Shareholder associations, control contracts and the organization of the firm

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An implicit normative evaluation of the set of relationships in and around the firm - between workers, executives, managers, directors, shareholders, and input suppliers - is fundamental to the conventional theory of the firm and much of the work in industrial economics. It also concerns the role of modern corporations in society, e.g. the issues of the power, legitimacy and responsibility of management (Graham, 1989).

The picture that is implicitly endorsed in conventional economic theory, can be sketched as follows. The shareholder is the owner of the firm. Being owner, the firm is (and should be) run in his interest. He does, and should, have authority and control over the firm. This control is, and should be, exercised via directors who are part of management. Directors are, and should be, elected, in a democratic process, by shareholders. Via, or in conjunction with, other (executive) members of management, they have authority over the workers, as they should, to run the firm in the interests of the "owners". Both the control of owners over "their" firm and their receipt of benefits from their property rights, are secured - and rightly so. The firm - the corporation - consists of shareholders, directors, executives (and workers).

Within this paradigm, a deep difference of opinion appeared with the appearance of the Berle and Means thesis, i.e. that there has been a separation of ownership and control, with a deplorable loss of control by owners over their firm, causing managers to be in full, non-legitimated control and potentially able to suppress or violate the property rights of the owners.[ii] Since property rights are non-violable and inalienable, some remedy is essential - preferably the restoration of corporate democracy and shareholder control over management, otherwise some form of state control over corporations.[iii]

The latter implication is the main source of the fiercely opposing opinion, mostly associated with the Chicago School of thought: that there has been no separation of ownership and control, and that firms still do (and of course should) pursue maximum profits. Accordingly, firms are subject to the discipline of the market, so that optimal allocation of resources still is assured; the market outcome is optimal and should be accepted; no state intervention is necessary. And, lastly, the neo-classical profit-maximisation theory of the firm is, without any doubt, proper. According to this school of thought, the ownership-and-control debate is all but closed.[iv]

Despite their differences, both these broad viewpoints approve of the picture sketched above.[v] The question is what the basis is for this approving evaluation.

This paper presents three main ideas. First, it argues that the firm needs to be emancipated from the inordinate property-based shareholder influence that is built into current corporate law and practice. The pre-eminent role of the shareholder in the corporation should be downgraded to a position more consistent with its relative role in a firm:[vi] "owners" should be transformed, not only de facto but also de jure, to investors.[vii]

A second aim of the paper is to provide a theoretical basis for this view. Both the in conventional economics approved picture of the shareholder-firm relationship and the associated positive (Western) legal framework are decisively based on the notion of property, and specifically of the firm as the property of the owners. It will be argued that this property basis is false. The conventional picture harbours inconsistencies, much of it because of its property basis. The systematical substitution of an alternative basis for shareholder involvement is a central concern of the paper.

Thirdly, the proposition is advanced that, beyond (or underneath) the various positive forms of the firm in its historical development, and amidst the various factual legal positions that may exist in different countries, an underlying structure of institutions and relationships can be distinguished. *The firm, and especially the corporate firm, is not what it seems, and more than one social organisation is involved.* A different underlying "picture" of structures and interrelationships is identified. The inherent nature of these relationships and institutions is decisive for a number of critical issues surrounding the corporation.[viii]

The analysis of the relationships and institutions provides a new basis for evaluating current positive legal forms of firms - against the background of a re-interpretation and re-explanation of the of the corporate revolution and corresponding reassessments of past and present forms of the firm. New possibilities for organising firms come to the fore.[ix] Lastly there are a number of implications for the theory of the firm.

1. Is the conventional view tenable?

A number of difficulties can be pointed out in the conventional conceptualisation of the relationship between shareholders and the firm, including the role of the board of directors and other executives (also see Graham, 1989).

(a) The most fundamental question is whether a shareholder can really be regarded as the "owner" of the firm, with concomitant *property* rights and an ensuing *intrinsic* right to control the firm. Such a view has prevailed since pre-industrial times, first in the case of one-person or family-dominated firms, and later extended to the corporate form of the firm.

While economists are divided on the nature of the firm, few would argue against the notion that the firm is an economic, producing or value-adding institution comprising a group of people forming an organisation within which they combine inputs to produce goods or services.[x] The firm is an economically qualified organisation of people, and not merely a collection of land, buildings, machines and other assets. It is inappropriate to regard an organisation of people as anybody's property, as the object of a property right.[xi] The application of the concept of ownership to the firm is spurious and irreconcilable with the typical (or underlying) nature of the firm.[xii]

(b) If shareholders in principle cannot really own the firm - although they have full ownership rights of their shares - that would imply that they may be no more than capital suppliers. In essence this is the core of what the issuing of shares is all about, and a necessary condition for

shareholdership. *In this capacity* the shareholder must be viewed as external to the firm, and as being to the firm in a relationship similar to that of any other external supplier of inputs, i.e. via an exchange or market relation.

This has important implications for the tenability and consistency of the conventional view:

1. If shareholders are in a supply relationship similar to that of *external* suppliers, how can they be regarded as *members of the corporation/firm*? Yet there seems to be some sense in the idea that shareholders are part of the corporation. Are the corporation and the firm identical?
2. If the firm is regarded as the *property* of the owners, how could those owners simultaneously be members/part of that firm? The idea that shareholders *own* the firm while being members of that same firm, is irreconcilable.[xiii] (This irreconcilability is further reason to abandon the idea of ownership of the firm.)

In itself an input supply relation typically (inherently) excludes any intrinsic right of authority or control, and any form of subordination. The shareholder has no inalienable (property) right to control the firm. Apart from the customary stipulations of positive law - decisively based upon the now suspect property right notion - is there any real foundation for shareholder control over the firm? Is there any a priori reason why the shareholder/capital-supplier should, in contrast to other (external) input suppliers, receive special treatment?[xiv]

(c) Further reason to reconsider shareholder status is a distinct problem with the view of the board of directors as the "management of the firm", such management then being elected by the shareholders. Generally speaking one can say that managers are those members of the firm who occupy offices of authority in the internal authority relation within the firm.[xv] The question is whether directors satisfy this description. If they do, why call them directors - what distinguishes them from other managers (i.e. executives)? If not, how can they be the firm's managers?

Furthermore, if they are indeed the managers of the firm, how can they be elected by shareholders who are, at least by the nature of their capacities as capital (input) suppliers, not members (workers or managers) of the firm, but external to the firm - the actual producing institution - as such?[xvi] In any case, if all directors are managers proper, why call some "outside"? If all directors and shareholders are members of the firm, why make the distinction between outside and inside at all? Does it not confirm the possibility that shareholders are also "outside"? And what would that really mean?

(d) All in all the proper role of the board of directors is unclear. Some see directors as an integral part of management, others see directors as those supervising, from a distance (or from "outside") and on behalf of shareholders, the managers proper. A related disagreement concerns whether the board of directors should be regarded as the servant of the shareholders or of the company.[xvii] This confusion is attributable to the variation in the form and functioning of actual boards - active boards, passive boards, boards with "inside" directors, boards dominated by insiders, effective governance by insider-dominated executive committees of the board, and so forth. Especially the case with both inside and outside directors impede one's ability to identify

the typical role of the board vis-a-vis both the firm and the shareholders. (Of course this variation may be due to confusion regarding the proper role of a board...)

While the conventional view hardly is tenable, it is not suggested that shareholders do not often have de facto control over managers, or that there are no rights to be encroached upon - nor indeed that there should not be any such control. There may indeed by a solid foundation for the capital supplier having a special relation to the firm, given the crucial and foundational role of capital in the founding and continued existence of a firm (see below). The suggestion is that such special relation and any control should not be viewed as being founded in property rights.[xviii] An alternative basis for special treatment of the shareholder must be provided.[xix] That is the purpose of this paper, also indicating new organisational possibilities.

2. Shareholders, the board of directors and the firm: an alternative view

Starting from the premise that the most basic, *a priori* or intrinsic status of the shareholder is that of an individual with an input supply relation with a firm (of which he is not a member), what then is the basis for any added status, of shareholder control over the firm? Is there another "picture", another plausible foundation for a control relation (in contrast to that which have always been called, for various reasons, a property right)?

In probing this question, it is essential to abstract from current corporate practices and positive law, and to consider a different structural vision of the "underlying nature" of relations and institutions. Again, the corporation may not be what it seems.

2.1 The notion of a shareholder association

If shareholders are external to the firm, they cannot be regarded as the enfranchised members of the firm. Yet shareholder voting is an essential element of shareholder control.

In considering the idea of shareholder voting (corporate democracy), two salient aspects are relevant: (a) In general an electoral process presupposes an association or body within which members elect leaders or representatives. An individual in isolation cannot vote - voting presupposes some social structure, e.g. the State whose citizens vote within that structure, and voting is available only to a member of such a body. (b) The direct *elective* meaning of a vote is confined to the internal sphere of that body - in the first instance it is a vote only with regard to the election of officers of that body, or decisions of that body.[xx]

This implies, firstly, that the notion of a vote is meaningless for an individual shareholder per se, in isolation. In the solitary relationship between an individual shareholder and the firm, which is outside any association and has a non-integrating character, voting is a concept without foundation. It can only be realised within some association, say a shareholder association or union. Secondly, voting by shareholders can only produce electoral decisions of an association of which they are members, and can only elect officers of that association. This means that shareholders, who are, as capital suppliers, external to the firm, cannot directly elect managers of the firm - the officers of another association of which the voter is not a member.

The key structural insight is that one has to conceptualise two separate associations/organisations if voting by shareholders is concerned. Only in the shareholder association, as distinct from the firm, can they exercise a vote to elect officers, who are then presumably responsible to the voters, the shareholders.

In the latter one finds, I submit, the original meaning of the term director: the elected official of a shareholder-association - which, in turn, may be the appropriate way of looking at the "corporation" (as distinct from the firm). In this view the director occupies an office within this association, and not within the firm. The offices of director and manager, like the board of directors and management, can be distinguished - at least conceptually but sometimes also in practice[xxi] - as clearly as the two corresponding associations themselves.[xxii]

2.2 Shareholder externality and control contracts

The existence of a shareholder association only provides a framework for the relation between shareholder and board of directors. An understanding of the rest of the overall shareholder-firm relationship[xxiii] can only be found in what is an external correlate of this relationship, i.e. the inter-associational relationship between the shareholder association and the firm. With each of these distinct organisations having its own "organ" of officers with internal jurisdiction, it reduces to an external, inter-relationship between the board of directors and management. Probing the underlying nature of this relationship is the key.

The underlying (innate, intrinsic) nature of an extra-organisational inter-relationship is such that it does not unite participants into a solidary whole. It leaves them free to interact, from positions of legal equality, in cooperation, neutrality or antagonism. (In this respect it is similar to an exchange relationship, or to the relationship between neighbours; see Fourie, 1989.) In such a relationship there is no basis for an inherent relation of authority and subordination, which can only be found *within* an organisation.[xxiv]

Consequently there is no foundation, in the intrinsic nature of the shareholder-firm inter-relationship, for any intrinsic control or authority of a shareholder association, or its board of directors, over the firm or its managers. The problem with the orthodox view is that it fails to make the crucial distinction between internal and external relations, and consequently sees the directors as having *authority* over the firm. Hence the view of the directors as the "managers" of the firm.

2.3 Control contracts

We can now deduce a critical conclusion emanating directly from the underlying nature of (a) the firm, (b) a shareholder association, and (c) external (inter-) relationships. If the individual shareholder does not have an intrinsic property right of control over "his" firm, and with no basis for intrinsic control or authority in the inter-relationship between shareholder association and firm, *the only remaining basis for formal control is a control contract between shareholder*

association and firm, effectively giving the directors direct contractual control over the firm. (Informal relations and influence can, of course, always play a role. See previous footnote.)

Below it will also be shown that this channel can explain, to a significant extent, the nature of factual board-management relations, including historical developments like the "separation of ownership and control". Factual arrangements can be seen often to be consistent with, and indeed to reflect, the inherent nature of the underlying structure of relations identified here.

First, the intrinsic nature, origin and existence of the shareholder-association have to be investigated.

2.4 Control contracts and the founding of the firm

In contrast to an institutions like the family, a firm is a voluntary association. One implication is that membership of the firm is voluntary. A second is that such an association has to be constituted by founders, who presumably see the particular kind of institution as a suitable avenue to achieve some end. Therefore the founding of a firm requires an inter-individual act of consensus and the founders coming to an implicit or contractual agreement ("social contract").

Given the economic nature of the firm, the act of founding has to involve the supply of capital to the firm,[xxv] plus provision for a manager or managers - who may or may not be founders - to execute the managing function. Although one assumes that a private capitalist firm is founded with the purpose of earnings or profits, the intended purpose may vary.

In the case of a voluntary association like a social club, the founders normally will also comprise the initial membership. The firm as institution is an important instance where this need not be the case. It has the peculiarity that founders often are neither workers nor, importantly, managers in the firm. This is particularly true for the corporate form of the firm. This introduces two complications which are apparent from conceiving of the founding process in two phases:

(a) Firstly, consider the case of a single founder who does not intend to be the manager of the firm he is founding. To provide for one, the founder must enter into an inter-individual contractual agreement whereby he contracts with some individual to serve as manager.[xxvi] The conditions of this agreement is at the discretion of the parties concerned, but notably involves the conditions under which either party can terminate the relationship. Minimally these could imply certain levels of performance which, if not maintained, allows the founder to "fire" the manager.

The hiring contract can also be seen to have a second part which allows the founder more comprehensive control over the internal operation of the firm. Given the purpose with the act of founding, and given the supply of the capital resources essential for the founding, explicit provision for such control rights in the contract between founder and manager is an expected outcome.

One sees here, as part of the conditions of the hiring contract, the origin of what can be called a *control contract* between the founder and the (top) manager.[xxvii] In principle the ensuing control of the founder over this firm would derive not from any notion of "ownership" of the firm, i.e. from intrinsic property rights, nor from any kind of authority, nor from foundership per se, but from a voluntary inter-individual contractual agreement between founder-capitalsupplier and (top) manager (the stipulations which are at their discretion, within the bounds of the law; how this works in reality is discussed below). This follows directly from the typical, underling nature of the firm, the shareholder association, and the relation between them.

(b) In the case of multiple founders, the formation of a founder association is implied in the founding of a firm. In getting together to constitute the firm, they are (implicitly or explicitly) first founding a founder association. This association is the formal founder of the *firm*, supplying the pooled capital resources of its members and contracting with a manager and acquiring control rights.

Since these founders are initial capital suppliers to the firm, this would explain the existence both of a shareholder association and a hiring contract between the latter and the manager of the firm. This voluntary contract, and only it, would provide a basis for any formal control that a board of directors - duly elected and authorised by shareholders - may exercise over management.

Conceiving of the founding of a firm in such a two-phase manner clearly separates the two voluntary associations, at the same time emphasising the coherence of their origins, as well as the specific nature of the resulting (external-type) inter-associational relationship.

In understanding the underlying nature of the relationship between shareholder association and firm thus constituted, the notion of "ownership" of the firm is neither relevant nor necessary - no matter how much the contract and control rights may resemble, or even be called, property rights. Nor do notions of real authority and subordination enter in this, an external inter-relationship. Apart from custom and legal restrictions, the extent of control rights would depend on the relative economic power positions of the parties to the contract. Any such control always is, in principle, voluntarily entered into. (That such control is voluntarily agreed upon of course does not imply that there is no asymmetric power relation which may or may not be abused.[xxviii])

3. Control contracts in practice[xxix]

3.1 A variety of positive forms

How does this analysis stand up against the variety of positive forms of the firm encountered, also in different legal systems?

The problem with a comparison is that actual legal arrangements and corporate charters are based on the traditional firm-as-property view. Customary corporate law often reflects the idea

that the firm is the property of the founder, and that the founder has full authority, based on property rights, over all activities of the firm. Actual stock certificates seem to imply a direct ownership-founded control right (by vote) over the enterprise. Moreover, the constitutions of the different voluntary associations, and the accompanying inter-associational control contracts, usually are merged into a single charter.

Nevertheless, the "structural" analysis above suggests and allows a plausible reinterpretation of these arrangements and customs. One can see through the variety of positive forms of firms, and recognise the existence of these relationships, albeit in perhaps distorted and often obscured form. That is, factual arrangements can be seen to be consistent with, and indeed to reflect, the inherent nature of the underlying structure of relations that is being uncovered here.

- What seems to be shareholder authority based on ownership, can be seen to be voluntary and contractually agreed upon control (via a shareholder association).
- What seems like one self-governing organisation of owners, managers and workers can be seen to be two separate associations linked by contract.
- A single "management" body of directors and executives can be seen to be two separate organs linked by a (perhaps automatically agreed upon) contract. This applies, notably, even when a director (or directors) is from management, i.e. an "inside" director.

Such dual roles should not be allowed to obscure the essential difference between these organs and between the capacities of director and manager. And the semblance of authority should not obscure the insight that if control is not contractually agreed upon - implicitly or explicitly - there is in principle no a priori basis for shareholder or director control over the firm.

The analysis also applies to non-incorporated forms of the firm, with the difference that interwoven or coinciding capacities occur to a greater extent, often "collapsing" certain relationships. In a single-"ownership" one person is capital supplier and founder (a collapsed founder association), with an absolute if trivial hiring and control contract with himself. In a partnership a few individuals form an implicit founder association (of which they are both members and directors) and hire themselves as managers, implying complete structural overlapping and automatic control of "directors" over "managers". In a sleeping partnership the founder association becomes more distinguishable, with only some founders being directors and/or managers. As fewer directors also act in the capacity of manager, the control relation becomes "opened" and non-trivial.

In general the spectrum of forms of the firm displays different degrees of separation, or differentiation, of the offices of director and manager, and therefore of the shareholder association and the firm. All structural interwovenness between founder association and firm disappears when no person acts as both director and manager, providing a structurally pure, unblurred picture and uncluttered room for the crucial remaining link, the hiring and control contract.

What is essential, is a clear structural understanding even when the factual situation is not uncluttered, when structural interlacements and coinciding capacities are present. This will preclude mistaken conclusions regarding the intrinsic nature, consequences and appropriateness of actual conditions and developments, and will allow a structurally sophisticated analysis of the dynamics of the shareholder-firm relationship.

3.2 The dynamics of contractual control relations

It is being argued that one should be willing to abstract from and inquire beyond the variety of positive forms of the firm, and the various institutional arrangements surrounding it, to some underlying structure of relationships and institutions. As soon as one does that, the usefulness and strength of this kind of analysis becomes apparent. It lies on at least two planes: gaining (further) understanding of historical developments in the firm (to be discussed next), and, flowing from that, forming a new perspective on both past and possible future developments in the firm (see section 4).

This structural approach provides a particularly insightful explanation of the dynamics of control relations, for instance as in the historical developments observed by Berle & Means. Why do "ownership" and "control" often separate, resulting in so-called management control? While the issue has received much discussion in the literature, the structural approach and the idea of underlying relations have much to add. Here the typical nature of a shareholder association is decisive, for its dissolution is what is involved.

3.2.1 Dissolution of the shareholder association

The structural distinction between shareholder association and firm necessarily implies that any perceived problem of ownership and control is not really that of a loss of control by the board over management. The board still exercises its formal powers over management. The difference is that most of the directors are from management, so that the control relation becomes more or less automatic (as in a one-person firm or partnership).

The difficulty is not between individual shareholders and management either. The decisive structural insight is that *the problem is internal to the founder or shareholder association*. It is located in the relation between its members and its elected officers, the directors. The members simply fail actively to exercise their electoral rights, allowing management to get their nominees elected via a nominal voting procedure utilising proxy machinery. But this election still is, squarely, within the separate shareholder association. This is often obscured by the way term "corporate democracy" is used, unthinkingly intermingling or identifying firm and shareholder association (corporation).[xxx]

An essential feature of a voluntary association is the *bond of solidarity* between the members. Without a unifying bond any voluntary association, and therefore also a shareholder association, will disintegrate - as reflected in the dispersion of members and the breakdown of the internal electoral process. Therefore the fundamental cause of the breakdown in "corporate democracy" must be sought in a loss of shareholder solidarity (see below).

Formally the observed separation of "ownership" and "control", and the resulting "management take-over", can be seen to happen in one of two ways:

(a) If, despite the loss of shareholder solidarity, there is no formal dissolution - if the legal system does not recognise the dissolution of the shareholder association (because it does not recognise it as separate from the firm, which continues to exist) - the association merely becomes dormant, and any control contract remains valid if unused. The office of director is kept alive nominally, occupied by managers. Upon subsequent revitilisation of the association due to newfound solidarity, any hiring and control contract can be re-activated.

In this scenario proxy votes are instruments that keep the association nominally alive while acknowledging its de facto demise. This allows the dominance of insiders on the board - a "management takeover". The board effectively functions as a shadow management until such time as the shareholders revive their association, its democratic processes, and its contractual control over the firm.[xxxi]

(b) If a loss of solidarity causes formal dissolution (de jure, recognised by the legal system), any contract between the founder association and the manager/firm would be null and void. The current board of directors would cease to have any legitimacy, as the office ceases to exist. The individual shareholder would be left in a relationship to the firm which does not embody any control contract nor, of course, authority or property rights. As shown below (section 4.2.2), this need not leave him at the mercy of management. (If stockholders were to get organised into an association later, this new association would in principle have no control contract with the firm.)

3.2.2 Explaining the presence or absence of shareholder solidarity

Since problems like those of attempting to organising shareholders have been well aired in the literature, only a number of new insights are added. Again the inherent nature of a voluntary association is relevant.

(a) Purposes and voluntary associations

Being voluntary, the founding of such an association presupposes a perception, among founders, that the particular kind of association can serve some shared purpose. This provides the necessary solidarity for the co-operative act of founding.

In the case of the private capitalist firm, shared convictions about the need for the founder association to ensure, via an appropriate hiring and control contract, that the firm continues to serve the original purpose of earnings on capital, is the basis of the necessary solidarity for the continued existence of that association.

This suggests that the level of purpose achievement, e.g. the level of earnings, acts as an important activator and determinant of solidarity, and of the use of the control contract. This implies that to the extent that shareholders receive at least their expected level of earnings, the perceived need for an association to oversee the firm can be expected to decline. The resulting loss of solidarity may eventually lead to its dormancy or effective dissolution. This clarifies

why the historical breakdown in "corporate democracy" can be (partially) explained by sustained sufficient levels of earnings (see Marris, 1964, pp. 16-17; also section 4.2.2 below).

(b) The role of a stock market

An effectively functioning stock market ensures that stockholding and membership of any shareholder association, which is voluntarily entered into, continues to be voluntary. This undercuts any depiction of the modern shareholder as being "oppressed" by "corporate dictators" (Berle and Means, 1932, pp. 244-5). By enabling a founder/shareholder to quit the capacity of shareholdership, a stock market both protects the individual shareholder and provides him with a channel of "power" with respect to the firm. Such power derives from the well documented constraint that the potential or actual selling of stock places on management autonomy.

This channel of shareholder power (a) would exist irrespective of any control contract or shareholder association, and (b) derives from the fact that capital supply and share-ownership inherently is a voluntary act. It also derives from share ownership as such, and not from membership of any association *or* from a control contract. As such it is the only right, and power, which attaches to share-ownership per se. It is also, in particular, a *typically economic* way of "having a say". That this right is likely to be activated by the level of earnings, stresses the critical importance of the basic responsibility that management has towards its capital suppliers to provide at least an expected or average level of earnings (determined in the context of a stock market, say).

This selling or withdrawal right provides another explanation for a loss in shareholder solidarity. The perceived need for control can be expected to decline insofar as there is a stock market through which shareholders can exercise their withdrawal right. Accordingly the development of stock markets is, and was, bound to bring about a changed relationship between shareholder and management, transforming the former from someone seeing himself as an "owner", to an investor and holder of a tradeable asset. The accompanying decline in the incentive to sustain a shareholder association would be quite natural.

(c) Interlocking structures

An important "structural" cause of solidarity is when a bond more or less unrelated to the purpose in founding the firm - a non-economic and a-typical bond - is superimposed upon the relationship between these individuals. More specifically, the superimposition of another social structure upon the founder association is a potent source of unity and solidarity, often keeping any control contract much alive.

A bond most notably present, especially in earlier forms of the firm, is that of the family.[xxxii] If all founders are members of the same family, it produces a bond which is independent of the level of purpose achievement, and which can unite the (implicit) founder association. The so-called entrepreneurial corporation is a prime example, where family dominance of the founder association enables family members to have themselves elected as directors and "hired" as top

managers. In this context "owners" can be seen to have a role in management insofar as the family is interwoven with "ownership".[xxxiii] As a firm has to go outside the family circle for financing, the significance of this superimposed bond decreases, leaving only such solidarity as provided by the level of earnings (also see 5.2.2 above).

The notion of another social structure being interwoven with the shareholder-association - the idea of interlocking structures - has quite general application. It occurs whenever another organisation owns a number of the shares of the firm, thus holding the corresponding votes within the shareholder association. This is what is essentially involved when one firm "owns" another, as well as in corporate take-overs: one firm interlocks or overlaps, not with the "owned" firm as such, but with its shareholder association (at least sufficiently to ensure electoral control).

This also applies when the State is in the role of the overlapping structure - when it owns, as sole or co-founder, shares in a firm. In this perspective the pure government corporation is an extreme case where the State as sole founder owns all the shares: it subsumes the founder association, and enacts any control contract. However, this does not change the fundamental nature of the concerned relationships. The firm is still a separate institution, and the picture is structurally unaffected by "State ownership of the firm".

An important conclusion of this structural analysis is that, in this specific sense, the "ownership" of the firm is irrelevant. A firm is a firm is a firm, no matter which non-firm structure may be interlocked with its shareholder association (although misuse of any concomitant control may imply a very much distorted form of the firm).

3.2.3 The complication of non-founder shareholders

Positive law usually makes no distinction between founder and non-founder shareholders, and all shareholder ("property") rights with respect to the firm are transferred upon a sale of shares.

The analysis above raises the question whether a new, non-founder shareholder should be regarded as a member of the original association (which holds any control contract with management). Formally this depends on the conditions for membership of this association. What can be argued is that, since this association was explicitly founded by the founders of the firm, membership should be conditional upon being a founder capital supplier (a non-transferable capacity). This would imply that the new shareholder should not be regarded as a member of the association, and should have no vote. This would reflect that the "share" he owns is in principle a derivative of capital-suppliership, while the control contract is a derivative of foundership. In this way eventual selling of stock by founders would lead to the dissolution of the founder association, and the expiration of the control contract.

The upshot would be a shareholder as capital supplier pure and proper. Given a stock market, this would leave the essential voluntarism of this capacity intact, plus the potential effect of stock sales on the firm's access to capital as an important channel of shareholder power. The absence of a contract would thus not leave management unconstrained or the shareholder at the

mercy of management. But the shareholder would be purely an investor, with no notion of direct control, authority or property rights. (This possibility is further discussed in section 5.2.)

3.3 Historical perspectives on the corporate revolution[xxxiv]

The essence of the structural approach is the distinction between various organisations or associations, and ensuing implications for particular kinds of relationships between these associations. This allows a very different interpretation of historical developments in the institutionalised form of the firm. This particularly relates to the "corporate revolution" so enthusiastically analysed in the Berle & Means tradition, and equally enthusiastically disputed by the Chicago School and property rights traditions. The legitimacy of both these viewpoints, each with clear normative intent, is challenged by the analysis presented here.

In a historical context the crucial structural idea is of the firm - explicitly taken to be a distinct social organisation or institution (cf. footnote 5) - becoming clearly distinguishable amidst a complex, obscuring web of interlacements with different institutions and associations. Most important are the family and the shareholder association.

The first important element in the process is the role of solidarity in a structural or institutional context:

(a) The notion that one structure, the family, can impose a non-economic bond on another, the shareholder association, helps to explain the effect of the historical dispersion of shareholders. As the scope of production forced family-held firms to go beyond the family circle for financing, the significance of the family bond decreased within the founder association (cf. Francis, 1980). Eventually the imposed or "artificial" solidarity provided by the (non-economic) family bond became irrelevant, leaving only such (economic) solidarity as provided, for example, by the level of earnings.

(b) Solidarity also concerns the internal (non-artificial) sources of coherence of a voluntary association. The increased need for capital from "outside" investors, plus the general increase in the number of corporate firms, created room for stock markets. Enabling voluntary withdrawal from shareholder associations, these obviated the need for direct shareholder control over firms, and transformed the shareholder from someone seeing himself as an "owner" to an investor and holder of a liquid asset. This explains the historical decline in the incentive to sustain shareholder solidarity and democracy, the disintegration of the (voluntary) shareholder association, and the change in the shareholder-management relationship which left management to operate more freely.

The recognition of different societal structures also enables a second important structural notion, i.e. of the historical *separation or differentiation*, into a more or less pure structural picture, of the three different societal institutions (structures): family, shareholder association, and firm:

(a) The way the role of the family decreased within the shareholder association suggests that the "corporate revolution" involved, inter alia, a separation and differentiation of the family and the shareholder association.

(b) Related to, and accompanying or following the latter change, a modification occurred in the relationship between shareholder association and firm. Like the changes with

regard to the family, the decreasing involvement of shareholders/directors in the internal management of the firm - the historical differentiation of the offices of director and manager - can now be seen to have involved the separation of the firm from an earlier tight interwovenness with the shareholder association.

Taken together this historical development process appears to have involved, from an initial three-level interwovenness or superimposition of structures, the firm moving out from under two very different institutions. Given the way family considerations may have been decisive in management decisions earlier, this change can in a real sense be described as the *freeing* of the firm as institution from earlier domination by the family. In turn this suggests that also the subsequent differentiation of the firm from the shareholder association can be depicted as a process of *disentangling* from earlier domination. This implications of this conclusion, which shows why the re-interpretation of corporate history above is of much more than descriptive interest, will be discussed below.

It is worth considering a second reason why there may be more to the analysis than a descriptive re-interpretation of history. This is concerned with an inquiry as to the reasons for the changes occurring in the specific way uncovered above.

An essential question raised by the analysis is whether the historical changes in the shareholder-firm relationship were more or less coincidental. More specifically the question is whether the intrinsic nature of the underlying associations and relationships were not much more than structural parameters of the process, but in fact were *enabling factors*, even causal factors, in the differentiation process.

Given the intrinsicality of elements identified above - the firm comprising people, the essential voluntarism of both the firm and the shareholder association, the internal limits of an electoral process, the role of purposes in the founding of voluntary associations, the absence of authority in (external-type) relations *between* associations, and so forth - one can argue that the historical development of the firm could not but reveal and manifest the underlying characteristics of the concerned relationships and institutions.

This suggestion also concerns the general relation between positive or legal forms of the firm and the inherent nature of the firm. If there is such an underlying, ultimately determining structural framework, it suggests that even if, for example, a legal system bundles everything together and regard shareholder-firm relations as property relations, *the nature of the relations ultimately tends to prevail or make its influence felt in one way or another* - as evidenced in the de facto dissolution of the shareholder-association when earnings are satisfactory or when an effective stock market comes into existence, etc. In this specific sense the structural developments of the "corporate revolution" may have to be described as natural.[xxxv]

4. Normative perspectives on the firm

Depicting the changes in the corporate set-up as "natural", and the use of terms like "disentangling" and "domination", are non-neutral. The normative implications of the structure of relationships surrounding the firm, plus the idea of a historical separation of institutions, are very important. These differ from those proffered by the Chicago School *and* the Berle and Means traditions. Suffice to mention a few:

(a) Given that capital supply or shareholding should not to be equated with "ownership" of the firm, any absence of control cannot be decried as a violation of *property* rights. A description of modern corporate managers as dictators who suppress the property rights of owners, is inappropriate (even for a critic of actual managerial behaviour) - without denying that any control rights can be open to abuse via the misuse of economic power, for example.

(b) The development of the corporate form of the firm, plus the accompanying phenomenon of shareholder apathy, need not be evaluated negatively. On the contrary, it may indicate the natural evolution of a more developed, and in any case more independent, form of the firm - its "coming of age" and development into a separate and distinctive social institution. The Berle & Means (1932) type of concern over the managerial revolution - seeing the shareholders as disenfranchised orphans of the business system, for example - is inappropriate.

(c) More specifically, an insight that flows directly from the structural distinction between firm and shareholder association, is that a decreased interwovenness between firm and shareholder association can be viewed as an *emancipation* from an earlier period of domination by the shareholder association. This has a major implication, i.e. that:

(d) Unconditional shareholder control (domination) have to be appraised negatively. It appears as the subjection of an entire social organisation to the interests of one group of people, its capital suppliers, and as a potential threat to the integrity of the firm. While the critical role of the level of earnings stresses the basic responsibility of management towards shareholders, and indeed protects shareholders by constraining management, the analysis also suggests an upper limit to this responsibility. Shareholder domination precludes this. In this context the outcome of the "corporate revolution" - the transformation of "owners" to investors - must be welcomed.

(e) The discussion of non-founder shareholders suggests the possibility that the founder association should be allowed to dissolve formally (legally) when founders sell their shares. Non-founder shareholders should perhaps not be regarded as members of the founder association, and should therefore not have access - via voting - to a control contract. This would leave the shareholder with all the protection and elements of economic power described above, but he would be purely an investor. This would leave the emancipation of the firm - with a very specific but circumscribed responsibility towards shareholders and capital suppliers - well nigh complete.[xxxvi]

(f) Such emancipation would not necessarily imply that management is free to do as it pleases. The interests of other parties - workers, consumers, society at large, the environment

- would now come into play without having to struggle for legitimacy against the overriding "inalienable rights of property owners". In a truly emancipated firm the real possibility appears of considering a wider set of responsibilities and interests which have to be balanced against one another. Of these the interests of shareholders are only one, albeit a critical one (given the importance of capital in the continued existence of a firm).[xxxvii]

(g) This implies, finally, that the view of Friedman (1972, pp. 141-7) that the consideration of any managerial responsibility other than towards shareholders, e.g. social responsibility, amounts to allowing a corporate manager to spend other persons' money in a way they would not have wished, is inappropriate.

5. Implications for the theory of the firm

The debate on the theory of the firm is intimately linked to questions of the "ownership" of the firm, the position of managers vis-à-vis shareholders, and the directly related issue of goals and motivation (cf. Sawyer, 1979; Putterman, 1986).

Whilst it has been argued that the neo-classical theory of the firm is only a mental construct and not intended to reflect the activities of real firms (Machlup, 1967, pp. 14-15), traditional economic theory is steeped in a very definite concept of the real firm. This is the view that the firm is run by an individual *owner* who is a profit maximiser (Shubik, 1970, p. 411). Large corporate firms are merely "inflated entrepreneurs", enabling the retention of the single objective of profits or owner welfare (Sawyer, 1979, p. 9). This view of the owner-controlled entrepreneurship has guided most economists' and businessmen's thinking for the last two centuries. It is built around the concepts of private property, private enterprise and the profit motive. It fits into a larger view of the (perfectly) competitive market which compels the firm to maximise profits.

In contrast stand the managerial theories of the firm, prompted by the perceived unrealism of the entrepreneurial model in advanced, corporate economies (cf. Sawyer, 1979; Marris & Mueller, 1980). Here the separation of "ownership" and control, manager discretion and the pursuit of goals other than profit maximisation, are fundamental (e.g. Baumol, 1967; Williamson, 1964; Cyert & March, 1963; Marris, 1964). Prominent is the idea of minimum earnings or stock market value as a constraint rather than as the dominant goal of the firm.

The "structural" analysis above has the following implications for the debate on the theory of the firm:

(a) The traditional (neo-classical) profit maximising model appears to be based on a historically undeveloped and unemancipated form of the firm, where the capacities of capital supply and managing still coincide, and where the shareholder association is still dominated by the family, and the firm by the shareholder association. On the other hand the managerial theories recognise a more emancipated, and structurally more developed, form of the firm, where the various structures and capacities have been separated out. Neither set of theories can be applied to the entire "developmental spectrum" of forms of the firm.

(b) The (approving) view, in traditional theory, of the firm as an owner-controlled singular profit-maximiser implies (and subtly supports) the total devotion of an entire social institution to the interests of its capital suppliers, and a distortive overemphasis of the role of capital in the existence of a firm.

(c) In simply assuming that owner control implies profit maximisation, neo-classical theory disregards the indications that the inherent nature of the different relationships do stubbornly manifest themselves in the positive form of firms, shareholder associations and associated inter-relationships. Managerial theories at least acknowledge these manifestations, although they still operate within the conceptual context of "ownership" relations.

(d) The goals actually pursued by the firm must be understood as dependent upon the extent and nature of interlacement with other structures, the degree of shareholder solidarity, and the historical development phase of the firm.[xxxviii] As long as the shareholder association is sufficiently interwoven with the firm (as long as the board of directors overlaps sufficiently with management), the control relation will be more or less automatic, and the goal of the shareholders is likely to be pursued - profits in the case of a private capitalist firm. When the so-called managerial revolution has occurred, i.e. when board an management do not overlap significantly, the relevant issue is the external power- and control-relation between the shareholder association and the management of the firm. In this case shareholder solidarity is crucial, as is the fact that the firm may be free to pursue other objectives as long as it fulfils its first responsibility towards capital suppliers (a minimum profit level).

In general, to the extent that a significant degree of structural overlap or interwovenness with the shareholder association exists, and given the continued de jure validity of control contracts, a meaningful impact on the goals pursued by the firm can be expected. This would depend on the particular institution(s) being interwoven with the shareholder association. If another firm (e.g. a financial institution) becomes significantly interwoven with the shareholder association and so imposes shareholder unity, its particular goals may be pursued. A high degree of State interwovenness could, but need not, imply stress on goals of a public nature (employment creation or infrastructure development). Labour union or worker involvement could imply a stress on worker interests. Family domination could imply profit as main goal, or secondary goals concerned with family interests. Significant interwovenness of non-economic institutions such as churches, foundations or trusts could put broader social or welfare goals on the agenda. (This may imply that the analysis of power, coalitions and games is very applicable here - not in the context of the firm, but of the shareholder association.)

On the whole the nature and degree of structural interwovenness becomes an important explanatory factor in the theoretical analysis of the firm. This interwovenness could also be influenced by the stage of development of firms, e.g. some "youthful" firms may still show significant family domination, or firms originally initiated by the State more State domination. As, or if, any such domination disappears, the resulting loss in solidarity would open the way for increased management discretion in the determination of goals. These would then have to be determined within the context of the different interest groups appealing to the firm: shareholders, workers, consumers, and so forth.

A variety of purposes may thus be pursued by firms, depending on the nature and strength of structural interlacements, which may vary over time. A theory of the firm which posits a singular goal therefore is inappropriate, structurally uninformed and a-historical. More generally, the theoretical acknowledgement of emancipated forms of the firm calls for a more emancipated theory of the firm that is more in tune with real firms.

6. Conclusion

The main contribution of the insights developed in this paper is the following. Based on an analysis of what appears to be the inherent nature of institutions and relationships, it shows that the current forms and interlacements of the associations and relations in and around the firm are based on the unfounded notion of firm ownership; secondly, that alternative arrangements which respect the structural nature of these relationships, can and should be instituted. It opens up possibilities for the constitution and organisation of firms that do not appear in a conventional analysis of the shareholder-firm relationship.

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Footnotes

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ii The latter is done by pursuing goals other than maximum profit - with the theoretical implication that non-profit maximisation, or managerial discretion, theories of the firm were required.

iii See Graham (1989) for a discussion of the issues raised by the Berle-type, or so-called *pluralist*, approach - as opposed to the *classical* and *neo-classical* models of the company (where the latter, in contrast to the classical, extends the idea of product market discipline to the markets for corporate control and corporate services).

iv It is not only in Chicago School context that the idea that shareholders have in fact lost control of firms, i.e. whether the managerial revolution has actually occurred, is disputed. See, for example, the argument of Pitelis and Sugden (1986) concerning the de facto control of a minority of shareholders in many cases. Francis (1980) provides additional empirical evidence, and also illustrates the need to move away from a simple either/or analysis of owner versus managerial control, since different nuances are possible.

v In opposition to both is the Marxist/socialist viewpoint, with fundamentally disapproves, in *its* turn at normative judgement, of this same picture. Shareholders/capitalists in fact do, in capitalist societies, have control over the firm and especially the workers, and exploit workers in the pursuit of profits. Capitalists, and their handmaidens, the managers, should not have control; workers should control firms, and manage it in their interests. Alternatively, or as an interim arrangement, the state should own firms and run them in the interests of the workers/people. Conventional, neo-classical economic theory is an instrument to justify the status quo, and should be rejected entirely.

vi That is, the shareholder should be "kept in his place" - a phrase borrowed from Arthur Okun, arguing in a different but related context that "the market needs a place and the market needs to be kept in its place".

vii A theoretical implication of this argument is that the neo-classical profit-maximising model is based on an unemancipated form of the firm, and implies a distortive overemphasis of the role of capital in the firm. The theoretical acknowledgement of emancipated forms of the firm calls for a more emancipated theory of the firm.

viii Factual arrangements will be shown often to be consistent with, and indeed reflect, the inherent nature of the underlying structure of relations that is being uncovered here - although often in distorted or obscured form.

ix These are not the kind of matters that can be settled in the manner prescribed by the methodology of positive economics. It is on the conceptual level, which has to precede something like empirical testing. "Choosing between ... competing views of the world is not merely an empirical matter. The differences are conceptual, with normative implications" (Graham, 1989, p. 200). As will become clear, the analysis suggests and requires a methodological understanding somewhat different from the simplistic positive/normative, or "what is/what should be" distinction.

x Others, notably the individualist and contractarian approaches (Alchian & Demsetz, 1972; Jensen & Meckling, 1976) see the firm as a "contractual team" or as a set of contracts between autonomous individuals engaged in market exchanges. For an internal critique of the individualist/contractarian approaches which asserts that the associated view of the firm is excessively individualist, and indeed "disintegrationist", see

Fourie (1989), who simultaneously argues for the acceptance of the firm as a societal whole. The latter contribution is another example of an approach that builds on the idea of an underlying nature of relations.

xi This becomes clear as soon as one realises that, formally, any subjective juridical rights (such as a property right) necessarily presupposes a legal *object*, i.e. existence of a subject-object relation. A person or group of persons can, however, not be the legal object of a subjective legal right, for juridical relations between persons or groups of persons are relations between juridical subjects, i.e. they are subject-subject relations, not subject-object relations. The important thing is that the former at most allows one juridical subject to have a juridical competence to exercise authority over another subject or to demand fulfilment of contractual obligations from another subject, but specifically excludes something like ownership rights (or other subjective juridical rights). Accordingly a team or organisation of people such as a firm cannot be reduced to being the object of a property right, cannot be owned by a person or group of persons.

xii In a critical analysis of the handling of property in orthodox economics, Ellerman (1980) stated the thesis that ownership of the firm is a myth, that there is no necessary identification between the corporation and the firm, and that the prerogative of capital to control the production process is unfounded. Although the analysis of the present paper derives independently and from a quite different perspective, the two contributions do relate to each other. Also see Fourie (1990).

xiii Membership is understood to include (internal) managers and workers/employees. Regarding what is understood under the term "manager", see sections 1(d) and 2. Fourie (1989) discusses the reasons for viewing employees/workers as members of the firm. Also see Knight & Sugden (1990:96-103).

xiv Indeed, one can argue that the intellectual onus is on the orthodox view to provide an *a priori* foundation for the position normally assigned to the shareholder.

xv Of course this departs from the views of the likes of Alchian and Demsetz (1972) who deny the presence of authority within the firm, or between managers and employees; see Fourie (1989).

xvi Here is one instance where one must immediately see beyond current positive law arrangements. In many countries shareholders are regarded as members of the corporation. Below I will suggest that there are structural reasons for the corporation (as an association of shareholders) and the firm (as a productive organisation) to be distinguished. In that case a shareholder's membership of the corporation is not equivalent to and does not imply or require membership of the firm as such.

xvii See Rostow, 1960, p. 63; Marris, 1964, pp. 12, 14; also Berle & Means, 1932, p. 197; also see Graham, 1989.

xviii Given the hallowed status of property rights in Western culture and of something founded in property rights, the relevance of this is much more than semantic.

xix This is not the kind of matter that can be settled in the manner prescribed by the methodology of positive economics, since it is on the conceptual level, preceding empirical testing. In any case the scientific grounds for convincing a reader includes (a) the plausibility and (b) the non-inconsistency of the suggestion with observable reality. Novelty and uncommonness - or even the fact that a reader may not be convinced - does not in itself detract from scientific plausibility.

xx Of course the voters can instruct the officers to, in accordance with some competence, do things which may affect other individuals or institutions. But then it would be the association as a whole, as an institution, acting in this way. And it should not confuse us as to the insight that an individual vote only has internal elective significance.

xxi In Germany public limited companies (AG's) have a two-tier board structure composed of a board of management and a supervisory board. The former is appointed and supervised by the latter, but the supervisory board does not take steps in the actual management of the company. Its members are chosen by the shareholders. See Graham (1989, p. 211).

xxii This distinction undercuts the notion that shareholder voting provides democratic legitimacy to the authority of management. The squabble about "self-perpetuating oligarchy" versus "corporate self-government" (Mason, 1960, pp. 1-9) therefore rests on a false conception of the relevant relationships. Improving corporate democracy can only affect the legitimacy and mandate of directors, can in principle only improve shareholder control over directors, and can only revive the voice of "owners" within the shareholder-association.

xxiii The orthodox view seess this as the director as having authority over the firm, and indeed as a manager of the firm.

xxiv Of course there is always room for informal relations and influence based on expertise, status, tradition, etc. This is also true for other forms of external (inter-)relationships, e.g. neighbourhoodship. The structural picture remains unaffected, however.

xxv In general one can distinguish the capacity of foundership and that of capital suppliership. Although in the case of a private capitalist firm these usually coincide, a variety of arrangements can exist. In the case of a worker-founded firm, for example, the founders can use external financing, for instance. The capitalist firm

thus should be understood as an illustration of a more general structural way of looking at the foundership and capital suppliership situation.

xxvi This is what is usually called, erroneously, the "employment" of the manager by the founder. If one defines employment proper as implying membership of the firm (Fourie, 1989), this cannot be true employment: the founder and the manager are not bound into one structure/organisation, but are members of two distinct associations. This does not rule out a contract between directors and managers, but such a contract should not be regarded as a true employment contract. It is a external subcontracting agreement. Therefore any control that my be implied by such a contract is not true authority.

xxvii In cases where the founder himself acts as manager, there is a coincidence of what can still be seen to be two capacities. This implies an absolute if trivial control contract.

xxviii For a discussion of the relation between voluntarism and power in market relations, see Fourie (1991).

xxix The structural approach presented above may straightforwardly be interpreted as a preferred set-up, as a view of how things should be. As noted, it clearly has "normative" implications, and these will be discussed in section 4. However, there is another dimension, which is that the notion of an underlying nature of relations is in the category of "what is" - whilst still being something different from what usually is understood under "what is", i.e. the observable, factual appearance of the variable forms in which firms and corporations appear. What is of concern here, is a deeper level of "what is", and one with a significance and a consequence that is both "positive" and "normative" (in the conventional sense) - the underlying nature of relations may to a large extent determine observable forms, and also have normative implications for observable forms. As indicated before, the issues raised here takes one beyond standard positivist methodological distinctions.

xxx This implies that the phases of the historical separation of ownership and control that Berle and Means (1932) identify have to be understood within this framework. The consecutive losses of control by shareholders can only relate to their reduced internal control over their directors who then achieve approximate autonomy upon too wide distribution of stockholdership.

xxxi From the point of view of management this renders the board of directors harmless, and protects the firm against misuse of the still existing control contract. This interpretation contrasts sharply the view of the managers nastily usurping the legitimate (property) rights of the "owners", reducing them to "voiceless orphans".

xxxii Aspects of the role of the family in firms have been examined by, for example, Francis (1980), who also considers the provision of finance. He also shows that family control in modern times is not uncommon.

xxxiii In the unincorporated form, the firm is so dominated by the family that it is not yet constituted as a separate structure, with no real question of separate director- or managerships. Founder, director and manager all coincide in the same person(s). Yet, in this more or less "collapsed" situation the structural analysis still applies, if almost trivially.

xxxiv The structural analysis developed here was largely based on the historical information and analysis in Chandler (1977). A similar source, in the British context, is Hannah (1983).

xxxv The use of the term natural is a risk. It should be clear that it should not be interpreted as implying either (a) that whatever positive forms or conduct transpires is acceptable or good in a normative sense, or (b) that the approach adopted here is a variant of the efficient social structures approach found in the Austrian economics literature. Since an in depth discussion of this suggestion, which has important methodological implications, especially concerning the positive-normative distinction, would take us outside the ambit of this paper, it is not pursued further here.

xxxvi As noted above, in many cases it can be argued that this is what has happened in any case, that the demise of corporate democracy is but a reflection of this underlying principle, that the nature of this underlying structure of relations ultimately prevailed. The existence of stock markets has ensured that the position of the shareholder purely as capital supplier, has ultimately prevailed - if not de jure, then de facto.

xxxvii Graham (1989, pp. 204-207) discusses ways that have been proposed to deal with non-shareholder interests, e.g. worker directors or public directors. However, these propositions still work within the shareholder-as-owner paradigm, and therefore faces potential problems that the structural approach suggested here, would escape.

xxxviii The idea that the behaviour of firms may be conditioned by their historical development, is in itself not new (see, for example, Francis, 1980, and Hannah, 1983). However, the identification of the structural element in this historical development is novel.