The Separation of Directors and Managers: A Historical Examination of the Legal Status of Managers

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ABSTRACT

While management emerged as a distinctive function at the turn of the 20th century, managers, unlike directors, have no particular status in law. This article examines how technological and innovation concerns motivated the rise of management but shows that they were largely overlooked by corporate law after 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. Paradoxically, however, the law does not clearly distinguish the role and duties of managers 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 has 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 examining the rationale for the distinction between managers and directors and the way it was implemented by law.*

In doing 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 observe are probably also followed in the other Western European countries (some evidence is available from France, Belgium, Germany and Italy but requires further investigation). We chose to examine the UK because the UK showed itself to willing to make radical regulatory changes to the relationship between shareholders and directors, and subsequently 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 discuss all the factors, sociological, political or financial, that drove the emergence of management. Rather, we 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

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demanded a new role for management. Management's role was not (only) to rationalize production and to reduce costs but also to devise innovative strategies and develop new organizational capabilities. Although limited, this focus on innovation allows us to identify some fundamental reasons for distinguishing between the role of directors and that of managers.

SEPARATION OF OWNERSHIP AND CONTROL: ECONOMIC AND LEGAL VIEWS

Since the seminal book of Berle & Means (1932), the separation of "ownership and control" has been the subject of constant lively debate. Beyond the discussions on when and how this separation occurred in different countries (Cheffins, 2001, 2008; Coffee, 2001), the extent of this separation is critical both for management and corporate governance. Along with the law, it influences the extent to which shareholders can intervene 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 risks and those who run companies on their behalf. It suggests that there is a need for more accountability of "agents" to their "principals", either through supervision by the principals or through other mechanisms that align their interests. On the other hand, legal scholars 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). In addition, the separation of "ownership and control" is seen as a precondition 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 (...), but more significantly, allowing corporations to be more than pure profit maximizers and simultaneously prioritize stakeholder interests and corporate social responsibility."

However, many authors have observed that in practice, shareholders have considerable influence over management (Zeitlin, 1974). This influence is all the more important with the rise of institutional investors in recent decades. The law does little to impede this, as directors are appointed and removed by shareholders, giving the latter 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 managers is crucial. As the management function was increasingly transferred from boards of directors to *managing directors* in the early 20th century, the emergence of professional management was accommodated within existing legal structures, rather than supported by a positive legal regime.

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 corporate law, capable of being dismissed and restrained from divulging trade secrets, but not having any other special status. Their function was never separated conceptually from that of directors, and they were never endowed with any special authority or autonomy.

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However, there were powerful drivers behind the emergence of professional managers, and it was essential that they be accorded considerable discretion in order to fulfil their distinctive function.

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 organizations, as well as intensive capital requirements. Less commonly discussed is that the increased pace of technological and scientific progress, and the rise of science-based industry, led to the rise of a new managerial authority both at the shop level and at the board level.

The new function of labor management

Around the turn of the twentieth century, labor law recognized 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, largely paid by the piece and responsible for organizing their own work. With the progress of mechanization, it became clear however that the more complex or innovative the products, the less the classical labour market could work: 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 engage experts to develop new knowledge and design innovative working processes (Hatchuel, 1996).

Subsequently, workers’ know-how was substituted by managerial prescription. 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, management was first and foremost concerned with renewing and developing workers’ capabilities. Progressive thinkers such as Commons (1919), grasped this shift from a theory of the man “as a commodity” to a theory of the man as “*a mechanism of unknown possibilities*”.

The transfer of control from directors to “executives”

The second change concerned the rise of the role of “chief executives” or “general managers”, which gradually became more critical as salaried managers, outsiders to the company, were increasingly appointed to run the businesses.

While owner families often kept control of their companies (via their control of the board), they progressively 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 started from the 1870s (Wilson et al., 2006). Whilst this was a slow process (Lewis, Lloyd-Jones, Maltby & Matthews, 2011), from the 1930s, the number of managers employed in British businesses began to grow rapidly. And by the middle of the twentieth century,

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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 "outside" the company who were specialists in the field, because the context and nature of their activities had radically 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 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. The introduction of science into industry did not entail imposing a definite scheme of production or product solutions: rather, science drove business organizations into the unknown, and so created a demand for new competencies to devise innovative but sustainable strategies. This explains 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 role of innovation in the emergence of the management function sheds new light on the implications of the distinction between directors and managers. In what follows, we characterize three fundamental rationales of this distinction: a new economic model based on innovation, the need for specific competencies and new social responsibilities. Our study shows that these rationales were 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 fulfilment of corporate social responsibilities.

Innovation-based economy and the return to ownership-based economy

With the rise of science-based industry, the economy moved from a traditional capital-based economy to an innovation-oriented one: the value of the enterprise no longer derived from the ownership of the means of production or the provision of finance. Rather, value was generated by the capacity to organize collective endeavors, i.e. from management. Contrary to the conventional economic view of the firm in which the role of management is to reduce transaction costs, management's function was 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 good illustration is provided by the Company Law Amendment Committee, known as the Cohen Committee, which 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.' However, starting from the a priori (and legally incorrect) assumption that shareholders were 'owners', 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

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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. This rule fundamentally changed the balance of power within companies, as it contributed to the emergence of hostile takeovers, which operated to dislodge previously entrenched directors (and the managerial hierarchies below them) (Johnston, Segrestin and Hatchuel, 2018). It restored the view that wealth creation resulted from the provision of capital rather than from the collective innovation processes organized by management. It laid the ground for the later economic reconception of managers as agents of shareholders, rather than "technocrats" or stewards of the enterprise, who exercised real managerial discretion (Veldman & Willmott, 2016).

The need for distinctive competencies and the return to non-executive directors

Managerial authority is inseparable from scientific approaches and the development of a new corpus of competencies. Traditional accounting methods and schools, and traditional economy were no longer 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.

However, the need for specific competencies was also overlooked by the regulators. This can be illustrated by 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 early efforts (e.g. the Confederation of British Industry's "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), before the Cadbury Report formalized 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 reversed 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 largely on financial metrics (Baysinger & Hoskisson, 1990). Since the role of management and their related competencies in generating value was never recognized, this reform pushed corporate governance back to the pre-managerial period of the nineteenth century.

The retreat from "common purpose" to private control

Beyond the promise of scientific progress to deliver goods that enhanced the welfare of the consuming public, managers frequently referred to their social responsibilities and the public or quasi-public services their businesses delivered (Marens, 2008). The rise of management was also likely to alleviate the conflict of interests between capitalists and workers: scientific managers played the role of a "neutral technocracy" (Berle & Means, 1932), pacifying tensions and balancing the interests of 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 noted, "the new management's 'wider outlook and deeper

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sensitiveness' made possible the fulfilment of social functions for employees over and above the pursuit of production" (Child, 1969).

However, these social responsibilities of managers were not explicitly recognized by law. Our analysis of the reforms in UK shows how the encouragement, and later emergence, of institutional shareholder engagement reversed this move towards "common purpose" in favour of a resumption of 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", which was endorsed by the 1992 Cadbury Report. Cadbury encouraged "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 an increasingly important aspect of corporate governance policy. Company law allowed institutional investors to have significant influence on strategy 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 growing role of science and technological innovation in business, we highlight how the rise of a distinctive management function constituted an important foundation for the separation of "ownership and control". We identify three basic rationales: the shift of the source of wealth creation from ownership to innovation management, the need for a specific skill-set, and the rise of new social responsibilities for business leaders. While corporate law clearly distinguished between directors and shareholders, the manager remained either an employee (with no autonomy) or a director. Gradually, reforms, which overlooked the historical emergence of, and justifications for, 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 became subordinate to maximizing shareholder value.

Today, more and more authors consider that innovative strategies are essential for the creation of value in the long term, for balanced stakeholder management and for a sustainable economic development. Our analysis shows how these concerns emerged but were then lost from view over the course of the twentieth century. It adds to the body of research on the separation of "ownership and control" by shedding new light on the historical status of managers, and suggests that the law has overlooked these fundamental changes in business organizations. We call for further research to make the distinctive role of management more visible in law. The history of management can inform new reform proposals, support a better conceptualization of management in law, and potentially fuel a new law of the enterprise. Shouldn't the law recognise the role of management in ensuring companies' survival and prosperity?

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