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Abstract

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corporate governance, corporations, models

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THE MODELS OF THE CORPORATION AND THE DEVELOPMENT OF CORPORATE GOVERNANCE

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The 20th century corporation was 'foreshadowed when the first promoters conceived the plan of distributing stock in an enterprise to be run by a board of managers - a device practiced in England at least as early as the sixteenth century.'¹ But the leap made by the corporation in the 20th century has been a quantum one, for 'only in the twentieth century has the process been conducted to an extent which revolutionizes national life.'² Therefore the 20th century can be quarantined as the modern era of the corporation.

It was recognized early in the 20th century just how important the corporate form was. In 1911, Nicholas Murray Butler, then president of Columbia University, claimed that 'the limited liability company outweighed even electricity as the greatest single discovery of modern times'.³

Identifying basic conceptions of the corporation

There is a basic dichotomy at play in the use and deployment of corporate models. In very broad terms, the company may be viewed as either a shareholder-focused entity, or as an entity with a wider array of interests to be met. Masahiko Aoki refers to this as 'a difference in organizational premise.'⁴ Important consequences arise from this basic characterization process. If the company is viewed as a shareholder-focused vehicle, it is likely, for example, that employees will play little or no part in the corporate governance of the corporation. If, on the other hand, the company is seen as a broader-based entity, it is likely that employees will be central to a range of corporate governance arrangements.⁵

Debate about the role and purpose of the corporation has been part of both academic and applied debate for a substantial period of the 20th century. In the early 1930s, a series of three articles published in the United States by Professors Berle

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¹ Berle A, *The Twentieth Century Capitalist Revolution* (MacMillan and Co Ltd London 1955) 19.

² Berle, *ibid*, 19.

³ The Rt Hon Patricia Hewitt, Company Law Speech, Cambridge Faculty of Law Friday 5 July 2002.

⁴ Aoki, Masahiko, 'Institutional Complementarities between Organizational Architecture and Corporate Governance,' RIETI Conference on Corporate Governance, January 8-9, 2003, <http://www.rieti.go.jp/em/events/03010801/report.html> 1.

⁵ This raises the basic notion of 'path dependency' in corporate law and governance; that is, a given point of origin is liable to elicit a series of networked responses.

and Dodd set out the essential parameters between the shareholder-focused model and the broader conception of the corporation.⁶ These articles marked the first 'great acclaim' of the corporate governance concept.⁷ Critically, the Berle-Dodd debate allows us to calibrate the various national systems, as operating on a spectrum between the two divergent models.

Professor Berle's article was first in time. His thesis was that:

'all powers granted to a corporation or the management of a corporation... are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interests appear.'⁸

This tension between the competing notions of power on the one hand, and its proper exercise on the other, meant that the issue had great practical importance. He noted that the question is not merely academic because it could 'give greater flexibility to corporate management in certain respects'.⁹ Berle's solution to the manager's dilemma was to suggest 'that managerial powers are held in trust for stockholders as sole beneficiaries of the corporate enterprise.'¹⁰

Professor Berle 'adopted a classic shareholder-centred model of fiduciary duties, in which profit maximization for shareholders was to be the guiding principle for directors.'¹¹ Under this model of the corporation, employees had little or no formal role in the corporate governance framework. This has led to modern forms of governance which focus fairly exclusively on 'the relationship between management and shareholders and on profit maximization for the shareholders. It is based on 'a tripartite system of directors, shareholders, and auditors.'¹²

Professor Berle's thesis immediately generated debate about the basic role and nature of the modern corporation. A year after his paper appeared, Professor Dodd wrote in response in the next volume of the *Harvard Law Review*. Whilst Professor Dodd was 'thoroughly in sympathy'¹³ with some of the technical suggestions made by Berle, he disagreed as to the fundamental conception of the company as a shareholder-driven entity. He highlighted the limitations of management focusing on shareholders by examining the use of property exercised by corporations. He noted that 'property employed in certain kinds of business is devoted to public use while

⁶ The three articles are Berle A, 'Corporate Powers as Powers in Trust' (1931) 44 Harv L Rev 1049 ; Dodd E, 'For whom are corporate managers trustees?' (1932) 45 Harv L Rev 1145; and Berle A, 'For whom corporate managers are trustees: a note' (1932) 45 Harv L Rev 1365.

⁷ Pistor K, 'Co-determination: A Sociopolitical Model with Governance Externalities' in Blair M and Roe M (eds), *Employees and Corporate Governance* (The Brookings Institution, Washington 1999) 163-193, 164.

⁸ Berle A, 'Corporate Powers as Powers in Trust' (1931) 44 Harv L Rev 1049.

⁹ Berle, *ibid*, 1049.

¹⁰ Dodd E, 'For whom are corporate managers trustees?' (1932) 45 Harv L Rev 1145, 1147.

¹¹ Hill J, 'Corporate governance and the role of the employee' in Gollan P & Patmore G (eds), *Partnership at Work: The Challenge of Employee Democracy: Labor Essays 2003* (Pluto Press Melbourne 2003) 114.

¹² Kendall, N & Kendall, A, *Real-World Corporate Governance: A Programme for Profit-Enhancing Stewardship* (FT Pitman Publishing London 1998) 16.

¹³ Dodd, n 10, 1147.

property employed in other kinds of business remains strictly private.¹⁴ He went on to state that 'it may well be that the law is approaching a point of view which will regard all business as affected with a public interest.'¹⁵

Dodd espoused a view that company directors are 'guardians of all the interests which the corporation affects and not merely servants of its absentee owners'¹⁶ i.e. the shareholders. He believed it to be undesirable 'to give increased emphasis at the present time to the view that business corporations exist for the sole purpose of making profits for their stockholders.'¹⁷ Dodd 'suggested that directors held their fiduciary powers in trust, not only for shareholders, but for a broader constituency associated with the organization, including employees, creditors and consumers.'¹⁸ Dodd concluded that:

'public opinion, which ultimately makes law, has made and is today making substantial strides in the direction of a view of the business corporation as an economic institution which has a social service as well as a profit-making function.'¹⁹

As Masahiko Aoki notes in summarizing this famous debate:

'An early forceful argument for the stakeholder-society perspective was pronounced by Dodd (1932) who argued in rebuttal to the shareholder-value position of Berle (1931) that the directors of a corporation must become trustees (if they are not already) not merely for shareholders but also for other constituents of the corporation, such as employees, customers and particularly the entire community.'²⁰

Berle's model of the corporation as shareholder-driven and as governed by private law principles is in sharp contrast to the more complex, broad stakeholder, public law model favoured by Dodd. Whereas Berle's model provides no formal place for employee involvement in governance arrangements, Dodd's model foreshadowed the increasing importance of employee participation in the governance of companies. Indeed, Dodd noted that 'there is a widespread and growing feeling that industry owes to its employees not merely the negative duties of refraining from overworking or injuring them, but the affirmative duty of providing them so far as possible with economic security.'²¹ Such a statement, now some seventy years old, is disconcertingly prescient in Australia, given the recent corporate collapses resulting in the loss of many jobs and the accompanying employee entitlements.²²

¹⁴ Dodd, n 10, 1149.

¹⁵ Dodd, n 10, 1149.

¹⁶ Dodd, n 10, 1157.

¹⁷ Dodd, n 10, 1148.

¹⁸ Hill, above n 11, 114.

¹⁹ Dodd, above n 10, 1148.

²⁰ Aoki, Masahiko, *Towards a comparative institutional analysis* (Massachusetts Institute of Technology, Cambridge Massachusetts 2001) 279.

²¹ Dodd, above n 10, 1151.

²² Hill, above n 11, 118.

As with any modeling approach, we need to bear in mind the limitations of the related working method. The models provide gateways into debates, rather than holy grails. They set out basic theoretical notions, rather than explain complex national arrangements. Whatever the ultimate use made of the basic models, the *preliminary* characterization of companies as either shareholder-driven or as more diverse entities, does appear to give rise to profound consequences for the various links in the chain between the firm, the corporate governance framework and issues such as employee governance provision. These consequences shape the role that employees take on within the firm. For example, a shareholder driven model will typically deny employees an active role in the management of the firm, whereas as a stakeholder model will embed employees as central stakeholders alongside shareholders and customers.

Models of the corporation and employee provision

The basic differences in the conception of the company highlighted by Berle and Dodd provide an organizing mechanism for corporate governance arrangements. At one end of the spectrum is the *de minimis*, shareholder-focused model and at the other, the more complex, hybrid model asserted by Dodd. Though their debate was about US corporations and took place more than 70 years ago, it remains highly pertinent for application in other countries and in other corporate contexts due to the ubiquitous nature of the choice of the two models.²³ It also serves to highlight the basic models of corporate governance provision for employees around the developed world.

The Berle model and the 'non-recognition' of employees

At one end of the spectrum, the role of employees may not be formally recognized in statute or in other formal sources of law. This model is based on the precepts set out in Professor Berle's first article outlined above. It focuses on the absent owners of the company, namely the shareholders. Given its focus on shareholders, it essentially blocks employees and others from a participatory role in the basic conception of the corporation. It provides a rational, linear operational model of the corporation. As a result, it requires precise legislative and other rules to cater for employees and stakeholder groups beyond the shareholders.

The centrifugal force of these systems of governance is towards shareholders. In this sense, they are shareholder centric and overwhelmingly the most important stakeholder cohort is the shareholder group. Analysis of the UK, US and Australian systems confirm this hierarchy.

Adolf Berle Jr, of course, went on to ameliorate some of the hard edges of his view of the corporation. The most famous of these was his work with Gardiner Means.²⁴

²³ See, eg, Parkinson J, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (Oxford University Press 1993).

²⁴ Berle, Adolf A Jr, and Means, Gardiner C, *The Modern Corporation and Private Property* (New York Commerce Clearing House Inc New York 1932).

For our purposes, the dualistic nature of the corporate models remains valid. Berle was the proponent of the shareholder-focused entity. As Bavlly notes:

‘Scholars debate whether corporations should serve the interests of their shareholders or their stakeholders. Contrarians argue that firms should maximize shareholders’ value, while communitarians maintain that there should be a balance between shareholders and stakeholders.’²⁵

Berle therefore is a central proponent of ‘contractarianism’ which ‘focuses on the contractual relations that exist among the firm’s so-called stakeholders.’²⁶ This theory was further developed by Ronald Coase shortly after the initial article published by Berle.²⁷ Coase ‘argued that firms exist to minimize the costs of trading in external markets.’²⁸ He was ‘the first to point out that trading in markets is costly, and that often these costs can be reduced by creating an organization within which market transactions are replaced by a *nexus of contracts* that governs trade among the contracting parties.’²⁹

One of the advantages of the contractual approach is that the value issue is relatively easy to identify. As William Rouse notes, ‘it is rare to encounter an enterprise that does not claim to be focused on providing value to customers or, more broadly, providing value to stakeholders or constituencies.’³⁰ The point is that ‘value means different things to different stakeholders.’³¹ This is especially problematic for workers because

‘the specific definitions of value for employees depend on the particular work domain. Although everyone is concerned about compensation, the broader set of attributes that affect perceived values varies substantially from production workers to executives to college professors to performance artists.’³²

On the other hand, ‘defining value is more straightforward for stockholders. The value of a share of stock is highly related to a company’s earnings, particularly the anticipated growth rate of its earnings’.³³

Because the share price and the value for shareholders is so accurate a measure comparative to other more ‘fuzzy’ and imprecise measures, it becomes a default

²⁵ Bavlly, DA, *Corporate Governance and Accountability: What Role for the Regulator, Director, and Auditor?* (Quorum Book Westport Connecticut 1999) 117.

²⁶ Bradley, Michael et al, ‘The Purpose and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads,’ *Law and Contemporary Problems*, Vol 62, No 3, Summer 1999, 1-86, 35.

²⁷ Coase, Ronald, *The Nature of the Firm*, 4 *Economica* 386 (1937).

²⁸ Bradley at al, above n 26, 35.

²⁹ Bradley at al, above n 26, 35.

³⁰ Rouse, William B, *Essential Challenges of Strategic Management* (John Wiley and Sons Inc New York 2001) 60.

³¹ Rouse, above n 30, 60.

³² Rouse, above n 30, 61.

³³ Rouse, above n 30, 61.

mechanism for also providing guidance to other stakeholders in their assessment of value. Therefore, Rouse surmises that:

‘to a great extent, the stock market valuation of a company is a good overall, albeit surrogate, measure of the company’s current and anticipated ability to provide value to customers and, less directly, to employees. This measure also has the very desirable characteristic of applying to all public companies. This enables comparisons across industries and time.’³⁴

This approach helps to explain the pre-eminence of contractarian values in capital markets which display, in turn, a robust stock market and a competitive environment for takeovers. In such habitats, the hegemony of share price as a litmus test for value is particularly strong.

The Dodd model extrapolated: the formal recognition of employees

At the other end of the spectrum, employees may be formally recognized and accepted as integral players in the corporate governance arrangement. This is the communitarian paradigm referred to above and is best recognized in German provision with its ‘hard’ or formal mechanisms for employees³⁵ and Japan with its soft, informal provisions.³⁶ This ‘formal recognition’ model foregrounds the role and interests of employees. It provides a discrete system of employee governance, unlike contractarian systems in which employees are subsumed within the broader arrangement and structure.

It is predicated on the more complex notion of the corporation espoused by Professor Dodd referred to above. Under this public law, community-focused model, the board of directors is required to pay attention to the needs and collective welfare of the employee group. Indeed, in the case of German corporate governance, employees actually assume guaranteed positions on the supervisory board that sits atop the two-tiered system board arrangement.

The practical difficulties associated with this model generate criticism in those countries that confer special status on the Berle model. As Bavly notes, ‘scattered among these interested parties are those who recognize that corporations are subject to social demands.’³⁷ The parties ‘interested in the corporation’ include short-term speculators looking for short-term gains and institutional shareholders more interested in the long term. Thirdly, there are ‘the stakeholders and the general public who care about what is going on, *even if they have no direct ownership in it.*’³⁸ (italics added) This final point of critique of communitarianism also reveals the

³⁴ Rouse, above n 30, 61.

³⁵ These include guaranteed employee representation on the supervisory board and strong union participation.

³⁶ These include the still remarkably persistent post World War II practices of lifetime employment, pay by seniority and the importance of unions in the politico-legal settlement of the workplace.

³⁷ Bavly, above n 25, 115.

³⁸ Bavly, above n 25, 115.

durability of the shareholder-focused approach. The Dodd model is constructed against, and in contrast to, the Berle model, and not the other way around.

The difference between shareholder centric and socially engaged firms has a fundamental influence on the firm's aims. Those who seek to cast the firm as a socially responsible entity, maintain that profits will flow in any event. The primary aim and the fundamental pillar is, however, based on a conception of social responsibility. As Bavly notes,

'this school of thought maintains that corporations have a duty to help bring about a better society which, the argument runs, should ultimately also benefit the company by increasing its long-term profits.'³⁹

Against this view, is the alternative argument espoused by Bavly:

'the social demands have not been fully defined, however, and as a result companies may exaggerate their responsibilities, even though doing so impairs their primary effort- that is, to produce the best product they can, as efficiently as possible, and at the most advantageous price.'⁴⁰

The inevitable conclusion reached is that 'expectations of corporate responsibility are tricky terrain, one in which both the general public and the government have more than a passing interest.'⁴¹

This analysis casts the wider, social responsibility Dodd model as imprecise, amorphous and, ultimately, distracting for the company as it seeks to maximize profits and returns for shareholders. This difficulty of proscribing the social dimensions of the company remain a stubborn resistant to change, for systems such as those in Australia, the UK and the US which firmly embrace the Berle model. Instead, they remain wedded to what they see as the safe haven and simplicity of the Berle shareholder model. Whether this is a reflection of inherent practical difficulties or socially-ingrained precepts remains to be seen. In particular, why should a lack of cogent definition impede firms seeking to explore broader social orientations with stakeholders.

Whilst Dodd foregrounded communitarianism as the model opposite to, and in potential collision with, contractarianism more than 50 years ago, the ferment remains. As Bradley at al note:

'The conceptual battlelines are stark. Where contractarianism finds its legitimacy in the values of liberty and competition, communitarians emphasize justice and cooperation. Where contractarians look to Adam Smith's invisible hand for a social welfare logic to justify the distribution of gains from corporate activity, communitarians yearn for an authentic community where the fulfillment of the true

³⁹ Bavly, above n 25, 116.

⁴⁰ Bavly, above n 25, 116.

⁴¹ Bavly, above n 25, 116.

needs of society's members justifies corporate activity. Focusing on the managerial means to achieve corporate ends, contractarians invoke norms of freedom, while communitarians emphasize responsibility.⁴²

Placing corporate governance models on the spectrum

The Berle and Dodd debate therefore provide both a starting point for, and a framework of, the contractarian and the communitarian debate. Bradley et al again:

'Stripped of their complexities, the debate in much of the scholarship on corporate governance can be distilled to one fundamental issue: whether the corporation should be viewed as a "nexus of contracts," negotiated among self-interested individuals or as a "legal entity," with rights and responsibilities as a natural person.'⁴³

Australia is most closely associated with the 'non-recognition' model, whereas Germany (and Japan to a lesser degree) formally recognize and account for the roles played by employees. The US and the UK approaches to employees and corporate governance provision sit somewhere between the two divergent models of contractarian and communitarian values.

We can see that an approach to an apparently discrete issue such as employee participation can proceed by moving across the spectrum, dealing first with systems displaying formal recognition features and then moving to systems with non-recognition as a hallmark. It would, of course, be simplistic to limit the resulting analysis to one simply evidenced by a resort to contractarian and communitarian tendencies. There are, additionally, a series of complex influences at play within a single national system. In an increasingly interlocked economic environment, the forces at work in relation to a national system extend beyond its geographic boundaries. The basic architecture of the firm, however, establishes and defines a *particular national* path dependency in terms of the emergent corporate governance. As a result, the importance of locally based culture, politics and economics remain as vital informants of the unfolding project of 21st century governance.

⁴² Bradley et al, above n 26, 42.

⁴³ Bradley et al, above n 26, 34.