf5VTMCEquTXmYBltNhtf4RFmgeMOhk =" }
```

### Translation to Hebrew

```
{ "Iv": "6htm0TUYJhEQNwXIcVWJgA ==", "j": 1, "iter": 10,000, "KS": 256, "TS": 64, "יבנח": "CCM", "ADATA": "", "לרז": "AES", "קזן": "skziDA4LN9M =", "CT": "9d3cyR546SDOwvufxpcncqGpLjBKufwS + XVDvqw1s5peeVDH4zIle9G4fxtbXt1tw6B9 / WoIjxHhWhVu5fyYX7p8arKE8tbDRIfftp3NqUHCAlydnk3hsl36izwYO2FG5Gf5VTMCEquTXmYBltNhtf4RFmgeMOhk =" }
```

Here is a recovery by backward translation of the wrong key.

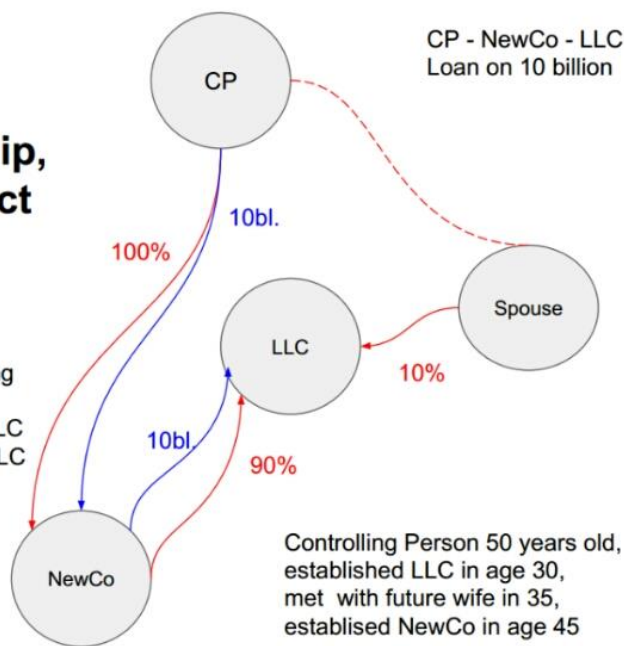
Reverse translations from Chinese to English by Google translate.

```
{
  "TV": "6htm0TUYJhEQNwXIcVWJgA ==",
  "V": 1,
  "ITER": 10000,
  "KS": 256,
  "TS": 64,
  "mode": "CCM",
  "ADATA": "password": "AES",
  "salts": "skziDA4LN9M =",
  "CT": "+ 9d3cyR546SDOwvufxpcncqGpLjBKufwS
XVDvqw1s5peeVDH4zILe9G4fxtbXt1tw6B9 /
WoIjxHhWhVu5fyYX7p8arKE8tbDRIftp3NqUHCAlydnk3hsl36izwYO2FG5Gf5VTMCEquTXmYB
ltNhtf4RFmgeMOhk ="
}
```

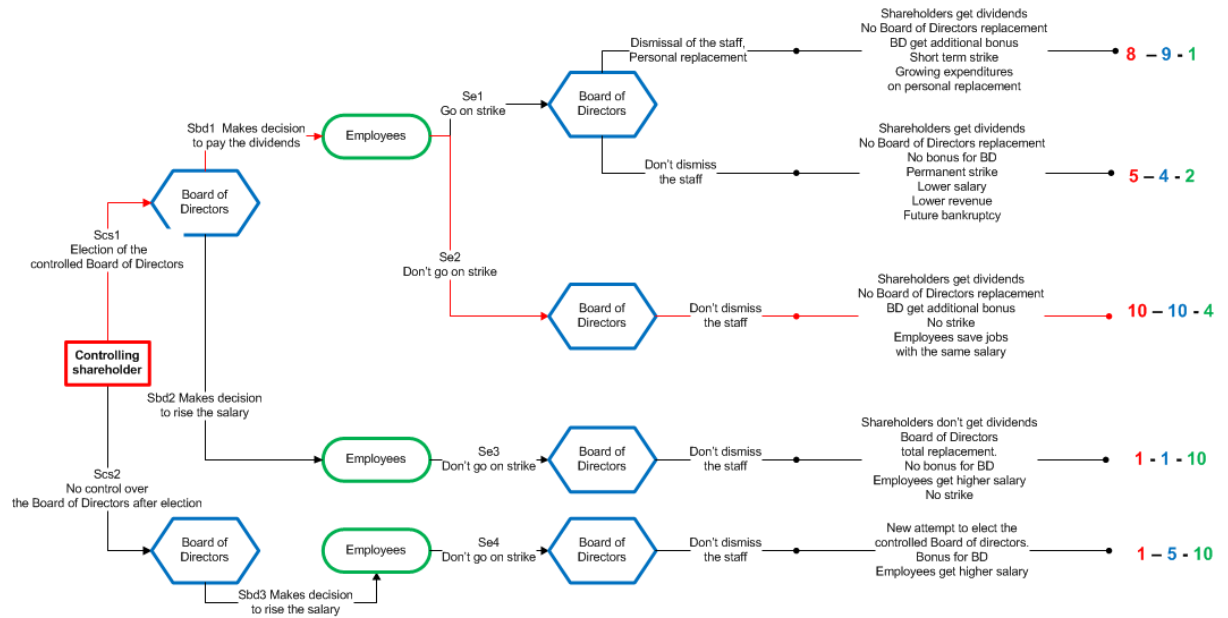
## Appendix 2

### Time, Voting Interest, Informal Relationship, Commercial Contract representation

Controlling Person has 100% voting rights in NewCo  
 NewCo has 90% voting rights in LLC  
 Spouse has 10% voting rights in LLC



# Appendix 3



## Appendix 4

