

Governance of the modern corporation

The most common form of capitalist business enterprise, the limited liability company, has a legal status or *persona* separate from owners or shareholders. Three features arise: debts incurred are the firm's, not the shareholders', whose maximum liability is restricted to their original financial outlay; the identity of the firm is unchanged should any shareholders transfer their ownership title to a third party; contractual relations are entered into by the firm's directors.

Limited liability permitted large-scale enterprise

It is widely agreed that the move to large-scale industrial enterprise was facilitated, and indeed made possible, by limited liability. The threat of potential confiscation of an individual's total wealth should part of it be invested in an unsuccessful company was removed. Moreover risk could be further reduced by investing in several and not just one firm. Large sums of untapped personal financial capital became available after the advent of limited liability. Transferability of shares permitted continuity of business operation not present in other forms of enterprise. The existence of the firm as a separate contracting *persona* permitted a productive division of labour between risk-bearing capitalist and business administrators.

Schumpeter criticised this division of labour as 'absentee ownership' which pushes 'into the background all ... the institutions of property and free contracting ... that expressed the needs of economic activity'. Others, such as Hessen, take the contrary view: limited liability and the joint stock firm are creatures of private agreement, not the state. Freely negotiated contractual specialisation is a device for greater efficiency in meeting private wants, not a shrinking of responsibility.

Historically limited liability was a state-created benefit awarded by fifteenth-century English law to monastic communities and trade guilds for commonly held property. Likewise in the seventeenth century, joint stock charters were awarded as circumscribed monopoly privileges to groups such as the East India and Hudson's Bay Companies. The two properties were amalgamated by a 1662 Act of Parliament. Many entrepreneurs, banned by law from adopting the corporate form, simply copied it using the common law provisions of transferable partnership interests alone or together with those of trusteeship. Indeed it was through those mechanisms that the British canal and railway systems were financed and managed in the 1780s-90s and the 1830s-40s respectively. The Bubble Act 1720, which was passed to suppress such innovations, failed and in 1844 the Companies' Registration Act effectively repealed it, setting up a registry for corporations which made their establishment cheap and easy; the state's role became simply that of a recording agency. The 1844 Act was amended in 1856 to provide limited liability to all registered companies. Thus it could be argued that either the selective legal privilege of limited liability was extended to all or alternatively that legislation was merely catching up with the reality in the financial market-place, namely that the characteristics of the corporation appeared without the need for government intervention. Nevertheless, corporations appeared in large numbers after the institution of limited liability.

Prior to that, and still numerically important in the 1990s, most businesses were conducted by sole traders and unlimited partnerships of two or more people. Incorporation encouraged firm growth and, except in the smallest corporations, shareholders participated less in day-to-day management. In the UK this growth continued well into the twentieth century resulting in an increasing concentration of industry.

Large scale reduced costs

Firms initially grew to obtain the advantages of scale economies and of monopoly power. The latter was perceived to be especially true in the USA where men like Rockefeller and Carnegie built industrial empires in the oil and steel industries. Congress, fearful of the consequences of industrial size, passed the Sherman Anti-trust Act in 1890, and firms such as Standard Oil and American Tobacco were ordered to divest themselves of assets and split into separate firms. In the next three-

quarters of a century many US firms took alternative growth routes, partly to minimise their visibility to trust-busters and partly to obtain the benefit of diversification. Risk-avoidance was obtained by spreading the company's efforts over a range of domestic markets for different products, or by expanding abroad with the original product range. These activities were mirrored elsewhere by British, German, Dutch and Swiss firms such as ICI, Hoechst, Philips and Nestlé respectively.

Customers prefer lower prices and better products

Some observers are concerned at the levels of industrial concentration. They argue that as a consequence prices are uncompetitively high, that very large firms become inefficient and reluctant to change and innovate. Others argue that concentration varies industry by industry and is determined by technology or is a reward for innovation and efficiency. Large firms become large only by winning the consumer's approval. The leading firms are also changing, and the leading 100 firms of 1900 were very different in both identity and in ranking from the leading 100 in 1990. Firms must either change as demand and supply conditions change or forfeit any position they have won through previous successful responsiveness to market conditions. This view holds that provided entry to and exit from an industry are easy, concentration levels need not be a cause for concern. The issue of whether industrial structure determines firm conduct and performance, or whether firm performance and conduct determines industrial structure, is still unsettled. If there are barriers to entry imposed by regulations, the truth may embody both theses.

Providers of risk capital are rewarded by customers

A further area of debate is the degree to which incorporation and what Berle and Means called the consequential 'divorce of ownership from control' has resulted in managers pursuing goals different from the maximisation of profit. Alternative theories have been put forward suggesting that managers pursue sales or asset growth, size *per se*, or maximise utility functions containing both financial and psychic variables. In most cases these alternative goals are subject to a minimum profit constraint which, if not met, would result in a takeover by another firm, loss of managerial job security and so a return to a profit target closer to that of maximisation. Proponents of these views argue that these alternative goals result in different patterns of firm behaviour if the external environment changes (for example, a flat rate tax on profits does not affect a profit maximiser's behaviour, but a sales maximiser subject to a minimum profits constraint would reduce output and raise price). Defenders of the traditional theory (such as Manne) argue that efficient stock markets, via the takeover mechanism, ensure that managers depart but little from profit maximisation. To the extent that they do, this is a cost borne willingly by owners to achieve the net benefits of specialisation of function between risk capital providers and the more risk-averse providers of managerial expertise.

Capitalists delegate to managers

The issue then becomes one of how best to minimise this agency cost. In countries such as Sweden, Switzerland and South Africa, pyramidal holding companies controlled by a few dominant shareholders are common. Proprietorial family groups such as the Wallenbergs or the Oppenheims control an array of companies while owning only a small percentage of the total capital. But this fraction notwithstanding, it represents a large proportion of the proprietors' wealth, motivating them to control management rather than to sell out if the companies controlled are not run in the proprietors' interest.

But shortsighted company law and antitrust can damage the system

In Anglo-Saxon countries such forms of corporate control are either discouraged or illegal. Roe documents the history of legal and political restraints on the control of US corporations by financial institution such as J.P. Morgan at the turn of the century and others such as insurers, banks and unit trusts today. Black and Coffee argue that similar less formal restraints were placed on British bank

ownership of shares by the Bank of England and that while UK institutions have been major shareholders for some decades they have been reactive rather than proactive owners. Thus the divorce of ownership from control in Anglo-Saxon countries, where not offset by the takeover mechanism, is on this view, exaggerated – by governmentally created constraints and prohibitions on minority proprietorial ownership structures which give disproportionate power to such owners, or by constraints on bank and institutional ownership, or by the ‘free rider’ problem. (Thus an institution with 5 per cent of shares acting on its own to improve corporate performance would gain 5 per cent of the benefits, and the remaining shareholders would reap the remaining benefits while incurring none of the costs.)

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