THE SEPARATION OF DIRECTORS AND MANAGERS: A HISTORICAL EXAMINATION OF THE STATUS OF MANAGERS

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ABSTRACT

While management emerged as a distinctive function at the turn of the 20th century, managers have no particular status in law compared to directors. This article examines how technological and innovation concerns motivated the rise of management; but shows that they have been largely overlooked by company law since 1945.

INTRODUCTION

The emergence of management as a distinctive "social stratum" (Child, 1969: 14) around the turn of the 20th century is recognized as a major breakthrough for industrial relationships and organizations. But paradoxically, the role and duties of managers are hardly distinct in law from those of directors. Corporate law seems to suggest "as patently is not the case – that the institutional function and legal roles within the corporation [of officers and directors] are the same" (Johnson et al., 2005: 1601).

While past research have extensively discussed the relative position of shareholders and directors, the aim of our article is to shed light on the separation of ownership and control by documenting *by examining the rationale for the distinction between managers and directors and the way it was received by law.*

To do so, our study confronts management history and legal history. It makes two methodological choices: As legislation varies between countries, and in order to have consistent data, we examine the evolution of law in a single country, even though we anticipate that the general movements we observed are probably also followed in the other Western European countries (some evidences are available from France, Belgium, Germany and Italy but would need further investigation). We chose to examine the UK because the UK showed itself to be among the most willing to make radical changes to the relationship between shareholders and directors, and has exercised a significant influence on global corporate governance through its practice of issuing soft law codes that increase accountability of managers to shareholders. Similarly, we do not study all the factors, sociological, political or financial, that drove the emergence of management. Rather, we specifically focus on the role of innovation. At the end of the 19th century, as technological and scientific progress sped up, the rise of science-based industry urged new roles for management. Management's role was not (only) to rationalize production and to reduce costs but it was also to devise innovative strategies and develop new organizational capabilities. Although limited, this focus on innovation allows us to identify some fundamental reasons of the distinction between the role of directors and that of managers.

SEPARATION OF OWNERSHIP AND CONTROL: ECONOMIC AND LEGAL VIEWS

Since the seminal book of Berles & Means (Berle & Means, 1932), the separation between ownership and control has continuously been a matter of lively debates. Beyond the discussions on when and how this separation took place in the different countries (Cheffins, 2001, 2008; Coffee, 2001), the foundations and reality of the separation are critical both for management and corporate governance. They delineate the sphere of intervention of shareholders in the management of the corporations. The separation of ownership and control thus shapes the conditions for managerial discretion (Finkelstein & Hambrick, 1990; Hambrick & Finkelstein, 1987; Phillips, Berman, Elms & Johnson-Cramer, 2010; Wangrow, Schepker & Barker, 2015). Different perspectives have been put forward. On the one hand, the economic literature has focused on the agency relationship between shareholders who bear the risks and those in the position of running the companies. It suggested that there is a need for more accountability of "principals" to their "agents", either through supervision by the principals or through other mechanisms that align their interests. On the other hand, accounts from law emphasize that directors, on the contrary, are not agents of the shareholders, and that the separation between shareholders and directors is legally grounded and economically sound because it supports specific investments of the different constituencies (Blair, 1995; Blair & Kruse, 1999). Besides, the separation between ownership and control is seen as a condition for stakeholder management (Johnson & Millon, 2005; Lipton & Rowe, 2007). As noted by Dai & Helfrich (Dai & Helfrich, 2016):

"Despite the necessary tensions intrinsic in this relationship, there are substantial benefits to this separation as well, namely creating a more efficient capital market system in which investors are able to use their time to invest rather than govern, but more significantly, allowing corporations to be more than pure profit maximizers and simultaneously prioritize stakeholder interests and corporate social responsibility."

Yet, many authors have observed that in practice, shareholders have great influence on management (Zeitlin, 1974). This influence is all the more important with the rise of institutional investors in the past decades. And it is obviously not prevented by law: in law, directors are appointed by shareholders, with the latter given an exclusive and ultimate right of control (Kaufman & Englander, 2005; Millon, 2013; Yosifon, 2014).

In these debates, the absence of an explicit legal mandate for manager appear crucial. Where management was strongly transferred by board to directors to *managing directors* in the early 20th century, the historical emergence of management was accommodated within existing legal structures, rather than supported by a positive legal regime. Managers were viewed as employees, and were never endowed with any special authority. Their function was never separated conceptually and clear from that of the directors.

The effect was that the managers below board level, whilst treated as representatives of the employer in labour law, were simply viewed as employees from the perspective of company law, capable of being dismissed and restrained from divulging trade secrets, but not viewed as having any other special status.

Yet, there were strong rationale for the emergence of management as a distinctive function and for managerial discretion.

THE ROLE OF INNOVATION IN THE RISE OF MANAGERIAL AUTHORITY

The rise of managerial authority is often associated with the emergence, at the end of the nineteenth century, of mass production, (Hounsell, 1984), the increasing size and administrative complexity of industrial organization, as well as intensive capital requirements. Yet, the increased pace of technological and scientific progress, and the rise of a science-based industry lead to the rise of a new managerial authority both at the shop level and at the board level.

The new function of labour management

Around the turn of the twentieth century, labour law recognised that employees were subordinated to employers, with a an "open-ended duty of obedience" on the part of employee (Deakin, 2009). This was a drastic change.

Until then, workers had been independent and organized their work in their own ways. With the progress of mechanization, it became clear however that the more complex or innovative were the products, the less the classical labour market could work: the workers were no longer able to produce the pieces with the know-how and tools they had. Frederic Taylor was among the first to conceptualize the need for business organizations to specialize experts in the development of new knowledge and the design of innovative working processes (Hatchuel, 1996).

Subsequently, workers' know-how was substituted by managerial prescriptions. The consequence was that workers no longer simply exchanged their labour for a salary. Instead, they saw their *capabilities transformed* as they were integrated into complex production systems. While Taylorism is often denigrated as de-skilling workers, the management was first and foremost a function to renew and develop workers' capabilities. Progressive thinkers such as Commons, grasped this shift from a theory of the man "as a commodity" to a theory of the man as "*a mechanism of unknown possibilities*" (Commons, 1919).

The transfer of control from directors to "executives"

The second change concerned the rise of the role of "chief executives" or "general management", which became progressively more critical when salaried managers, outsiders to the company, were progressively appointed to run the businesses.

While owner families often kept control of their companies (via their control of the board), they progressively but massively recruited managers to run their companies (or sent their sons to the high schools that would make them knowledgeable themselves) (Joly, 2013). In the UK, the founding families maintained their representatives on the board of directors for an exceptionally long time (Keeble, 1992), but the same handover of "control" of the business to professional managers, with the appointment of professional managers, started from the 1870s (Wilson et al., 2006). Whilst this was a slow process (Lewis, Lloyd-Jones, Maltby & Matthews, 2011), from the 1930s, the numbers of managers employed in British businesses began to grow rapidly. And by the middle of the twentieth century, professional managers were increasingly being appointed to boards (e.g. up to three quarters in the steel industry in 1947 (Erickson, 1986)).

Instead of relying on their directors, companies tended to recruit men from the field from "outside" the company, because the context and the nature of the activities have deeply changed. In particular, the need for scientific investigation became a pressing matter in a number of industries. From the chemical industry to telecommunications, via glass and electricity, historians have well described the rise of industrial research laboratories at the end of the nineteenth century. A new “science-based” industry was beginning to emerge, transforming the enterprise from a productive to an innovative organisation. But introducing science in industry was not imposing a definite scheme of production or product solutions: quite on the contrary, science drove business organizations into the unknown, and so created a demand for radically new competencies to devise innovative but sustainable strategies. Hence the new role of executives and the need for managerial discretion.

THE RATIONALES FOR SEPARATING DIRECTORS AND MANAGEMENT AS A BLIND SPOT FOR COMPANY LAW

Understanding the nature of the new management function sheds light on some grounds of the separation between ownership and control. We characterize three fundamental rationales for this distinction: a new economic model based on innovation, the need for specific competencies and new social responsibilities. Our study shows that these rationales have been overlooked by company law. The lack of conceptualization of the managerial function in law allowed reforms in the second half of the twentieth century that weakened managerial discretion, reducing the scope for innovation and corporate social responsibilities.

Innovation-based economy and the way back to ownership-based economy

With the rise of science-based industry, the economy has moved from a traditional capital-based economy to an innovation-oriented one: the value of the enterprise doesn't derive so much from the ownership of production means or finance than from the capacity to organize collective endeavors, i.e. from the management. Contrary to the conventional economic view of the firm in which where the role of management is to reduce transaction costs, management appeared to design previously unseen strategies and to produce *new* goods and to *renew* the means of production (Goyder, 1987; Segrestin & Hatchuel, 2011).

Yet, this view was eclipsed in UK by company law. A Company Law Amendment Committee, known as the Cohen Committee, was appointed in 1943 and reported in 1945. The Committee was given the mandate ‘to consider and report what major amendments are desirable in the Companies Act, 1929, and, in particular, to review the requirements prescribed in regard to the formation and affairs of companies and the safeguards afforded for investors and for the public interest.’ But considering shareholders as ‘owners’ and ‘those on whom the first loss falls’, the Committee focused its attention almost exclusively on strengthening the position of shareholders in relation to directors. It concluded that it was “desirable to give shareholders greater powers to remove directors” (Cohen, 1945). The most important change was the Committee’s recommendation that “any director (…) should be removable by an ordinary resolution, without prejudice to any contractual right for compensation.” (Cohen Committee, para 130) This mandatory power was introduced by section 148 of the Companies Act 1948. And this rule fundamentally changed the balance of power within companies, as it allowed hostile takeovers to emerge as a means of dislodging managers. It restores the view that the wealth is due to ownership of capital providers rather than to the collective innovation processes, organized by management. And it basically allows to see managers as agents of shareholders, rather than “technocrats” or stewards of the enterprise, and with real managerial discretion (Veldman & Willmott, 2016).

The Need for distinctive Competencies and the way back to Non-Executive Directors

Managerial authority is inseparable from scientific approaches and the development of new corpuses of competencies. Traditional accounting methods and schools, and traditional economy were no more sufficient to address the modern innovation challenges. Management was called upon “to develop a steadily increasing technique and a more and more specialized vocational training of its own” (Webb, 1918: 6). There was therefore considerable effort to conceptualize the new function of “business administration”, which departed fundamentally from classical accounting, engineering and political economy.

Yet, a second fundamental change began during the 1970s, as policy-makers began to call for greater numbers of non-executive directors (NEDs) on boards. After different attempts (cf. the Confederation of British Industry (CBI) published a report known as the Watkinson Report), the Bank of England began to push for more NEDs, culminating in the establishment in 1982 of an agency for the Promotion of Non-Executive Directors (known as PRO NED) (Bank of England 1983), chaired by Sir Adrian Cadbury from 1984, before the Cadbury Report formalised these developments in 1992. These efforts bore fruit: by 1988, 75 per cent of directors were independent in the sense of having no previous or present relationship with the company (Bank of England 1988).

The rise of NEDs reverses the earlier transfer of control from “directors” to executive managers. Although we have little evidence as to the information on which NEDs base their decisions (see for example Higgs Report 2003), it has been shown that that NEDs’ control over management is based mainly on financial metrics (Baysinger & Hoskisson, 1990). Since the role of management and the related competencies was never recognized, this reform pushed corporate governance back to the pre-managerial period.

From “Common Purpose” back to Private Control

Beyond the promise of scientific progress to deliver goods of great social utility for the people, managers were often putting forward their social responsibilities and the public or quasi-public services they were delivering with their businesses (Marens, 2008). The rise of management was also likely to alleviate the social conflicts between capitalists and workers: scientific managers played also the role of a “neutral technocracy” (Berle & Means, 1932), likely to pacify the relationships between owners and workers (Savino, 2009). This role had a broader purpose than the economic profit of the company: the aim was to develop workers’ and organizational capabilities. As Child analysed, “the new management’s ‘wider outlook and deeper sensitiveness’ made possible the fulfilment of social functions for employees over and above the pursuit of production” (Child, 1969).

But these social responsibilities of managers were not explicitly recognized by law. And our analysis of the reforms in UK shows how the rise of institutional shareholder engagement brought from “common purpose” back to private control. Policy makers saw engagement by these new institutional investors as a complement or alternative to the market for corporate control in terms of ensuring accountability of management to shareholders. In 1972, the Institutional Shareholders’ Committee (ISC) was created, with the support of the Bank of England. In 1991, the ISC issued a statement on the ‘Responsibilities of Institutional Shareholders in the UK’, and the 1992 Cadbury Report on the Financial Aspects of Corporate Governance endorsed this, encouraging ‘regular systematic contact at senior executive level to exchange views and information on strategy, performance, board membership and quality of management’ (Cadbury, 1992).

From this point on, institutional investor activism became a progressively more important part of corporate governance policy. Company law allowed institutional investors to have significant influence on strategy and without bearing responsibilities to employees or to the wider society and environment.

CONCLUSION AND FURTHER RESEARCH: TOWARDS A NEW STATUS FOR MANAGERS?

In this article, we contrast the historical rise of professional managers with the law's silence on their function. Focusing on the increased role of science and technological innovation in business, we highlight how the rise of a distinctive management function engrained some important foundations for separating ownership and control. We identify three basic rationales: the shift of the source of wealth from ownership to management, the need for specific skill-set, and the rise of new social responsibilities. While corporate law clearly distinguished between directors and shareholders, the manager remained either an employee (with no autonomy) or a director. And progressively, reform – overlooking the historical emergence and justifications of management - gave back control to shareholders and limited the scope of managerial discretion.

Taken together, these changes were crucial because the overall mission of management to develop new capabilities and to organize innovation processes has progressively become secondary to the purpose of maximizing shareholder value. Yet, more and more authors consider today that the innovative strategies are essential for the creation of value in the long term, for a balanced stakeholder management and for a sustainable economic development.

Our analysis adds then to the body of research on the separation of ownership and control by adding new light on the historical status of managers. It also suggests that the law has overlooked some fundamental changes in business organizations. It therefore calls for further research to make the distinctive role of management more visible in law. The historical grounds of management can inform new proposals of reform and a better conceptualization of management in law could probably fuel a new law of the enterprise. Shouldn't the law recognise the role of management in ensuring companies' survival and prosperity?

REFERENCES AVAILABLE FROM THE AUTHORS