

# **REFGOV**

***Reflexive Governance in the Public Interest***

## ***Corporate Governance***

### **The Corporate Governance of the Firm as an Entity: Old Issues for the New Debate**

By Marc T. Moore and Antoine Rebérioux

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# The Corporate Governance of the Firm as an Entity: Old Issues for the New Debate

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Corporate governance debates are primarily concerned with the allocation of power within listed companies, from a positive and a normative point of view. On both aspects, these debates have been structured, throughout the 20<sup>th</sup> century, between managerialist and agency theories. The theory of 'managerialism', as set out in the seminal work of Berle and Means (1932), stresses the inherent divergence of interest that occurs within widely held firms between corporate 'owners' (shareholders) and 'controllers' (managers), and the resultant 'politicisation' of the corporation as an object of public concern. In response to the perceived need to minimise this separation, 'agency theory' suggests a range of market and institutional mechanisms aimed at bringing the incentives of managers into line with those of shareholders.

Over the last two decades, pro-shareholder mechanisms have become increasingly prevalent within corporate governance, in the United States and in the European Union. At first sight, this development would appear to signal the failure of managerialist theory, and the final victory of the agency perspective and its underpinning contractarian approach. In this chapter, we cast doubt on the above account. If traditional managerialist theory is somewhat misleading as a depiction of present day capitalism, this does not necessarily imply that shareholder primacy is 'right'. In fact, current evolutions show that the growing implementation of shareholder sovereignty has dramatic consequences, which are hardly explicable within the confines of the agency paradigm. The story becomes much more intelligible once we adopt a conception of the firm as an entity, rather than as a nexus of (complete or incomplete) contracts. The idea that corporate governance discussions should be based on a theory of the firm is obvious: it is hard to figure out how a firm is governed and how it should be governed without any conception of what is, precisely, a 'firm'. Therefore, this article intends to show that considering the

firm as an entity allows us: (i) to understand the failure of shareholder primacy as a way to foster managerial accountability; and (ii) to reject shareholder primacy in favour of a more inclusive model of corporate governance. From this point of view, the normative conclusion put forth by Berle and Means (1932) still represents a powerful insight: managerial accountability is best achieved through the promotion of common interest rather than through shareholder primacy.

The article is organized as follows. The first part offers an original account of corporate governance in the 1990s and the 2000s that runs against the predictive dimension of agency theory. In the second part, we highlight the limitations of this theory, and its underpinning contractarian logic, as a normative basis for corporate governance. Based on these findings, we set out in the third part a preliminary scheme for the implementation of Berle and Means' inclusive model of the firm within a market-based environment, taking insights from both the US and evolving European model of corporate governance.

## **1. Positive assessment: whose interest does the corporation serve?**

The multiplicity of factors that determine the allocation of power within listed companies gives rise to disputes as to which agents are the main beneficiaries of the corporate economy. We first present the debate between managerialist and agency theories (1.1) before questioning the ability of both accounts to describe accurately the typical configuration of the 1990s and 2000s (1.2).

### **1.1 Managerialism *versus* agency theory**

In 1932, Adolf Berle and Gardner Means published what was to become one of the most influential and inspirational social-scientific works of the twentieth century. Berle was a corporate lawyer by trade, and Means an economist. The book in question is titled *The Modern Corporation and Private Property*. One US historian has gone so far as to describe *The Modern Corporation* as “an ideological rationale for New Deal planning, consumer activism, labor organizing, and financial regulation of the large

corporation, indeed all of American capitalism” (Lichtenstein 2002). Berle and Means’ thesis was concerned with the then growing economic and political phenomenon known as the widely held or ‘quasi-public’ company. Unlike smaller closely held or ‘private’ companies, these larger companies were capitalised by the investment of finances from the private wealth of members of the public at large. The extraordinary nature and potential of the quasi-public company resided in the fact that, unlike smaller business units, in which a dominant shareholder or group of shareholders either managed the business personally or at least undertook some degree of active control over an appointed management team, the quasi-public company, at least in theory, exhibited a complete separation of ownership and control.

This was on account of the fact that the controlling managers of these quasi-public companies, unlike their counterparts in closely held firms, in many cases held a small or even negligible ownership stake in the firm, and therefore derived the main component of their income not from returns on company shares, but rather from a fixed salary in essentially the same vein as any other officer or employee of the company. The ownership of these firms, meanwhile, was increasingly becoming vested in a multitude of small-scale individual investors, lacking both the resources and also the incentive to undertake effective control over the use to which management put their economic investment in the firm. This meant that, not only were the respective functions of share ownership, on the one hand, and business management, on the other, generally carried out by different and distinct persons, but the shareholders of the typical quasi-public company were generally neither willing nor able to exert effective control over management, so that, in effect, the function of overseeing management on a day-to-day basis became, somewhat perversely, the responsibility of *management itself*.

In *The Modern Corporation and Private Property*, Berle and Means (1932: 7) observed that “[t]he separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappeared”. Berle and Means distinguished the position of the modern shareholder from that of the pre-corporate owner-manager (see also Berle 1965, this volume). The latter, although often taking no part at all in the day-to-day management of his

business, was at least in a position to step in as and when he so chose, whether personally or through his subordinate managers on the 'shop floor'. The shareholder in the typical quasi-public company was, in contrast, "entirely quiescent", his position having "been reduced to that of having a set of legal and factual interests in the enterprise", without any corresponding effective powers over it, which, as a matter of fact, had become vested entirely in management (1932:112 - 113). Berle and Means therefore described corporate managers as '*economic autocrats*', whose ability to effectively perpetuate their own existence had promoted them to the position of "*the new princes*", assuming unchecked control over their "economic empires" (1932: 116).

According to Berle (1960) himself, though, the *complete* emancipation of management from active shareholder control was only finally brought about after the Second World War, as a result of the increasing popularity of professional financial institutions, particularly those managing pension funds and life assurance policies. The growing profile of financial institutions at the time stemmed from the fact that individual investors, lacking sufficient expertise and time to invest their savings prudently, could entrust their money with these specialist trustees, who would agree to purchase, sell and (where necessary) vote shares on investors' behalf. This meant that many shareholders were now no longer responsible for the management of their share portfolios whatsoever, having placed all rights of control over their investments into the hands of these institutions. Whilst shareholders retained an interest in the profitability of their shares, this entitlement no longer stemmed directly from the shares themselves, but, rather, derived solely from the shareholder's contract with the financial institution, which was obliged to pay over to their client the residue accruing over time upon their original investment. In Berle's opinion, this revolutionary economic development served to completely divorce the control rights on these shares from the economic interest that they were created to protect, so that the shareholder of the mid-twentieth century now lacked not only the practical ability, but also the legal *capacity* to exert active control over corporate management. This had the consequence of further disempowering shareholders in the corporate control process, depriving them even of the remote possibility of mobilizing their resources in order to resume powers of control as a last resort in extreme cases of mismanagement.

Furthermore, as Galbraith (1973) later noted, even to the limited extent that any shareholder or financial institution was sufficiently disposed to intervene from time to time in the operational affairs of the companies in which they were interested, any action that they took or demands that they made in this regard were inherently irrational, given the inability of these 'outsiders' to acquire sufficient information or expertise to be able to properly pass judgment on the merits of managers' strategic decisions. Not only were shareholders physically detached from the day-to-day affairs of the business, but they were also excluded from what Galbraith termed the corporate "technostructure", which he defined as the collective body of corporate officers, including managers themselves who, by virtue of the supremacy that they, as a group, enjoyed over the base of scientific and technical skills, knowledge and expertise upon which the company's operations were dependent, enjoyed the exclusive capacity to command strategic control over all business affairs. In other words, Galbraith believed that, in the modern corporate economy, where operations were increasingly technical and specialised in nature, the 'real' power within the large company rested with those that possessed the relevant *knowledge*, rather than the wealth, that comprised the business, thereby excluding shareholders from the realm of effective corporate control.

In spite of its undoubted popularity in the first half of the twentieth century, Berle and Means' central descriptive claim, that the modern corporation no longer served the interests of its shareholders, was quick to attract strong opposition. Throughout the latter half of the century, a convincing academic counter-representation of the widely held company was developed under the rubric of 'agency theory'. This more 'orthodox' branch of corporate scholarship, as developed in the works of the Chicago School economists Eugene Fama, Michael Jensen and William Meckling, adopted as its conceptual basis the contractarian paradigm, considering the firm as a self-determinative nexus of contracts linking together various individual input-providers (Fama 1980; Jensen and Meckling 1976; Easterbrook and Fischel 1991).<sup>1</sup>

In the context of corporate governance, the most significant achievement of agency theory was its capacity to reinvent, using contractarian analysis, the concept of the competitive market as a means of disciplining inefficient corporate

managements. However, according to agency theorists, the most powerful discipline over management stemmed not from the product market, but, rather, from the market for the financial stock of companies themselves, which was forwarded as a much more compelling and therefore *relevant* institutional factor motivating continual improvements in managerial performance (Alchian 1969). Indeed, a liquid stock market is not only valuable as a medium through which firms must compete with one another to raise equity capital at low cost, but, more significantly, it is also a necessary prelude to the effective functioning of the market for corporate control and the associated disciplinary device of the hostile takeover (Manne 1962). Meanwhile, the detrimental effect of a low share price on managerial reputation provides corporate controllers with an ongoing incentive to prioritise the interest of shareholders, even in those instances where firm underperformance is not so severe as to warrant the initiation by an outsider of expensive hostile takeover proceedings (Fama 1980).

Insofar, though, as the doctrine of shareholder primacy relies for its effective realisation upon the functioning of a liquid and efficient stock market, then it is necessarily supportive of legal and other institutional mechanisms that enable the continual publication of credible information on firm performance for the benefit of discerning investors. Indeed, without a reliable informational substructure, a liquid market in corporate securities is impossible. Within a complete market-based corporate governance system, reliable information on the firm is obtained through the interaction of two key groups: first, by the board of directors, which is formally appointed by and therefore controlled by shareholders; and, secondly, by external 'gatekeepers', most notably financial auditors, securities analysts and ratings agencies. The role of the former body is to act as an independent supervisory panel situated between the shareholders' General Meeting and management team, thus providing an 'internal' point of surveillance over managers in the absence of direct shareholder monitoring. The latter actors, meanwhile, are vested with the responsibility of verifying the honesty and relevance of financial information disclosed by the company's accounting reports, thereby reducing informational asymmetries between investors and insiders (agents in the company) so as to ensure the proper working of financial markets (Aglietta and Rebérioux 2005; Biondi 2004)).

On the basis of this information, investors (shareholders) buy and sell securities, thus generating stock price movements, which in turn trigger either or all of the above market-disciplinary mechanisms. At the same time, managers' interests can be theoretically aligned with those of shareholders on an *ex ante* basis through the use of incentive-remuneration devices such as executive stock option plans. In accordance with the above mechanisms, then, shareholders enjoy the capacity not only to compensate, at the macro level, for the separation of ownership and control at the level of the individual firm, but also to impose a more efficient form of control over management than could be achieved *via* direct supervisory oversight of individual companies. This is in view of the allegedly superior efficiency of the price signals of competitive investment markets in reflecting professionally acquired information on relative firm performance, coupled with the low transaction costs that shareholders face in disposing of holdings in underperforming firms on a liquid market (Easterbrook and Fischel 1991).

We began this section by asking a question: whose interest does the corporation serve (at least in the Anglo-Saxon world)? We then reviewed two opposing answers to this question. According to the managerialist theory of Berle and Means, the separation of ownership and control within the modern corporation renders it subservient to the interests of managers, to the detriment of shareholders. According to agency theory, on the other hand, the corporation is rendered exclusively accountable to shareholders by virtue of market-based incentive and disciplinary mechanisms. The two answers are clearly different, yet they share one crucial assumption: they are both premised upon the existence of a *conflict* of interest between managers and shareholders, and this conflict represents the matrix, under each answer, of the so-called corporate governance 'problem'. The next section casts doubt on this view.

## **1.2 The paradox of the 90s: a convergence of interest**

The success of the contractarian paradigm (of the agency perspective) may be appreciated in the academic sphere as well as in the political one, insofar as corporate governance is concerned: for the last twenty years, shareholder primacy



has deeply influenced the evolution of corporate governance regulations and practices, in the United States and, to a lesser extent, in the European Union. The rights of (minority) shareholders got stronger everywhere, primarily through federal law in the US and trans-national law in the EU (Cioffi and Cohen 2000). Besides, institutional investor activism has promoted best practices closely akin to shareholder primacy: this point marks a clear departure from Berle's account (1960), which regarded the growing presence of these investors in the stock market as representing the final step in the process of separation of ownership and control (see *supra* 1.1). In actual fact, these investors have succeeded, despite the diversification of their portfolios, in significantly increasing the sensitivity of the corporation to the interest of its shareholders, leading to "a partial remarriage of ownership and control" (Hawley and Williams 2000).

The growing success of a shareholder value orientated approach to managing a business can be observed on at least at three levels. First, the presence of independent non-executive directors, mostly in *ad hoc* committees (audit, nomination and remuneration), is now the rule rather than the exception: according to Finkelstein and Mooney (2003), outside directors accounted for 75 % of directors in 2003 on the average board of firms in the Standard and Poor's (S&P) 500. Secondly, stock options are increasingly used as a remuneration device: whereas stock options accounted for less than 25 % of the average S&P500 Chief Executive Officer (CEO) pay package at the beginning of the 1990s, this part has stabilized at around 50% since 1999 (Jensen and Murphy 2004). Last but not least, 'Value-Based Management' - the use of management tools for establishing the creation of 'shareholder value'- is now a common practice for listed companies (Cooper *et al.* 2000). Through these tools, constraining criteria of financial returns are imposed on firms (see *infra*). The competition among investment funds to attract collective savings is then transferred onto the companies, which are judged by these funds on the basis of their ability to meet the financial demands imposed on them.

By and large, the compliance of executive officers with shareholder primacy seems to be greater than it has ever been in the previous century. According to the managerialist perspective *and* the agency view, this situation should be beneficial, in the first place, to stockholders. In effect, the wealth accruing to equity holders,

through dividends, stock repurchase and increased market value has increased significantly since the 1980s. Conversely, managers should be the main loser: their ability to capture part of the profit stream should be reduced as well as their discretionary latitude in making business decisions. However, the case for this last assertion is not so good, leading to a striking paradox. Indeed, recent decades witnessed a huge rise in executive compensations in the US. According to Holmström and Kaplan (2003) overall CEO compensation increased by a factor of six during the 1980s and the 1990s. Most of this increase took the form of incentive pay - primarily stock options. This process has resulted in a deepening of intra-firm inequalities, of which the *Business week* pay executive survey gives an idea: in 1980, the average income of CEOs of the largest firms in the US was 40 times the average salary of a worker. In 1990, it was 85 times greater, and in 2003, it jumped to 400 times greater. A similar evolution is observable in the UK: the executive pay consultancy Independent Remuneration Solutions (IRS) has found that since 1998, average CEO salaries have risen by 58% whilst total executive remuneration increased by 208%. In the same period, average earnings went up by 33% and retail prices by 15%, whilst the FTSE 100 index fell 13%.

These evolutions strongly suggest that the last decades have been characterized by a process of *convergence of interest* between stockholders and corporate officers. From a theoretical standpoint, it is crucial to note that this process does not fit with the basic assumption underlying the managerialist and the agency perspectives (see *supra* 1.1).<sup>ii</sup> According to the latter, if shareholders succeed in aligning officers' incentives with their own personal financial interest, then an optimal (first best or second best) contract is achieved. However, the current situation may hardly be considered 'optimal', for at least two reasons. On the one hand, such an increase in officers' compensation raises serious concern *from a strict economic standpoint*: it is hard to explain on the basis of incentive factors alone, despite the effort made by some authors (see in particular Jensen and Murphy 2004). Rather, the most plausible account of this evolution is the occurrence of a process of rent extraction by corporate managers (Bebchuk and Fried 2004; Bratton 2005). On the other hand, confidence in financial markets has been seriously undermined by the major wave of high-profile corporate scandals and accounting irregularities that followed Enron and WorldCom's bankruptcies.

Such evidence indicates that a decline in managerial or corporate accountability took place during the 1990s, and may continue. We have already noted, however, that this decline seems by and large to profit shareholders. If this diagnosis is right, then the conclusion is clear-cut: other stakeholders do not benefit from current practices and evolutions in corporate governance, nor the firm as a (productive) entity. In the rest of this section, we offer an explanation for our main diagnosis - the fact that the growing implementation of shareholder primacy leads to a decline in corporate accountability. This decline, we argue, is the direct consequence of the intrinsic limitations of a mode of control relying solely on market-based solutions - that is, of a mode of governance where the stock market is the only valuation machinery for firms. To better understand this statement, an in-depth analysis of the functioning and implications of the most popular 'Value Based Management' tool - Economic Value Added (EVA) - may prove to be particularly useful: indeed, this metric, in both its informational and operational dimensions, reveals the logic of (stock) market control over listed companies.

'Value-Based Management' tools - and in particular the EVA metric - are said to offer to investors on the stock market the technical capacity to accurately assess business conduct. Indeed, the EVA metric is supposed to condense the complex sphere of information and contingencies determining the success of any one firm in its product markets into one or more general, all-encapsulating measure(s) of firm performance. The first function of EVA is therefore *informational*: it is considered to be the most relevant criterion for the prediction of stock market prices. The key point is not that value-based performance measures are comprehensive, in the sense that they reflect all or even nearly all of the information that shareholders would otherwise require to make a 'rational' economic decision. Rather, and crucially, the point is that value-based performance measures are informationally *selective* mechanisms for evaluation of management, in that they possess the technical capacity to abstract, out of the complex field of economic and political contingencies determining the 'right' strategic direction of the firm, the specific, definite and arbitrary performance yardsticks that are 'relevant' to the evaluation of management by shareholders over any given time period. As a result, value-based performance measures promise to vest shareholders, particularly professional portfolio investors, with the capacity to compensate for the informational deficit that they encounter *vis-à-vis* management

consequent upon the separation of ownership and control. Interestingly, however, shareholder value achieves this end not by increasing the informational base that shareholders actually enjoy in assessing managers but, rather, by *reducing* the informational base that shareholders *need* enjoy in order to be able to make an allegedly 'rational' judgment of management as such. Specifically, this minimal necessary informational base under current convention comprises the difference between financial profitability (the accounting Return On Equity) and the firm's cost of capital. Here we meet the second function of EVA, the *operational* one: EVA is set down as *the* management criterion for executives, who must seek to maximize the difference between the ROE and the cost of capital. This latter figure is no longer considered to be a consequence of the firm's productive and commercial operations, determined *ex post*. Rather, cost of capital is now a benchmark in itself, determined *ex ante*. The use of benchmarking thus provides financial investors with the ability to undertake a continuous and generalised comparison between listed companies.

Let us denote  $R$  the net result,  $D$  the book value of debts,  $r$  their average costs,  $EC$  the book value of equity capital,  $k$  the equilibrium return on equity capital (or the cost of capital) as determined by the Capital Asset Pricing Model,  $WACC$  the weighted average capital cost ( $WACC = k \cdot EC/K + r \cdot D/K$ ) and  $K$  the total book value of the assets ( $D + EC$ ). The simplest expression of a company's EVA is then the following:

$$EVA = R - k \cdot EC \quad (1)$$

By denoting  $ROE$  the return on equity ( $R / EC$ ),  $ROA$  the return on assets ( $R / K$ ),  $d$  the financial leverage ( $D / EC$ ) expression (1) rewrites:

$$EVA = (ROE - k) \cdot EC \quad (2)$$

$$= (ROA - WACC) \cdot K \quad (3)$$

These alternative expressions indicate the different (financial) strategies used to produce and increase EVA:

- the repurchase of shares ( $\Delta EC < 0$ ), that increases the return on equity ( $ROE$ ) - see (2).

- the asset-light strategy ( $\Delta K < 0$ ), that automatically raises the return on assets (*ROA*) - see (3)
- the increase of the debt-to-equity ratio (financial leverage  $d$ ), when the cost of debt  $r$  is below the cost of equity capital  $k$  - see (4)

These methods have been used extensively by officers of Enron, WorldCom and Ahold - some of the most representative corporate scandals of the 2000s. Through value-oriented financial engineering techniques, managerial wealth increases irrespective of, or even at the expense of, corresponding improvements in firms' *productive* efficiency. Clearly, none of the previous methods are sustainable in the medium-to-long-term. These are short-term strategies aiming at fostering financial returns beyond the market equilibrium. As such, they are highly risky and encourage bold innovations flaunting acceptable standards of caution.

At this stage of the argument, it is important to note that the devices available for monitoring corporate officers are not necessarily strengthened by a strict, scrupulous implementation of shareholder value. The case of the board of directors is striking. According to institutional investors as well as shareholder primacy proponents, the *raison d'être* of the board of directors is to enable control *from inside* of the managerial team on behalf of distant stockholders, rather than the strategic assistance of executives in their business choices. Following this line, independence - as a way to prevent collusion between the controllers (board members) and the controlled (managers) - came to be a cornerstone of corporate governance reforms. If it is hard to give a precise content to the concept of independence, institutional investors need clear signs, visible from a distance. Among these signs, the absence of relationships with management is favoured. But as Roberts *et al.* (2005) note, such an approach towards independence tends to limit the involvement and engagement of non-executive directors in corporate affairs. In turn, this means a rather weak knowledge of the firm and its productive and commercial dynamics. As Roberts *et al.* (2005: 19) conclude: “[...] the advocacy by institutional investors, policy advisors and the business media of greater non-executive independence may be too crude or even counter-productive”<sup>iii</sup>. The assessment of the board of directors offered by the

doctrine of shareholder primacy is therefore paradoxical in that it advocates an increasing *exteriority* for this *internal* mode of control.

In a (pure) shareholder-oriented mode of governance, the role of the gatekeepers (rating agencies, securities analysts and external auditors) is then obviously crucial: once insider mechanisms of control - such as worker representatives or informed (internal) directors - have been dismissed, the gatekeepers *de facto* become the central (unique) supervising device. If they did fail in these high profile scandals, cognitive reasons may be at least as important as incentive concerns<sup>iv</sup>: by nature, the gatekeepers are limited in their ability to evaluate the origins of corporate profits, which are intimately linked to the functioning and dynamics of the firm-entity. External surveillance devices, however sophisticated they may be, have intrinsic limits that point to the cognitive dimension of control and coordination. We mentioned, in part 1.1, Galbraith's (1973) argument that the power of corporate insiders derives from, and is justified by, the informational advantage that they enjoy over liquid shareholders. Any attempt to empower the latter constituency therefore comes up against this cognitive issue – a fact that shareholder primacy proponents seem to have bypassed rather too easily.

Let us sum up our main argument. If capital markets are now able to command results (through the generalisation of benchmarking), they are limited in their ability to appreciate the way in which these requirements are met. This contributes to making managerial power *less* accountable: financial irregularities multiply and executive remunerations explode. Shareholder primacy fails exactly where it strives to succeed: it reinforces the discretionary power of managers rather than limiting it. We have argued that this failure highlights the limitation of a pure external (market-based) control - a notion that lies at the core of the doctrine of shareholder primacy in the context of a liquid stock market. According to this view, the firm is regarded as a standard financial asset, with one important consequence: a level of financial profitability is required *ex ante* (the cost of capital). Meanwhile, firms within the same risk category (as defined by financial analysts) are judged on a single dimension: their ability to overcome this benchmark, regardless of the specific circumstances of the business concern in question. This conception, however, denies the productive and cognitive dimension of the firm-entity. Interestingly, we find a

similar oblivion in the contractarian paradigm, focused on the exchange rather than production process (see Weinstein in this volume). From this point of view, the inclination of the contractarian approach to advocate shareholder primacy should come as no surprise.

## **2. Normative assessment: whose interests should the corporation serve?**

Our analysis of contemporary corporate governance practices, marked by a serious drift in corporate accountability disguised behind the façade of compliance with shareholders' interests, logically leads us back to the classical question: whose interests should the corporation serve? Whereas we intend to demonstrate that Berle and Means' positive account of divergent interests between stockholders and officers represents in some sense an inaccurate analysis of the contemporary situation, we would argue that their normative account offers some powerful insights.

### **2.1. Berle and Means: the 'institutionalisation' of the modern corporation**

Berle and Means' Book IV – the final one – opens with the following passage:

The shifting relationships of property and enterprise in American industry [...] raise in sharp relief certain legal, economic, and social questions which must now be squarely faced. Of these the greatest is the question in whose interests should the great quasi-public corporations [...] be operated

(Berle and Means 1932: 294).

Berle and Means (1932) identified two alternative answers, corresponding to two different doctrines: on the one hand, the doctrine of managerial sovereignty; and, on the other, that of shareholder sovereignty. The *managerial sovereignty* doctrine takes cognizance of the concentration of power in the hands of the managers, observing that it is the result of a strictly contractual process: the shareholders have accepted loss of control over the company in exchange for greater liquidity. In other words, they have traded control for liquidity (Berle and Means 1932: 251). Consequently, the shareholders can no longer legitimately demand control over the company, so

that ultimate power of direction over the firm rests with managers. Berle and Means (1932) expressed concern about this approach on the basis that it gives almost dictatorial power to the managers, whom they described as “the new princes” (see *supra*). Although Berle and Means regarded the *shareholder sovereignty* doctrine to be a better (or, at the very least, *a less worse*) solution, they were not especially enthused by it either, precisely because it refuses to acknowledge the trade-off between control and liquidity. A careful reading of subsequent writings by Berle - and in particular of “The theory of enterprise entity” (1947)<sup>v</sup> - suggests another reason for these authors' unease with shareholder primacy as a guideline for corporate power. This reason is the following: shareholder primacy, at least as a legal doctrine, tends to ‘hypertrophy’ the corporation (as a legal device with artificial personality) to the detriment of the firm (as a productive entity). It is precisely against this ‘bias’ of the “corporate theory” that Berle has developed the “theory of enterprise entity”:

The divergence between corporate theory and the underlying economic facts has occasioned a variety of problems (dealt with ad hoc by the courts) [...] It is the thesis of this essay [t]hat the entity commonly known as ‘corporate entity’ takes its being from the reality of the underlying enterprise, formed or in formation

(Berle 1947: 344).

This article is of foremost importance, for it suggests that the dismissal of shareholder primacy is, at least in Berle's mind, rooted partly on consideration of the intrinsic economic nature of the firm. Put differently, to focus on the productive dimension of the firm, rather than on its legal or financial aspects, supports the idea that corporate governance should not deal solely with shareholders.

Let us now return to Berle and Means' position concerning the accountability of corporate managers. This position is briefly presented in the very last chapter. This chapter begins with a long quotation from Walther Rathenau, industrialist, statesman in the Weimar Republic and social theorist, describing the German conception of the public limited company in the following terms: “The depersonalization of ownership,



the objectification of enterprise, the detachment of property from possessor, leads to a point where the enterprise becomes transformed into an institution which resembles the state in character.” (Berle and Means 1932: 309). Likewise, in the new introduction for the 1967 edition of the *Modern Corporation and Private Property*, Berle wrote: “There is an increasingly recognition of the fact that collective operations, and those predominantly conducted by large corporations, are like operations carried on by the state itself. Corporations are essentially political constructs.” (Berle and Means 1932: xxvi).

Both quotations shed light on the distinction between two antagonistic logics. According to the logic of *ownership*, the (legal) world is divided between owners (legal persons, whether human or non-human) and objects of ownership. The owner of an object has 'subjective' power over that object, which means that he has the right (the power) to do whatever he wants with it under the law (Robé 1999). Note that shareholder sovereignty and managerial sovereignty both analyse the corporation through this logic: the company is an object of ownership. The difference is the identity of the owners. According to the doctrine of shareholder sovereignty, the only legitimate owners are the shareholders. According to the managerial sovereignty thesis, the ownership has been traded off in favour of liquidity, so that managers are the real owners. In contrast, the logic of *institution* dictates that the holder of power should not be free to exercise it in his interest (subjectively), but in the interests of those affected by it. The reference to the State in Rathenau's and Berle's quotations is significant on this level: the distinctive feature of a non-totalitarian State resides in the fact that the concentration of power within the State apparatus, necessary for its efficiency, is counterbalanced by limits placed on that power. The exercise of power is subjected, by means of various procedures, to the will of the people. Hence, the idea defended by Berle and Means is that the liquidity of stock markets calls for a rethinking of the nature of power within large companies. The firm is no longer an object of property, but an *institution* that must be governed as such. If the corporation is an institution - meaning that subjective interest should not be a guideline for the exercise of power - then it is necessary to set limits on managerial power to ensure that it is exercised on behalf of the company's constituents: shareholders, certainly, but also workers and, even further, the communities in which these companies thrive. Managers should not be accountable solely to the shareholders; they must be made

accountable to all the stakeholders in the firm. *The Modern Corporation* therefore ends with a plea for management that would be a “purely neutral technocracy” (p.312). Ultimately, whereas the agency perspective seeks to *minimize* the separation of ownership and control, Berle and Means offer to *exploit* it in order to enhance the role of public concern in capitalism.

## **2.2. The contractarian approach: toward a rejection of shareholder primacy**

The rejection of the concept of ownership, as applied to the business firm, is a standard assumption of the contractarian approach in law and economics (see for example Fama 1980). However, the similarity with Berle and Means is only superficial. This rejection is bound to a conception of the firm as a ‘nexus of contracts’. By definition, one cannot possess a contract (or contracts) as one can possess a standard asset. However, the core of the ‘ownership conception’ remains: as argued earlier, the agency model confers upon shareholders subjective power over the corporation - even if this subjective power is *de facto* limited by the opportunism of corporate executives. The substance of the agency model is unambiguous: an efficient corporation is a corporation where shareholders are able, through a diversity of mechanisms, to impose their subjective interests. Shareholders are not depicted as owners, but as sovereigns. The implications, as far as corporate governance is concerned, are basically the same: managers and directors should be accountable solely to stockholders. Accordingly, exclusive control by stockholders over the board of directors is necessary.

It is therefore remarkable that the most recent works on corporate accountability inside the contractarian approach tend to give credence to the idea defended, over seventy years ago, by Berle and Means (1932). For that reason, the articles by Zingales (1998 and 2000) and Blair and Stout (1999) are of particular importance and deserve careful examination. From a methodological point of view, these articles put forward the notion of contractual incompleteness – so that Zingales (1998) writes of the “incomplete contracts approach to corporate governance.”

The hypothesis of contractual incompleteness lies at the heart of the contemporary theory of the firm. It is one of the foundations of transaction cost theory, pioneered by Williamson (1975; 1985), and of modern property rights theory, developed by Grossman and Hart (1986). Both these approaches explore the way in which parties to a transaction secure their reciprocal investments when contracts are incomplete. In this context, protection of specific, non-redeployable investments cannot be achieved beforehand by the establishment of a contract providing for every possible contingency. Consequently, the parties to the contract are led to establish institutional devices, enabling them to appropriate a share of the organizational quasi-rent as a return on their investment. When applied to corporate governance, this schema considers rights on the board of directors as a tool for securing investments.

This path was first explored by Williamson in Chapter 12, entitled *Corporate Governance*, of his seminal 1985 book *The Economic Institutions of Capitalism*. His argument is taken up and furthered in two articles, one by Williamson and Bercovitz (1996), the other by Romano (1996). These works recognise that shareholders are not the only risk-takers within the firm. In particular, the increase in the specificity of human capital constitutes a risk-taking factor for the workforce: workers' payoff depends on the future distribution of the quasi-rent generated by the investment in human capital, which is fundamentally uncertain. This risk is all the stronger as the specificity of capital, in other words its non-redeployable nature, places employees in a disadvantageous position at the time of (re-)negotiation of the allocation of the quasi-rent. Reflection is thus focused on the measures capable of efficiently protecting those parties which incur the greatest risk (shareholders and employees), whereas contracts are incomplete. These authors reach the following conclusion: shareholders should be protected through rights of control over the board of directors. As for employees' investments, they should be secured by means of various devices: a pre-defined system of promotion, severance packages and procedures for settling internal disputes. Employee participation on the board of directors, however, is not envisaged. One may be surprised by this asymmetry between the treatment of shareholders and that of employees: in one case, the recognition of a weakness gives the right to control; in the other, it gives the right to protection against the arbitrary nature of decisions. The conclusion of Romano (1996:

293) is clear: “Transaction cost economics offers no analytical support for expanding board representation to non-shareholder groups, and indeed, cautions against such proposals.” The German model, in which employee representatives sit on the supervisory board,<sup>vi</sup> is deemed to be inefficient.

The work of Zingales (1998; 2000) and of Blair and Stout (1999) has developed the incomplete contract approach to corporate governance pioneered by Williamson. The role of human capital, through specific investment, in the generation of organisational quasi-rent is fully acknowledged. Besides, Zingales (1998; 2000) and Blair and Stout (1999) observed that the quasi-rent created by the firm derives from the pooling of complementary factors of production, in the form of tangible, and also intangible, human and financial capital. Compared with the work of Williamson, more emphasis is therefore placed on the synergies that come into play between the investments of the different stakeholders. The firm is thus conceptualized as a “nexus of specific investments”. The allocation of rights of control over the entity thus created plays a decisive role, in that this allocation will determine how the value created is divided up within a framework of contractual incompleteness. Consequently, each stakeholder will be more or less motivated to commit to the firm, and this will influence the very level of the organisational quasi-rent.

Taking into account the complexity of the relationships formed between the different stakeholders, Zingales (1998) and Blair and Stout (1999) propose a solution that moves away from the doctrine of shareholder value: the stakeholders should delegate their powers to an independent third party - the board of directors - whose objective is to serve the best interest of the constituted entity. In this context, the directors are no longer simply the agents of the shareholders; their fiduciary duties must be exercised towards the whole firm. Thus, the productive capital of the firm must be managed in the interest of the firm itself. This point is new compared with the work of Williamson, for whom the role of the board of directors was to serve the interests of the shareholders. In short, the primacy of shareholders is partially challenged, in order to foster firm-specific investments.<sup>7</sup> Zingales (2000) goes one step further in an article of a very prospective nature entitled *In Search of New Foundations*: “In the current environment, where human capital is crucial and contracts are highly incomplete, the primary goal of a corporate governance system

should be to protect the integrity of the firm, and new precepts need to be worked out” (Zingales 2000: 1645).

Examination of the contributions of Zingales (1998; 2000) and of Blair and Stout (1999) therefore brings out a remarkable principle: the stronger the emphasis on contractual incompleteness, the more corporate accountability is extended. Put differently, it appears that the rejection of shareholder primacy is linked to a (theoretical) recognition of the incomplete nature of contracts. Zingales (2000) thus calls for reflection on new principles of governance in light of the current situation in which contracts are “highly incomplete” (see *supra*). From a mode strictly centred on shareholders (Williamson 1985), principles of governance were first extended to the management of productive capital in a common interest (Zingales 1998, Blair and Stout 1999), before finally embracing protection of the “integrity of the firm” (Zingales 2000).

It should be noted, however, that this principle, by which the widening of the field of incompleteness is accompanied by an extension of corporate accountability, raises deep theoretical problems. The widening of the field of incompleteness progressively reduces the validity of the contractual analysis on which the work of Zingales and of Blair and Stout is founded. To say that contracts are incomplete is to acknowledge, by definition, that the ‘off-contract’ plays a role in coordination. Broadly speaking, the ‘off contract’ is constitutive of all the social regularities or forms (routines, norms, conventions, legal rules etc.) that underlie the productive process and that are not the direct outcome of voluntary agreement. Weinstein, in this volume, offers a survey of the theories of the firm (e.g. the resource-based and evolutionary perspectives) that focus on those regularities, taking into account the cognitive dimension of intra-firm coordination. As the incompleteness of contracts increases, the scope of contractual analysis tends to shrink (Favereau 1997), whereas the analytical accuracy of those cognitive perspectives increases. This difficulty is recognized implicitly by Zingales (1998: 502), for whom “at the current state of knowledge the [incomplete contracts approach to corporate governance] lacks theoretical foundations.” The author adds

by way of conclusion: “Without a better understanding of why contracts are incomplete, all the results are merely provisional.”

The argument developed in this section may be summarized as follows. The contractarian approach strongly advocates shareholder primacy, mostly through the agency conception of the firm. Nonetheless, there are some exceptions that severely qualify or reject this model of corporate governance. On closer scrutiny, these exceptions share a common assumption: the incomplete nature of contracts is recognized as a crucial feature of the business firm. In turn, it is essential to note that such recognition ultimately amounts to concluding that intra-firm economic coordination is partially (or essentially) outside the realm of contractual order. This is precisely the core meaning of the theory of the firm-entity. *In fine*, acknowledgement of the specificity of productive activity and dynamics leads to a rejection of shareholder primacy, for at least two reasons: the need for internal control mechanisms (section 1) and the need to foster firm-specific investments (section 2).

### **3. The governance of the firm-entity**

Having highlighted the receding relevance of the classical theory of the firm, Berle and Means had paved the way for the development of a new social-scientific model of the enterprise, which took account of the revolutionary changes brought on by the development of the quasi-public corporate form. As discussed above (see *supra* 2.1), the new conception of the company which Berle and Means suggested was that of a “purely neutral technocracy”, (1932: 312) where management would be required to resolve its freedom from market-institutional pressures in order to further some set of commonly agreed politico-economic goals. It is at this point, though, that we come face to face with a vexing paradox in Berle and Means' work. Whilst their apparent goal in writing *The Modern Corporation and Private Property* was to challenge the financial shareholder's exclusive status as the legal beneficiary of corporate managerial decisions, the authors' very highlighting of the separation of ownership and control contrarily served to earmark the shareholder-managerial relation as *the central focus* for future Anglo-Saxon corporate governance scholarship. In this way, then, *The Modern Corporation* had the unintended consequence of providing a

conceptual frame of reference for future academic debate on the issue of how to minimise (rather than actually exploit) the so-called separation of ownership and control within the modern corporate enterprise. In part, this was due to the early caution shown by Berle (1932) himself in stressing the need for courts and legislators to maintain the legal principle of shareholder primacy in the absence of a robust regulatory scheme for making company directors directly answerable to the community as a whole. However, cause must also be attributed to the failure of subsequent corporate scholars to use Berle and Means' work as the foundation for a thoroughgoing conceptual remodelling of the business enterprise. Had such a reformulation of the modern corporation been carried out, it may have been capable of providing normative content to Berle and Means' fledgling proposal for a director's legal duty of "economic statesmanship" (1932: 313).

To this end, our aim in this final section is to put forth suggestions on how Berle and Means' conception of the company as a publicly orientated institution might be effectively implemented within a contemporary market-based corporate governance system. We consider first, as a regulatory means towards this end, the anti-takeover legislation that has been developed in recent decades within the majority of US state corporate law systems. In vesting managerial boards with formal discretion to block hostile takeover bids, such provisions effectively promote the integrity of the productive corporate enterprise above any conflicting considerations of shareholder value. Moreover, anti-takeover legislation serves to earmark managerial discretion, rather than shareholder self-interest, as the basic institutional determinant of corporate prosperity. At the same time, though, it is essential to recognise the ultimate futility of relying upon managerial discretion alone to bring about a more inclusive system of corporate governance within an Anglo-Saxon context, given the underlying alignment of the managerial interest with that of stockholders (see *supra* 1.2). Accordingly, we argue, anti-takeover provisions must be supplemented by effective procedural mechanisms for ensuring the influence of key *non*-shareholder interests at the heart of the corporate governance process, at least if the law is to have any meaningful effect in breaking down the organisational dominance of stockholders and managers. In this latter regard, we therefore rely on the evolving European model of corporate governance and, in particular, its central theme of promoting the participation of employees in corporate decision-making *via*

formal rights to information, consultation and (to a limited extent) representation on the board of directors itself.

### **3.1 The interest of the company: insights from US anti-takeover legislation**

In the United States at present, the clearest doctrinal embodiment of the entity conception of the firm is the collection of controversial non-shareholder constituency laws that regulate the conduct of takeover bids at state level. In the 1980s, following widespread political and popular unrest with the social consequences of finance-driven takeover activity, many American states implemented radical reforms in their corporate statutes in an attempt to counteract this potentially harmful phenomenon. The common (and intended) effect of these amendments was to vest managements of target companies with the discretion to block hostile takeover attempts, using defensive tactics if necessary, where the directors felt in their good faith judgement that the takeover would overall have a negative effect upon the corporation and its constituents (Parkinson 1993). To date, 43 out of America's 51 state corporate law systems<sup>9</sup> contain an anti-takeover provision of this sort,<sup>10</sup> which typically exhibit a number of salient features. The defining characteristic of such rules is the explicit discretion which they afford a target company's board of directors to consider the consequences of the takeover for “any or all groups affected by such action, including shareholders, employees, suppliers, customers and creditors”, together with “communities in which offices or other establishments of the corporation are located” (Pennsylvania Consolidated Statutes, Title 15, § 511(d)(1)). Some versions of the rule even go so far as to specify “[t]he economy of the state and nation” (Ohio Revised Code, § 1701.59(E)(2)) as a legitimate subject of managerial concern.

A further typical feature of such provisions is the licence that they afford managements to take into account “[t]he long-term and short-term interests of the corporation and its stockholders, including the possibility that these interests may be best served by the continued independence of the corporation [from its potential acquirer(s)]” (General Laws of Massachusetts, Part I, Title XXII (Corporations), Chapter 156B, Section 65). One version of the rule adds, as a further ground for consideration, the general value of “the stable, long-term growth of domestic public



corporations” (South Dakota Domestic Public Corporation Takeover Act, § 47-33-2(3)), while another pays specific regard to “benefits that may accrue to the corporation from its long-term plans” (Pennsylvania Consolidated Statutes, Title 15, § 511(d)(2)). Most extensively in this regard, the South Dakota Domestic Public Corporation Takeover Act contains an express Declaration of Public Policy, which (*inter alia*) asserts that:

[t]akeovers of publicly held corporations are...frequently financed largely through debt to be repaid in the short term through changes in the operations of the target corporation, by the sale of substantial assets of the target corporation, and other means. In other states, such takeovers have impaired local employment conditions and disrupted local commercial activity. These takeovers...may undermine the state's interest in promoting stable relationships involving the corporations that it charters' (§ 47-33-2(5)).<sup>11</sup>

A final and complementary feature of non-shareholder constituency laws is their general discouragement of directors, when deciding upon the merits of a takeover proposal, from regarding the interest of any one or more particular constituent groups (e.g. shareholders) as “a dominant or controlling factor” (Indiana Code 23-1-35-1(f)) in their decision *vis-à-vis* the interest of the productive corporate enterprise as a whole.

These provisions represent an *ex ante* statutory guard against the potentially degenerative effects of finance-led acquisition policies. Moreover, by recognising the fact that hostile takeovers very often place the dual interests of the corporation and its shareholders starkly into conflict with one another, US anti-takeover legislation represents an authoritative refutation (at least within the takeover context) of the orthodox contractarian assumption that what is good for shareholders is, by implication, also good for enterprise and society (Coates 1989; Millon 1990).<sup>12</sup> However, while the end result of these provisions would appear to be that of reducing the organisational dominance of shareholders within the US corporate governance arena, the US anti-takeover machinery is, in reality, emasculated in its effect by the practical reality of how public corporations are actually run within America. Indeed,

despite their apparent theme of politico-economic 'inclusivity', American anti-takeover protections are ill equipped to ensure that managements are made any more answerable to vulnerable non-shareholder groups than would be the case under an 'orthodox' shareholder-oriented understanding of the company's interests. This is due to the fact that these provisions are underlain by an assumption of management *autonomy*, which can be exploited in order to ensure that shareholders' interests do not ride rough-shod over those of other participants whenever the shareholder and general corporate interest come into conflict with one another.

As logical as the foregoing course of reasoning may be, however, it is premised upon one erroneous factual premise: managements are *not* 'autonomous' in either of the above respects, but are in fact heavily coloured in their day-to-day decision-making by the same (or at least very similar) financial motivations as shareholders. This point is not in need of any further explanation, but rather is borne out by the arguments put forth in part 1.2 above. It therefore follows that a board of directors, if left to its own devices, will not be necessarily prone to regard a financially driven takeover attempt as in conflict with their own material interest. Indeed, not only will the resultant rise in firm share price probably benefit the incumbent managers themselves *via* incentive-remuneration schemes, but senior management will also likely enjoy a significant control premium, whether in the form of a lucrative (albeit less senior) office within the reorganised company (Manne 1962) or, at the very least, a substantial 'golden parachute' payment upon termination of office (Coffee 1988).

Accordingly, while the US directors' fiduciary duty (as typically formulated within state corporate law systems today) is sufficiently designed so as to afford legal protection to management (and, indirectly, other corporate participants) in the face of acquisition attempts that are potentially harmful to the incumbent board personally, it is not designed to afford *direct* protection to vulnerable non-shareholder groups in the more likely event that such a project will reap reciprocal gains for shareholders and senior executives alike. As a result, American corporate law cannot stop management from sanctioning a potentially harmful acquisition attempt that promises side-benefits for them personally, nor indeed any other form of financial restructuring (e.g. a downsizing project, share buyback plan, or debt-for-equity restructuring) which

serves to favour the financial well being of the shareholder-managerial coalition at the expense of the integrity of the productive corporate enterprise as a whole.

### **3.2 Empowering non-shareholder constituents: insights from the European model**

This is not to say, however, that existing US anti-takeover legislation is incapable of providing at least a basic guide as to how Berle and Means' "neutral technocracy" conception of the company might be effectively implemented today within a market-based corporate governance system. Indeed, not only do many of the statutory provisions referred to above emphasise the socio-economic value of the company's stable growth and long-term strategic plans, but many also recognise the likelihood of there being *conflict* between, on the one hand, the financial interest of shareholders, and, on the other, the interest of the corporate enterprise in the wider sense. In this way, American formulations of the corporate interest are at the very least capable of providing the seeds for a new publicly orientated understanding of the doctrine (Teubner 1994), which might represent a countervailing influence to the dominant mantra of the EVA metric and other managerially-enriching performance measures. However, given the position of the shareholder-managerial coalition as a significant vested interest in the corporate wealth-distributional process, coupled with the proven discretion enjoyed by management in allocating corporate returns, it becomes clear that fundamental changes in *actual decision-making structures* are a further necessary prelude to the legal implementation of the entity conception of the firm within an Anglo-Saxon context. In particular, it is submitted that the effective 'institutionalisation' of shareholder-managerial prerogative in the Berle-Means sense is contingent not only upon the vesting of the board with ultimate rights of veto over hostile takeovers and other financial restructurings, but also upon the installation of truly independent *non-shareholder* interests within companies' internal decision-making mechanisms (Stone 1975; Nader *et al.* 1976; Teubner 1985; Parkinson 1993).

In this latter respect, the developing 'European model' of corporate governance stands out as a fledgling model of good practice for its Anglo-Saxon

counterpart (Rebérioux 2002). Indeed, a dominant theme apparent in recent EU corporate and labour law legislation has been the Community-wide expansion of mandatory mechanisms for management-labour dialogue on important issues relating to the strategic and technological development of the employer undertaking. These measures include the EC Directive of 2002 establishing a general framework for informing and consulting employees in the European Community (Directive 2002/14/EC - 'the ICE Directive'), which stresses (in its recital) the need for Member States to take efforts to ensure "that all citizens benefit from economic development" through the promotion of "social dialogue between management and labour". To this end, the ICE Directive demands generally that the management of a large undertaking, employing at least 50 employees in any one Member State, initiates procedures at the request of the workforce to enable the periodic provision of relevant information to elected employee representatives for purposes of consultation. Specifically, Article 4 of the Directive obliges management to disclose information on "the recent and probable development of the undertaking's activities and economic situation", together with the "situation, structure and probable development of employment within the undertaking", and "any anticipatory measures envisaged...where there is a threat to employment within the undertaking." In addition, management must report to employees on "decisions likely to lead to substantial changes in work organisation or in contractual relations."

The requirements of the ICE Directive are backed up by the supplementary provisions of the European Works Council Directive (Council Directive 94/45/EC - 'the EWC Directive'). Unlike the former scheme, the EWC Directive applies specifically to "community-scale undertakings", defined as those with 1,000 or more employees, at least 150 of whom are employed in two or more different EU Member States (Article 2). In essence, this latter Directive requires management (at the employees' request) to create the conditions for the setting up of a special European Works Council ('EWC'), comprised of three or more employee representatives, at least one of whom should represent each Member State in which the undertaking carries on its operations ('Subsidiary Requirements'). The specific purpose of the EWC scheme is to enable the provision of information by management to the workforce, and subsequent management-labour consultation, focussed upon those trans-national matters concerning the Community-scale undertaking as a whole, or at

least two of its establishments situated in different member states. As to the precise nature of the information to be provided and discussed, the Subsidiary Requirements of the EWC Directive list an extensive range of strategic and financial issues, including (*inter alia*): the undertaking's structure, economic and financial situation; the probable development of the business and of production and sales; the introduction of new working methods or production processes; and transfers of production, mergers, cut-backs or closures of undertakings.

From the perspective of the argument at hand, the above provisions would at first sight appear to represent a valuable step in the right direction, insofar as they provide for the involvement of employees at a relatively early stage in the corporate decision-making process. This should, in theory, enable some degree of non-shareholder input into important strategic decisions (e.g. mergers or major financial restructuring projects) on an *ex ante* basis, thus vesting employee representatives with the formal role of 'policing' controversial exercises of managerial prerogative. A notable contrast can be drawn here with the traditional structure of industrial relations in the United Kingdom, in which labour interacts on a primarily conflictual basis with management by 'collective bargaining' *via* the channel of trade union representation, thereby perpetuating a view of employees as being situated 'external' to the enterprise, with shareholders and managers enjoying exclusive 'insider' status (Kahn-Freund 1956; Deakin and Morris 2005). Furthermore, both Directives contain an equivalent Article 9 provision, requiring consulting parties to "work in a spirit of co-operation and with due regard for their reciprocal rights and obligations, taking into account the interests of both the undertaking and the employees." The resultant expectation of reciprocal dialogue in discussions might better encourage a process of organisational 'learning' on the part of management and labour representatives, thereby progressively integrating these parties' countervailing conceptions of the 'good' of the company on a decision-by-decision basis (Teubner, 1985).

Additionally, over the last couple of years, the subject of reforming the composition of company boards has been subject to some renewed interest on a pan-European level. The catalyst for this moderate resurgence of the 'industrial democracy' debate was the introduction in 2001 of the long-awaited EU Directive on worker involvement in the European Company (Directive 2001/86/EC). In essence,

this Directive makes provision for the involvement of employees in strategic decision-making, at board level, in any business that is registered as a *Societas Europaea* (SE) or European Public Limited-Liability Company. The SE is a specialist corporate form available to trans-national undertakings conducting business in more than one EU Member State, aimed principally at reducing the transaction costs involved in effecting mergers and other reorganisations between companies subject to separate domestic legal regimes (see Regulation (EC) No 2157/2001 - 'the European Company Statute'). In theory, use of the SE form provides such enterprises with the convenience of a uniform legal structure upon registration, applicable across the Community as a whole so as to avoid the inconsistency and confusion that results from different companies within the same undertaking being subject to differing sets of company law rules depending on their particular State of registration (Davies 2003; Deakin and Morris 2005).

Of relevance for present purposes are the provisions of the supplementary Directive on worker involvement noted above. In its original guise in the 1970s, the European Commission's blueprint for worker involvement in the European Company proposed a mandatory system of worker representation at board level effective within SEs across the Community as a whole. The suggested board composition for SEs was based loosely on Germany's 'two-tier' board model, featuring equal representation for shareholders and employees on an 'upper' supervisory tier, which would be vested with the responsibility of appointing and overseeing a 'lower' managerial board (Davies 2003). The employee representation requirements as set out in the final 2001 draft of the Directive are less stringent in nature, due in part to the opposition shown towards earlier drafts by some Member States, in particular Spain and the United Kingdom (Rebérioux, 2002). Nevertheless, Article 13 will have the effect of imposing mandatory employee representation requirements upon SEs registered in States with traditionally shareholder-oriented corporate law systems (e.g. the United Kingdom), in the event that that SE is formed as part of a joint venture involving a company whose 'host' State already has such a system in force (e.g. Germany or the Netherlands). The potential effect of this provision, in encouraging the (limited) extension of 'Rhineland' board structures into the Anglo-Saxon corporate governance systems of Britain and Ireland, both replies to and contradicts Hansmann and Kraakman's (2002) influential prediction that competitive

and ideological forces are compelling international convergence towards the latter type of model.

Although the above developments are admittedly limited in scale, their symbolic value is undeniable. They constitute a new corporate design - purely European - in the global market, that is a coherent alternative to the Anglo-Saxon model. Indeed, the (limited) pan-European spread of industrial democracy within corporate governance exemplified by the above developments, together with their underpinning 'social' rationale, breeds hope for a viable ideological alternative to the Anglo-Saxon orthodoxy of value-based management and its underpinning contractarian logic. In particular, the above developments could be regarded as indicative of a fundamental paradigm shift in the international corporate governance debate itself, inspired at root by two crucial contemporary developments explained above: first, the increasing *convergence* of the shareholder and managerial interest brought upon by value-based performance measures and related incentive-remuneration schemes (see *supra* 1.2); and, secondly (and correspondingly), the growing *divergence* between, on the one hand, the financial interest of shareholders (both managerial and non-managerial), and, on the other, the integrity of the productive corporate enterprise together with the welfare of its key non-shareholder participants.

Against this backdrop, the (limited) institutionalisation of the views of the workforce within companies' decision-making procedures can be portrayed as a structural safeguard against the misalignment of financial and productive interests. To this end, labour representatives will be expected to challenge the purported integrity of controversial managerial statements by reference to key financial *and* non-financial information pertaining to both the company's financial performance *and* its recent industrial operations. The main responsibility of labour representatives in this novel regard is to verify the honesty and justifiability of any managerial claim that a proposed corporate restructuring project, imposing costs upon vulnerable non-shareholder interests, is indeed motivated by 'economic necessity', 'the genuine needs of the business', or whichever variant of these terms is deployed by management to provide some moral vindication for the course of action in question. For example, the management of a company that decides to dismiss a large number

of employees, or sever important links with long-standing suppliers, would find it difficult to justify the taking of that step if it is subsequently shown that, in the same or following financial year, that firm returned a considerable amount of its potential investment funds to shareholders via a large-scale stock repurchase. Likewise, a company that undertakes a significant downsizing project whilst, at the same time, paying exorbitant stock-based remuneration to its senior executives, would again face the need to justify any claim that it is motivated by genuine entrepreneurial considerations as opposed to mere shareholder-managerial control over the firm's wealth-distributional process. In such instances, the responsibility should fall on the company's management to reflect upon the reasons for its proposed policy, both by collecting (and disclosing to labour representatives) relevant financial and non-financial information, while also engaging in genuine reciprocal dialogue with employee representatives (whether at board or Works Council level) centred around the common aim of determining whether the proposed changes are indeed merited by market and/or technological factors.

#### **4. Conclusion**

It may therefore be the case that, within the current cultural climate of 'shareholder value', the corporate governance structure that is best capable of re-aligning the dual financial and productive dimensions of the corporate enterprise will be derived from a combination of certain features of both the American and European models. The corporate governance of the firm as an entity, it is submitted, must be based at root upon the managerialist conception of the interest of the company characteristic of most US state corporate law systems, which formally vests the board with discretion to prioritise the continuing integrity of the productive corporate enterprise in the face of finance-led acquisition policies aimed centrally at the creation of shareholder value. However, in recognition of management's *non*-independence from the shareholder interest, our suggested model of corporate governance will also borrow heavily from the evolving European 'social' model of corporate governance. In this article, we forward the European model as an institutional blueprint for the incorporation of employee representatives into the corporate governance process as



a formal 'check' on managerial decision-making discretion. In this way, labour has the potential to represent a locus of countervailing power *vis-a-vis* the dominant shareholder-managerial interest base within the widely held firm. It is hoped that, by identifying and responding to the dangerous coalition of financial interests at the heart of the corporate governance process, the law might effectively counteract the expansion of market-based governance structures on an international level. This is an especially urgent task given the acknowledged informational weaknesses of the Anglo-Saxon model.

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<sup>i</sup> For more details on the contractarian theory of the firm, see Weinstein in this volume.

<sup>ii</sup> We do not intend to decide who is the primary beneficiary of finance-led capitalism - shareholders or managers. For the purposes of our argument, it is sufficient to note that *both* are beneficiaries.

<sup>iii</sup> Note that Enron's board was composed of 12 'independent' directors of a total of 14.

<sup>iv</sup> The conflicts of interests that used to run through the audit profession are put forward as the main factor explaining the corporate scandals of the Enron era (see for example Coffee 2002).

<sup>v</sup> Reprinted in this volume.

<sup>vi</sup> Here, the difference between the board of directors and the supervisory board is of little importance. In both cases, we are dealing with the central strategic organ of the firm.

<sup>7</sup> For Zingales (1998) and for Blair and Stout (1999), though, rights of control over the board of directors should be vested in shareholders. One may be surprised by this conclusion, which seems to

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run counter to the idea of the board as an independent and neutral body, born out of an agreement amongst the various stakeholders. Blair and Stout (1999: 324), however, justify this allocation by pointing to the synthetic character of shareholders' interests: "Share value can sometimes be a proxy for, or an indicator of, the total value of rents being generated by the corporation. Not a perfect proxy, we believe, but at least it is one legitimate indicator." This is a classical, yet rather strange argument. Indeed, Blair (1995) had, in an earlier (and influential) work, defended the idea that the maximisation of stock price is different from the maximisation of the organisational quasi-rent as soon as workers invest in firm-specific human capital. Here, we find a mode of reasoning analogous to that of Williamson who, after recognising the importance of employees in terms of the creation of value (through their specific investments), excludes them from board-level participation.

<sup>9</sup> This figure includes the District of Columbia.

<sup>10</sup> The anomalous 8 states where there is no such provision in force are: Alabama, Alaska, Arkansas, California, District of Columbia, Montana, New Hampshire and West Virginia.

<sup>11</sup> Likewise, the Laws of New York make explicit reference in this regard to "the ability of the corporation to provide, as a going concern, goods, services, employment opportunities and employment benefits and otherwise contribute to the communities in which it does business": § 717(b)(v). The corresponding provision in force in the State of Missouri even goes so far as to adopt accounting terminology. In particular, it sanctions awareness by management to "[t]he future value of the corporation over a period of years as an independent entity discounted to current value", together with any "existing political, economic and other factors bearing on security prices generally or the current market value of the corporation's securities in particular": § 351.347. 1(1)(c), (2). The latter provision is further notable insofar as it highlights, as another managerial decision-making criterion, "[t]he financial condition and earnings prospects of the person making the acquisition proposal including the person's ability to service its debt and other existing or likely financial obligations": § 351.347. 1(5).

<sup>vii</sup><sup>12</sup> British company law, in contrast, has traditionally avoided engagement with this underlying politico-economic conundrum, by virtue of the preclusive 'proper purpose' doctrine applied by the English courts in regulating (*inter alia*) the conduct of a target company's management when faced with an actual or potential takeover bid. In essence, this doctrine serves to protect the accepted proprietary entitlement of shareholders, vested in them under the company's constitution, to consider the merits of any proposed bid personally, and to subsequently vote upon that proposal with a view to their own financial self-interest. To this end, defensive tactics by target boards are, as a general rule, forbidden under the common law, a position that is today backed up by the even stricter prohibition on 'poison pill' strategies laid down by Regulation 7 and rule 21 of the City Code on Takeovers and Mergers. On the effect of the proper purpose doctrine and above City Code provisions generally, see Parkinson (1993), pp. 140 - 146. <sup>vii</sup> For more details on the contractarian theory of the firm, see Weinstein in this volume.

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