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

ACCEPTED VERSION Dec. 16. 2018. - *Journal of Management History*

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

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## **STRUCTURE ABSTRACT**

### **Purpose**

The aim of the article is to contrast the historical rise of the managerial function and its reception in law. It thus contributes to the debates on the separation of ownership and control, by showing that managers were never recognized in law. As a result, the managerial function was not protected in law.

### **Design/methodology/approach**

We bring together management history and the history of UK company law to study the emergence of management in the early twentieth century and the law's response. We bring new historical evidence to bear on the company law reforms of the second half of the twentieth century, and in particular, on the changes brought about by the Cohen Committee report of 1945.

### **Findings**

Scientific progress and innovation were important rationales for the emergence of managerial authority. They implied new economic models, new competencies and wider social responsibilities. Our analysis shows that these rationales have been overlooked by company law. The lack of conceptualization of the management in law allowed reforms after 1945 that gave shareholders greater influence over corporate strategy, reducing managerial discretion and the scope for innovation.

### **Research limitations**

Our study focuses on the UK. Further research is needed to confirm whether other countries followed a similar path, both in terms of the emergence of management, and in terms of the law's approach.

### **Originality/value**

This article is the first, to our knowledge, to examine the law's historical approach to management. It calls for a reappraisal of the status of managers and the way corporate governance organizes the separation of ownership and control.

**Keywords:** Ownership and control, management, company law, corporate governance, management history, directors.

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

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## **INTRODUCTION**

Since the seminal work of Berle & Means (Berle and Means, 1932; Mizruchi, 1983), the separation between ownership and control in business has been the subject of lively debate. There have been important discussions on when and how this separation took place in different countries (Coffee, 2001; Cheffins, 2001; Cheffins, 2008; Foreman-Peck and Hannah, 2015; Guinnane et al., 2007; Guinnane et al., 2017). But, whatever the process of this separation, the literature on corporate governance sees it as critical because it delineates the sphere of intervention of shareholders in the management of corporations. The separation of ownership and control therefore shapes the conditions for managerial discretion (Hambrick and Finkelstein, 1987; Finkelstein and Hambrick, 1990; Phillips et al., 2010; Wangrow et al., 2015). Different perspectives have been put forward. The economic literature has focused on the agency relationship between shareholders, who bear risks, and those who run companies. The general idea is that more accountability of “agents” to their shareholder “principals” is needed, either through supervision by the principals or through other mechanisms that align the interests of the two groups (Fama and Jensen, 1983; Jensen 2001). The legal literature, however, insists that directors 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 from different constituencies (Blair, 1995; Blair and Kruse, 1999). The separation between ownership and control would thus favor a director primacy model, which is also seen

as a condition for stakeholder management (Johnson and Millon, 2005; Lipton and Rowe, 2007). Dai & Helfrich (2016: p. 4) noted:

“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. ”

Many authors, however, have observed that, in the Anglo-Saxon world, shareholders have significant influence on management (Zeitlin, 1974). This influence is all the more important with the rise of institutional investors in recent decades. It is also clearly not prevented by law, because directors can be legally removed by shareholders, with the latter given an exclusive and ultimate right of control in the UK and US at least (Kaufman and Englander, 2005; Millon, 2013; Yosifon, 2014).

In these debates on the legitimacy and reality of the separation between ownership and control, previous studies have extensively documented the positions of shareholders and directors (Franks et al., 2005; Foreman-Peck and Hannah, 2011; Hannah, 2007a; Guinnane et al., 2017; Hannah, 2007b). Few researchers, however, have examined the position of managers, and the separation between them and the board. Historically and practically, the function of management clearly separated from that of directors (Freeland, 2001; Wilson and Thomson, 2006). The emergence of management as a distinctive “social stratum” (Child, 1969, p.14) is evidenced by the rise of scientific management and debates about professionalisation around the turn of the twentieth century. As we show, it was recognized as a major breakthrough for industrial relationships and organizations by numerous commentators such as Fayol, Burton and, later, Berle. Whilst management science focused, appropriately enough, on the role of management and paid little attention to directors, the law did the reverse, concerning itself only

with directors. Even now, 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 and Millon, 2005, p.1601).

The aim of our article is to shed light on the separation of ownership and control by documenting the historical emergence of the function of management and its reception by the law. In particular, it considers two questions. First, what were the fundamental roots of the separation between directors and managers, and second, how did the law deal with the emergence of this distinctive management function?

Methodologically, our study draws on both management history and legal history. We make two methodological choices, and they entail important limitations. We presume that the claim of the paper that the rise of a distinctive managerial function in business companies was overlooked by law can apply quite broadly to Anglo-Saxon worlds, as well as to different Western European countries (some evidence is available from France (Fridenson, 1987), Belgium and Italy but would need further investigation). Typically, the literature usually considers that the models of corporate governance, whether shareholder primacy or director primacy, apply primarily, but not only, to the Anglo-Saxon world. However, there are obvious differences in the evolution and content of both management thought and legislation between countries. Therefore, to have consistent data, we focus on a single country. We chose to examine the evolution of law only in the United Kingdom on the basis that this country has shown itself to be among the most willing to make radical legal changes to the relationship between shareholders and directors. It has also exercised a significant influence on global corporate governance through its practice of issuing soft law codes that seek to increase the accountability of managers to shareholders.

Our second methodological choice was not to study all the factors, sociological, political or financial, that drove the emergence of management, but rather to focus on the role of science

and innovation. At the end of the nineteenth century, as technological and scientific progress accelerated, the rise of science-based industry demanded a new role for management. Managers were needed 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 the distinction between the roles of directors and managers.

Building on the business history literature, we first identify three main rationales for the separation of manager and director: i) in the new business model, the source of wealth generation shifted from ownership to administrative capability; ii) managerial authority was grounded on new techniques and competencies; and finally, iii) managerial authority entailed a new social responsibility to advance the interests not only of shareholders but also of the different constituencies.

The case of the UK is, however, specific: the UK is known, historically, to have been reluctant to embrace managerialism, slow to introduce scientific management and to separate ownership and management (Wilson and Thomson, 2006). Part of this resistance may be attributed to ownership structure, as well as the organization of the engineering profession and the cultural dimension. Yet, recent works of business history on the UK as well as contemporaneous sources (textbooks, treatises and essays written on management in the early 20<sup>th</sup> century) reveal that the rise of management was still clearly observable in the UK (Quail, 2002). The fundamental rationales for the distinction between director and manager, although developing with a specific pace and intensity, were relevant in the UK. They motivated the emergence of new management functions, approaches and competencies, with particularly wide diffusion of Taylorian principles (Whitston, 1995). In essence, as Quail suggests, while the ownership structure was “prophylactic to managerialism” in the UK, “managerial capacity” nevertheless developed, combining new skills with changed power relations (Quail, 2002).

This situation contrasts with the approach taken in company law, which accommodated but did not provide positive support for these developments. We bring new historical evidence to bear on the company law reforms of the second half of the twentieth century, and in particular, on the changes brought about by the Cohen Committee report of 1945, which led to the introduction of a new Companies Act in 1948. These data show that the law ignored the fundamental rationales for the emergent distinction between directors and managers. We then argue that the absence of any positive legal conceptualization of management allowed a series of reforms after World War II that paved the way for an increased role of shareholders in corporate strategy and management.

This article is the first, to our knowledge, to examine the law's historical approach to management. The objective is not primarily to advance knowledge on the history of business in the UK. Instead, the aim is to contribute to the corporate governance literature on the separation of ownership and control. It also aims to stimulate further research at the crossroads of law and management to reappraise the status of managers and the implications of this for corporate governance.

### **SEPARATION OF OWNERSHIP AND CONTROL: ECONOMIC AND LEGAL VIEWS**

The separation of ownership and control is perhaps the most famous issue in corporate governance, first identified by Berle and Means (1932). At the end of the 1920s, these authors observed the rise of “modern corporations”, giant and powerful business organizations where powers were allocated in new and puzzling ways. At that time, most Western countries had adopted limited liability and consolidated the law for public corporations (for example, the UK's Companies Act 1862 consolidated earlier Acts and gave full separate legal personality to joint stock companies). The new legal setting allowed massive fundraising and led to the



dilution or dispersion of ownership (Franks et al., 2005; Berle and Means, 1932). Those providing the funding did not necessarily control the business. In fact, the separation of ownership and control gave rise to two possible models of corporate governance, namely shareholder primacy and director primacy (Lipton and Rowe, 2007; Lan and Heracleous, 2010).

This section reviews these different models of corporate governance and shows how the sphere of intervention of shareholders has largely been discussed in relation to directors, rather than managers.

### **The arm's length model of control and the model of shareholders' primacy**

The first model, often labelled "shareholder primacy", is usually closely associated with the Anglo-Saxon system. This system is often characterized as an "outsider/arm's-length" model: "outsider" because share ownership is dispersed rather than being concentrated in the hands of family owners, banks or affiliated firms; and "arm's-length" because investors in the US and the UK are rarely poised to intervene in running a business. Instead, they tend to maintain their distance and give executives a free hand to manage (Cheffins, 2001).

In this system, the dominant theoretical framing views shareholders as mandating managers to run companies on their behalf, under the monitoring and control of the board of directors. This "delegation allows agents to opportunistically build their own utility at the expense of the principals' utility (wealth)" (Donaldson and Davis, 1991). This is why agency theory justifies empowering the board of directors to monitor and control managers (Fama and Jensen (1983, p. 311)<sup>1</sup>. As "residual claimants", shareholders get returns only when the firm makes a profit,

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<sup>1</sup> Fama and Jensen consider that if shareholders and managers, then control rights and decision rights also need to be separated. Control rights are given to the board. They write: "Such boards always have the power to hire, fire, and compensate the top-level decision managers and to ratify and monitor important decisions. Exercise of these top-level decision control rights by a group (the board) helps to ensure separation of decision management and control (that is, the absence of an entrepreneurial decision maker) even at the top of the organization." (Fama and Jensen, 1983, p. 311).

i.e. when “contractually-prescribed amounts” have been paid to other stakeholders. Shareholders therefore have the greatest incentive to monitor executives, improving efficiency. There is also an argument that shareholders should be given exclusive ultimate control rights (Jensen, 2001) to ensure optimal control and avoid contradictory expectations (Tirole, 2001). Some authors go as far as suggesting that shareholders should be given more direct influence over business decisions, especially when these decisions frame the “rules of the game” (e.g. closing the company, scaling down, and distribution of profit) (Bebchuk, 2005). Under the agency perspective, therefore, as management separates from ownership, there is a need for more monitoring and control by directors on behalf of the shareholders.

### **The view in law: the director primacy model**

Agency theory sees managers as the agents of shareholders, whereas the board is a body that is supposed to exercise control over the managers. But this interpretation has been strongly challenged by legal scholars (Lan and Heracleous, 2010). The most important challenge to date to the “grand design principal–agent model” of the corporation has come from Margaret Blair and Lynn Stout (Blair and Stout, 1999). They argued that corporate law in the United States separates the board of directors from the shareholders. But directors are neither agents of shareholders nor controllers. Instead, business corporations are seen as the locus of team production, intended to produce a “collective output”, which is “qualitatively different and vastly larger than the sum of what each individual could produce separately” (p. 264). Team production requires various parties to make contractually-unprotected firm-specific investment. It also requires mechanisms to reassure the parties that they will be protected against opportunism and rent-seeking by other team members (p. 251-2).

This, in Blair and Stout’s view, is precisely what the law provides by separating shareholders and directors. Protection of firm-specific investments comes in the form of a

neutral mediating hierarchy, “whose job is to coordinate the activities of the team members, allocate the resulting production and mediate disputes among team members over that allocation”. The board of directors is at the top of the hierarchy, and the key decision-making body<sup>2</sup>, with legally-protected independence from other team members, and “an extraordinary degree of discretion to pursue other agendas and to favour other constituencies, especially management, at shareholders’ expense”.

This approach runs counter to agency theory as regards the role of the board, giving it the broader function of protecting the “enterprise-specific investments of all the members of the corporate team, including shareholders, managers, rank and file employees, and possibly other groups, such as creditors” (Blair and Stout, 1999, p.253). This vision of team production recognizes that a number of different groups make investments in the enterprise and bear risk, and therefore that a fair allocation of the results of collective production is required. Team production theory, unlike the economic theory of the firm, also gives an important place to the corporate legal entity as a means of committing resources to the enterprise.

This model sees the separation of ownership and control as the separation between shareholders and the board of directors, with the latter being the key decision-making body of the corporation. This vision is, compared to agency theory, more accurate from a legal perspective.

### **Company law and director primacy**

As Lan & Heracleous suggest, the director primacy model, “may be seen as more applicable and palatable to countries other than those in the Anglo-Saxon world, such as China,

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<sup>2</sup> “The board of directors is seen as a key decision-making body whose decisions on such matters as CEO appointment and compensation, response to takeover attempts, mergers and acquisitions, and shareholder dividends, as well as powers to review and control other major strategic decisions, provide a framework for the myriad decisions made by managers.” (Lan & Heracleous, 2010, p. 300).

Germany, Japan, and Russia, that are more stakeholder oriented and where shareholders are not always treated as primary” (Lan & Heracleous, 2010, p. 310). Yet, the legal systems in the Anglo-Saxon world also support this view: basically, being a shareholder does not establish a right to participate in the management of the business (Lipton and Rowe, 2007).

In the United Kingdom, company law clearly separated shareholders and directors from the Companies Act 1844 onwards (Ireland, 2010; Guinnane et al., 2017). At this stage, the directors always managed the business, and this was reflected in 1844 in a statutory power to “conduct and manage the Affairs of the Company”. Shareholders were explicitly excluded from management unless appointed as directors (Section 27 Joint Stock Companies Act 1844). Shareholders were later given limited liability, arguably making their position analogous to that of creditors.

Several legal elements further solidified the separation between shareholders and directors. First, the early Companies Acts gave shareholders little or no power to remove directors, and few means of obtaining redress if they were dissatisfied, other than to sell their shares. It remained normal practice to require directors to hold significant quantities of shares, which ensured that they were responsive to shareholder interests, but directors were insulated from shareholder demands by a number of rules (Campbell and Turner, 2011). The 1844 Act gave shareholders no power to remove directors outside of a three-yearly retirement cycle, and from 1862, the default rule was that directors could only be removed by special or extraordinary resolution, both of which required the support of 75% of those voting in person or by proxy (Guinnane et al., 2017). As the shareholders became increasingly dispersed, it became very difficult to achieve the necessary majority. Directors were also commonly entrenched through provisions in the articles. By default, boards were “staggered” with one third of the directors required to retire each year but available for re-election by the general meeting by simple majority. However, this offered little help to restive shareholders because, as a default rule, it

was avoided in a number of ways. Some companies made no provision for removal of directors whatsoever, which meant that the shareholders had to pass a special resolution to change the articles before they could vote on removal of directors. Before 1906, most companies made bespoke provision to designate one or more managing directors who were exempt from retirement by rotation (Parkinson, 1993, p.77).

Second, between 1906 and 1935, the courts consistently prevented shareholder interference in the decisions of directors, offering a number of different justifications for this, ranging from protection of minority shareholders to the status of the company as a separate legal entity. Third, the courts relied on a strong presumption (known in the United States as the “business judgement rule”) that directors were acting in good faith. In doing so, they gave directors a broad discretion to determine whether particular actions were for the benefit of the company (Parkinson, 1993, p.77), and made it very difficult for shareholders to use litigation to challenge directors’ decisions. The result of these rules was that individual directors were answerable to, and subject to the residual control of, the board of directors rather than the shareholders.

### **The ongoing influence of shareholders and the impossibility of director primacy**

While company law supports a priori the director primacy model of corporate governance, the influence of shareholders on management has always been important in the Anglo-Saxon world (Zeitlin, 1974).

Despite some legal insulating mechanisms, the real pressure for shareholder wealth maximization that undermines the prospects of the board acting as a mediating hierarchy comes from market rather than legal forces. Groups of shareholders can make exit threats which are far more credible than those made by employees who have made investments in firm-specific human capital (Millon 2000, p. 1028). Exit may result in a decline in the share price, and therefore the threat of hostile takeover, reduced bonuses for executive directors and senior

managers, shareholder activism, and, in the US, a proxy fight in which a shareholder seeks to install a new board.

More generally, the board of directors is not sufficiently “insulated” from shareholder pressure (Gelter, 2009). As shareholders have considerable direct and indirect influence over directors, the mediating hierarchy role of the board has been compromised (Millon, 2000; Kaufman and Englander, 2005). This has been exacerbated by the growth of active institutional and alternative investors such as hedge funds, which demand short-term shareholder value maximization (Coffee and Palia, 2015). In particular, the law, both in the US and in the UK, gives shareholders great powers of influence over directors (Mayer, 2013; Greenfield, 2008; Greenwood, 2005). Directors can sometimes be forced or incentivized to give up social purposes to favor more profitable strategies (Haigh and Hoffman, 2014) or to pursue shareholder interests at the expense of the firm's long-term welfare (Lazonick, 2014), especially in takeovers or other changes of control (Page and Katz, 2010).

To summarize, company law a priori supports the separation of ownership and control but in practice, this separation is not achieved since directors, who are supposed to run the company for the joint welfare of its constituencies, ultimately are accountable to shareholders. Once these factors are taken into account, the prospects of a mediating hierarchy look much weaker. However, in all these debates, the role and authority of managers, as opposed to directors, has been overlooked.

## **THE RISE OF MANAGEMENT: NEW RATIONALES FOR SEPARATING DIRECTORS AND MANAGERS**

Few studies have analyzed the separation of ownership and control from a managerial perspective. In Blair & Stout’s analysis, there is little or no emphasis on the distinctive role of managers. Managers barely figure in this account, appearing, like employees, merely as

functional or “*bona fide*” team members (Lan and Heracleous, 2010). This contrasts with what we know from management science, which highlights the profound, transformative effects of management on employees, as they are guided to develop the capabilities necessary to achieve the enterprise’s goals (Conner and Prahalad, 1996; Eisenstat et al., 2008).

It is therefore worth trying to reappraise the separation of ownership and control, drawing on a view from management. The rise of managerial authority is often associated with the emergence, at the end of the nineteenth century, of mass production (Hounshell, 1984), the increasing size and administrative complexity of industrial organizations, and intensive capital requirements. Another factor, however, was also important: the increased pace of technological and scientific progress, and the rise of a science-based industry. In a few decades, innovation radically changed the nature, forms and purpose of corporations, and provided strong new rationales for separating ownership and control.

In this next section, we examine the role of science and innovation in the emergence of the management function, as a broad phenomenon that affected most Western countries.

### **The rationale for separating management and directorship: the role of innovation**

The “managerial revolution” has been defined in many different ways, but it became observable when managers, as a new social and professional group, obtained great influence through strategic leadership and considerable hierarchical authority over employees.

The first manifestation is the transfer of control from directors to managers. It took place in the US and in France for instance at the end of the 19<sup>th</sup> century. It became progressively more critical as more salaried managers, without being shareowners, were appointed to run businesses. Owner families often kept control of their companies (via their control of the board),

but they progressively and massively recruited managers to run their companies or sent their sons to schools that would make them knowledgeable enough to do so themselves (Joly, 2013).

The second manifestation of the managerial function is the recognition that employees were subordinated to employers within the enterprise. This was a drastic change, described in France as a “coup de force dogmatique” (Cottureau, 2002). The trend in the nineteenth century had been to conceptualize work relationships in contractual and commercial terms. Workers were more or less independent contractors or suppliers, with their own methods, and often their own tools. There were very few supervisory or managerial staff (Lefebvre, 1999). To the extent they existed, the role of hierarchies or intermediate managers was mainly to find and hire labor, and bargain over prices. The new employment contract had distinctive features: unlike self-employment, it featured an “open-ended duty of obedience” for employees (Deakin, 2009), and was based on the recognition of managerial authority (Freeland, 2009).

Building on business history, we can identify three main rationales to explain these shifts.

### **Innovation-based economy: management as a new source of wealth**

*The rise of science-based industry.* The beginning of the twentieth century was marked by integration of science and industry (Le Chatelier, 1935; Fridenson, 1987). Innovations had been, until then, often left to individual inventors or entrepreneurs (e.g. Watt & Boulton in 1795 in United Kingdom). As technologies became more complex, the development of new technologies required fundamental research (Noble, 1979; Letté, 2004). The need for scientific investigation became a pressing matter in a number of industries. From the chemical industry to telecommunications, via glass and electricity, US corporations developed industrial research laboratories from the end of the nineteenth century (Hounshell and Smith, 1988; Hughes, 1983). The number of American companies engaged in scientific research grew from 500 in 1921 to



1,000 in 1927, and exceeded 2,200 by 1940 (Reich, 1985). A new science-based industry was beginning to emerge, transforming enterprises from productive to innovative organizations.

***A new economic model.*** With the rise of science-based industry, the economy moved from one based on traditional capital to one based on innovation: the value of the enterprise increasingly derived from the capacity to organize collective endeavours rather than from ownership of the means of production or access to finance. As a consequence, capital became “passive ownership” and shareholders were simply suppliers of finance (Berle and Means, 1932).

Classical economic theory was based on production and consumption functions: it was unable to account for the production of research and the innovative power of modern companies (Rathenau, 1921; Segrestin, 2017). But in the modern innovation-based economy, the role of management was not only to reduce costs. It was more fundamentally to design previously unseen strategies and produce *new* goods and *renew* the means of production (Goyder, 1987; Rathenau, 1921; Segrestin and Hatchuel, 2011; Segrestin and Hatchuel, 2012).

### **Managerial authority based on the development of new competencies**

***Scientific management.*** The notion of “scientific management” which spread at the beginning of the twentieth century transformed labour management into a series of techniques (e.g., organizational control, executive recruitment and training, and incentive payments). Here again, the organization of work activity was not only due to the imperative of reducing costs. With the progress of mechanization, it became clear that the classical labor market did not work for more complex or innovative products. Workers were no longer able to produce the outputs with their existing know-how and tools. In innovative production regimes, the old rule-of-thumb method of management by incentives and initiatives was a (highly conflictual) dead-end. Management therefore had to organize the development of new working methods more scientifically. In Taylor’s (1911) view, the tasks of scientific management were to 1) “develop a science for each element of a man’s works, which replaces the old rule-of-thumb method’

and 2) “scientifically select and then train, teach, and develop the workman, whereas in the past he chose his own work and trained himself as best he could” (Taylor, 1911).

*A new conception of labour.* The scientific approach to the activity of labour resulted in profound changes to the employment relationships (Fridenson, 1987). Until then, workers had been independent and organized their work themselves. Labour had previously been seen as a commodity, with wages driven by the competitive market. Subsequently, their 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. Taylorism is often denigrated as de-skilling workers, but management was first and foremost a function to renew and develop workers’ capabilities. Progressive thinkers such as Commons (1919) grasped this shift from a theory of the man as a commodity to one where he was considered “a mechanism of unknown possibilities” (Commons, 1919).

### *A new field of expertise*

A new field of expertise, that was not just technological but also social and human engineering, emerged. It required new skills and competencies to organize research activities and innovative processes. And the more science drove business organizations into the unknown, the bigger the demand was for radically new competencies to devise innovative but sustainable strategies. This, in turn, drove the new role of executives and the need for managerial discretion.

Traditional accounting methods and schools, and traditional economics could not address the new industrial challenges. New curricula on administrative science were therefore introduced at universities. In the United States, following the creation of Wharton School of Business in 1881, Harvard launched its Master of Business Administration in 1908, and the

number of business schools grew rapidly (O'Connor, 2012; Hambrick and Ming-Jer, 2008; Khurana, 2007), “a manifestation of the modern conception of business” (Brandeis, 1914).

### **New social responsibilities**

The rise of management overwhelmed traditional economic and industrial relationships but did not occur without frictions and conflicts. Globally, however, it was part of a progressive movement and the recognition by labour law of managerial authority implied increased responsibilities for managers. For instance, at the end of the nineteenth century, employment relationships meant the employer absorbing social risks. Legislation towards the end of the nineteenth century made employers responsible for workplace accidents (Commons, 1919; Saleilles, 1897).

More generally, the role of management was positively correlated with the public interest for two main reasons.

First, the scientific rationalization of work was likely to both stimulate the production of useful goods (Rehfeldt, 1988; Fridenson, 1987) and increase wages, as well as potentially reducing working hours (Brandeis, 1914: 41). The promise of scientific progress was also enormous: electricity, automobiles, telecommunications, and polymers, for example, were expected to deliver great social utility. Managers often put forward their social responsibilities and the public or quasi-public services they were delivering as part of their businesses (Marens, 2008). Perkins, for instance, considered managers as “quasi-public servants” (Perkins, 1908).

The rise of management also played a political role as it was also likely to alleviate the social conflicts between capitalists and workers. Scientific managers played the role of a “neutral technocracy” (Berle and Means, 1932), likely to calm relationships between owners and workers (Savino, 2009). This role had a broader purpose than the economic profit of the

company. Its aim was to develop workers' and organizational capabilities. Many authors and businessmen considered that 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). This clearly went with the responsibility to define a common purpose capable of mobilizing different stakeholders (Barnard, 1938). A number of texts from the period, across different disciplines, repeated the idea that managers were professionals, trustees, and impartial judges or arbitrators (cf. Perkins, 1908; Dodd, 1932; Brookings, 1925; see also Cambon, Le Chatelier or Amar, in France, quoted by Fridenson, 1987). Modern management therefore had wider social responsibility than directors had.

### **THE RISE OF MANAGEMENT: THE SPECIFIC CASE OF THE UK**

It is clear that the development of management followed a different pattern in the UK than in the US, or in Germany or France. Different reasons have been put forward. Among them, we can quote the ownership structure and the related "proprietary theory of the firm" (Quail, 2002), but also the noticeably different approach to engineering (Buchanan, 1989). It is beyond the scope of this paper to offer a detailed account of British business history, but it is important to note that recent historical works have traced the rise of management in the UK during this period.

The influence and authority of management was important both at the head of business companies and upon employees.

At the headquarters level, for instance, founding families maintained representatives on the board of directors for an exceptionally long time (Franks et al., 2005; Keeble, 1992; Wilson and Thomson, 2006). The handover of control of the business to professional managers, however, started in the 1870s (Wilson and Thomson, 2006). This was a slow process (Lewis et al., 2011), but accelerated from the 1930s, when the number of managers employed in British

businesses began to grow rapidly. 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)).

At the level of employees, in the United Kingdom, master and servant law was definitively abolished very late in 1875 (in France, this change came much earlier, with the Revolution at the end of the eighteenth century proscribing contracts that were not between juridical equals, like those of guilds). But the same “conceptual shift” (Deakin, 2009) from commercial relationship to employment contract was observable at the end of the 19<sup>th</sup> century. Similarly, the development of the management function was less dramatic than in the US, but it still increased importantly: the proportion of administrative, technical and clerical staff grew from 8% of the workforce in 1907 to 15% in the mid 1930s and to 20% by 1948 (Whitston, 1995).

Basically, the structure of ownership slowed down but did not prevent the rise of the managerial function, and there is evidence to indicate the three main drivers we identified above were relevant for UK too.

- ***A new business model based on innovation***

The rise of management driven by science-based industry was also less visible in the UK: engineers, who elsewhere were a symbol of the integration of science and industry, followed a different “craft” model in the UK (Smith, 1990; Smith and Meiksins, 1995). British engineers historically entered the engineering profession through apprenticeships. This system emphasized the importance of engineering as a “practical craft” rather than a theoretical discipline, and connected technical workers to manual crafts. While in the late nineteenth century American universities were restructured to supply engineers to take up positions in the corporate hierarchies of large firms (Noble 1977), in Britain engineering courses were

restricted to a few institutions and did not in any way disrupt the apprenticeship systems (Seethamraju, 2004)

However, different evidence can be put forward. As Whitston (1995, p56) puts it, "...even in Britain, business was being driven slowly, painfully and unevenly down the path already trodden in America." It was for instance the key purpose of the Institution of Mechanical Engineers, created in 1846, to bridge science and industry. Its purpose was "to enable Mechanics and Engineers engaged in the different Manufactories, Railways, and other Establishments in the Kingdom to meet and correspond, and by mutual exchange of ideas respecting improvements in the various branches of Mechanical Science, to increase their knowledge and give an impulse to inventions likely to be useful to the world" (Buchanan, 1989, p. 80). This occurred gradually, as demand for research in industry, while heterogeneous, grew at the end of the 19th century, especially in the industries that relied on new technologies.

As a consequence, the education of engineers was also pushed progressively toward more scientific curricula. This move was certainly weak and late compared for instance to Germany, but after initial unsuccessful attempts in London at University College and King's College, Glasgow and Manchester established more systemic and theoretical programmes for engineers (Buchanan, 1989).

Finally, beyond engineers, many industrialists (as well as scientists, e.g. (Crookes, 1898)) recognized the critical role of science: "It is chiefly in the manufacturer's appreciation of the scientific branches of his establishment, and of research work that the need lies. We require more employers with Captain Cuttle's admiration of the man chock full of science." (Burton, 1899)a

- **New managerial competencies and curricula**

Regarding the recognition of a distinct corpus of managerial competencies and the creation of new business schools, the UK was late too<sup>3</sup>. Yet, here again, there is strong evidence that managerial principles, methods and tools were passed to UK companies too.

It is now acknowledged that, especially through the role of production engineers in new industries, the influence of the Taylorian movement was evident in the early 20<sup>th</sup> century. At the end of the nineteenth century, early labour management policies rejected the “laissez faire” doctrine and adopted the “industrial betterment” principle to improve working conditions and standards of rewards (Child, 1966, p. 35). It was clear, at least in a few pioneering companies, that labour could be approached in a rational way and organized with limited effort for improved outcomes (Rowlinson, 1988). Industrialists such as Cadbury, Rowntree and Renold were both receptive to and critical of scientific management. They were reluctant to consider workers as “living tools”, but were also convinced by the importance of developing new expertise to rationalize working processes and train workers.

It is true that business schools were introduced very late in the UK – especially at Cambridge and Oxford (Arena and Dang, 2011) - but there were moves to institutionalize the new knowledge. For instance, between 1918 and 1921, the Industrial Welfare Society, the National Institute of Industrial Psychology and the Institute of Industrial Administration were founded.

There were also considerable efforts to conceptualize the new function of business administration. By 1914, management started to be formalized<sup>4</sup>. A whole body of literature emerged from practitioners (such as Burton, Renold, and Lee in the UK), who tried to synthesize their experience and careers as general managers. They also theorized the new role

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<sup>3</sup> Charles Babbage was a pioneer and a notable exception when he called, as early as 1835, for a systematic and rational discussion of engineering (Babbage, 1835).

<sup>4</sup> See for instance: Edward Cadbury, *Experiments in Industrial Organization*, 1912; or Herbert N. Casson, *Factory Efficiency*, 1917).

of administration in modern companies, which went far beyond the roles of cost reduction or monitoring that had been conceptualized by economists. All these authors felt that management required methods and doctrines which departed fundamentally from classical accounting, engineering and political economy.

- **Extended social responsibilities**

Finally, there is also a range of evidence as to the progressive role and extended responsibilities of business men associated with the new managerial ethos. For instance, as managers started to organize the work of employees, the law made employers liable for industrial accidents: the Workmen's Compensation Act 1897 in the United Kingdom introduced liability a year before France. Whilst obviously not all managers followed this approach (see e.g. Quail 2002), a 'public service' mandate was claimed by many industrialists in the United Kingdom, including W. L. Hichens (chairman of Cammell), Lord Leverhulme and Seebohm Rowntree, who claimed they regarded industry as a national service. Management was identified as the agent of technological change and a vital force for human progress.

As Whitston puts it, "Scientific management was a 'progressive' movement". In the UK, he explains, the advocates of scientific management "denounced the conservatism of employers as well as workers. They attacked the lump of labour fallacy but also demanded high wages for productive work; criticised laissez faire and lauded planning. They offered a vision of social and industrial peace based on worker and employer co-operation in generating a surplus big enough to have no need to argue about its distribution. Scientific managers were more likely than others to welcome new ideas about human relations because they were seen, by Taylor's successors, as an extension of the science of management" (Whitston 1995, p.156).



In summary, despite significant differences in the timing and institutionalization compared with the US, the rise of modern management was broad-based and significant in the UK.

## **MANAGEMENT AS A BLIND SPOT FOR COMPANY LAW AND ITS REFORMERS: THE UK CASE**

### **The reception of the rise of management in law: an ambiguous turn**

How did the law respond to rise of management? In labour law, a power to manage was recognized. The status of managers was not, however, clarified because formally the employer is the company, and not the manager. Managers are basically viewed as representing the employer (Davies and Freedland, 2006). To grasp managers' status, we therefore need to look at company law.

As a separation between directors and managers began to develop in practice, this was belatedly recognized by the law, which had always by default allowed directors to delegate their management function to one or more of their number (Art 68 Table A 1862). From 1908, the law allowed directors to appoint a *managing director* or a *manager* “for such term, and at such remuneration (whether by way of salary, or commission, or participation in profits, or partly in one way, and partly in another), as they may think fit...” (Art 72 Table A 1908).

The effect was that managers below board level were treated as representatives of the employer by labour law, but simply viewed as employees from the perspective of company law. This meant that they could be dismissed and could be restrained from divulging trade secrets, but were not subject to fiduciary duties and had no other special status.

“A sharp line was drawn between the directors (seen as partial owners representative of the owners as a whole) and managers (seen as employees). Firms were viewed as sets of

operations carried out by employees but initiated and supervised by directors in a manner analogous to the separate roles of politicians and civil servants.” (Quail, 2002).

The role of managing director is therefore a strange hybrid. The managing director also had to be a director, to maintain a connection between the board and the management. As the practice evolved of directors appointing one or more of their number as managing directors to act as the head of management, the courts had to identify the legal implications of appointing a managing director. They recognized the validity of these contractual arrangements, and took the view that a managing director is both a manager and a director. However, beyond stating that the role was “of a managerial and not of a subordinate character”, the law did not prescribe the functions of the managing director, which were determined by the contract between the director and the company.<sup>5</sup> A company law textbook of 1920 explained that “The duties of the managing director are to attend to the commercial part of the business of the company, and not to things which concern the company itself but not its business” (Stiebel, 1920, p.43). There was a separation between the management function, which could be delegated by the board, and the control function, which could not. In effect, in law, the management function was a residual category, consisting of all those functions which the directors were allowed to delegate.

Hence, boards could not delegate to managers in such a way that they would be free from board supervision. In one case,<sup>6</sup> the company, acting through the two governing directors named in the articles, had appointed the plaintiff as sole manager of its confectionery department with full power to conduct the business of the department without interference from the directors except as regards expenditure of capital on new branches, erection of buildings and machinery and conduct of legal matters. The court ruled that the agreement was outside the power of the company (that is, it was an infringement of the articles), and therefore the

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<sup>5</sup> Per Lord Reid in *Harold Holdsworth & Co (Wakefield) Ltd v Caddies* [1955] 1 All ER 725 at 738.

<sup>6</sup> *Horn v Henry Faulder & Co* (1908) 99 LT 524.

plaintiff could not rely on it to prevent interference. Power to manage the business had been delegated by the company to the two governing directors under its articles, and the company therefore had no power to appoint someone who would have a share in the management “independently of the control of the governing directors”. Where management was delegated to a general manager, the courts took the view that the scope of permissible delegation was determined by the articles. This meant that “the only duties which [the board] could delegate to the general manager are those which belong to the management of the ordinary commercial business of such a company”.<sup>7</sup>

The historical emergence of management was therefore accommodated within existing legal structures, rather than supported by a specific legal regime. Managers were viewed as employees and were never given any special authority. As a result, managers’ innovative function, distinct competencies and social responsibilities were neither defined nor protected by law. Instead, the law’s focus was restricted to the relationship between directors, shareholders and the corporate entity. As we will see in the next section, this legal ambivalence opened the door for these developments to be reversed following World War II.

### **The absence of management in company law and corporate governance reforms**

We now review more thoroughly the main changes to company law and corporate governance after World War II that affected the status of management in the United Kingdom. We do not purport to offer a comprehensive account of company law reforms, but to show how particular changes overlooked the issue of managerial authority and left the door open to principles of corporate governance that weakened the management function, giving non-executive directors and shareholders greater influence over strategy. More precisely, our analysis shows that the absence of a clear managerial status allowed reforms that reversed the

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<sup>7</sup> *County Palatine Loan and Discount Company. Cartmell’s Case* (1874) L.R. 9 Ch.A 691.

managerial “revolution” (Fourcade and Khurana, 2013; Styhre, 2015) outlined in the previous sections. These reforms basically 1) reduced managerial authority and restored ownership as the source of legitimate power; 2) suppressed the reference to special competencies to run companies; and 3) alleviated the reference to social responsibility and the role of businesses in society and the collective interest.

*The 1948 Company Law Reforms – the way back to ownership-based economy?* A Company Law Amendment Committee, known as the Cohen Committee, was appointed in 1943 and reported in 1945. This review took place against a background of recognition of the growing separation of ownership and control, concerns about the quality and reliability of company accounts, and a wider debate about the role of companies in society (Clift, 1999; Bircher, 1988). 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”.<sup>8</sup> With key members considering shareholders as “proprietors” and “those on whom the first loss falls”,<sup>9</sup> the Committee focused its attention almost exclusively on strengthening the position of shareholders in relation to directors. There was no discussion during the reported proceedings of the Committee about the emergent role of management during the first half of the twentieth century.

After reviewing the evidence on the growing separation of ownership and control, the Committee concluded that it was “desirable to give shareholders greater powers to remove directors”.<sup>10</sup> To make it easier for shareholders to exercise control over the directors, the Committee recommended a number of changes, including the introduction of mandatory

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<sup>8</sup> Cohen, *Report*, 7

<sup>9</sup> HMSO, *Minutes*, paras 1743, 3682 and 10205

<sup>10</sup> Cohen, *Report*, para 130

minimum notice periods for general meetings to make it easier for shareholders to attend, facilitating shareholder resolutions and making it harder for directors to solicit proxies. The most important change, however, 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 only briefly discussed by the Committee during its meetings at a late stage in the process, but was introduced in section 148 of the Companies Act 1948 and overrode the provisions in the articles relating to the removal of directors, which, by default, required a 75% majority of shareholders.

The importance of this change was almost entirely overlooked by commentators, both at the time (see for example Dodd, 1945; Kahn - Freund, 1946) and in the years that followed (Wedderburn, 1965). Introduced by section 148 of the Companies Act 1948, this rule, however, fundamentally changed the balance of power within companies. In particular, it allowed hostile takeovers to emerge as a means of dislodging managers. Before 1948, hostile takeovers were virtually unheard of, but the first wave struck the UK in 1952. Section 148 opened up many companies to takeover, because incumbent directors knew that even if a bidder only acquired majority control of the general meeting, it could remove them from the board, leaving them locked in as minority shareholders (for an example of this in 1953, see Bull and Vice, 1961). In essence, it amounted to a statutory "breakthrough" rule that allowed any shareholder who acquired a majority of the shares to take control of the composition of the board, leaving the board and the management vulnerable to change at short notice (Johnston, Segrestin and Hatchuel, 2019).

This rule was introduced with no regard to the separation of directors and management that occurred during the first half of the twentieth century. It represented a return to the view that the wealth of a company is the result of its ownership and capital provision, rather than the collective innovation processes organized by management. It relied on reductive assumptions

about shareholders as owners, and sought to make directors accountable to shareholders, entirely ignoring the new role of managers as technocrats or stewards of the enterprise, with real discretion (Veldman and Willmott, 2016).

*Non-executive directors – a transfer of control back from managers to directors.* A second fundamental change began during the 1970s, as policy-makers began to call for greater numbers of non-executive directors (NEDs) on boards. There had always been NEDs on the boards of listed companies, as a way of reassuring shareholders, but they were widely disparaged as “guinea pigs” (Samuel, 1933). Their rehabilitation as a means of “countering the vicious practice of having the board controlled or dominated by the managers” began in the United States in the 1930s (Douglas, 1934). In the 1940s, the US Securities and Exchange Commission (SEC) began to recommend that publicly-held companies should have audit committees consisting of “non-officer board members” as a “means of strengthening auditor independence” (Earle, 1979). The SEC became more active during the 1970s, with successive chairmen arguing for more outside directors, until in March 1977 the New York Stock Exchange imposed a listing requirement that companies should have audit committees composed at least predominantly of outside directors. This requirement took effect from June 1978 (Sommer, 1977).

As the takeover boom of the 1960s faded, these US developments influenced the United Kingdom. In 1973, the Confederation of British Industry (CBI) published a report entitled “A New Look at the Responsibilities of the British Company”, with the support of the Governor of the Bank of England. The report concluded that “inclusion on the board of non-executive directors was highly desirable”. The CBI was strongly opposed to the introduction of two-tier boards with employee representation, which had been proposed by the European Economic Community in its Fifth Company Law Directive. This recommendation sought to head off that threat by increasing the monitoring role of the one-tier board. The government supported an

expanded role for NEDs, but declined to legislate. However, the CBI's recommendations had considerable influence, and ultimately acted as a starting point for the work of the Cadbury Committee. From 1978, 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 formalized these developments in 1992.

These efforts bore fruit. In 1976, boards in the United Kingdom still tended to be dominated by management, with around 25% of the largest 1000 companies having no NEDs, and the majority having between one and five. These NEDs were rarely in a majority on the board, with larger companies tending to have boards of ten or more directors, but few having more than five NEDs (Bullock, 1977; 1978). By 1979, however, the Bank of England estimated that 88% of the largest 1000 companies had at least one NED, while 53% had three or more, with higher numbers in the largest companies (Bank of England 1979). By 1988, 75% of directors were independent, in that they had no previous or present relationship with the company (Bank of England 1988).

The rise of NEDs therefore reversed the earlier transfer of control from directors to executive managers. In practice, the growing number of NEDs had significant implications for management. We have little evidence on the information on which NEDs base their decisions (see for example the Higgs Report 2003), but their control over management is largely based on financial metrics (Baysinger and Hoskisson, 1990). The role of management and its related competencies were never recognized, so, like the 1948 law reforms, this soft law reform pushed corporate governance back to the pre-managerial period.

***Institutional investor engagement: from common purpose back to private control.*** One last change is worth mentioning to show how the rationale behind the distinction of

management was eclipsed in the second half of the twentieth century. The rise of institutional shareholder engagement and, later, activism, was strongly encouraged by policy makers, with little regard to the need to separate ownership and control in modern businesses.

From the mid-1950s onwards, institutional investors began to increase their shareholdings, so that by 1963, they owned 21% of listed company shares (King and Fullerton, 2010). Their shareholdings continued to increase steadily, from 37.8% of listed companies' shares in 1969 to 58.9% in 1985 (Cosh et al., 1989). Policy makers saw engagement by these new institutional investors as a complement or alternative to the market in ensuring that shareholders could hold management to account. In 1972, against the backdrop of a downturn in the takeover market, the Bank of England set up a working party to discuss the creation of a "central organisation through which institutional investors, in collaboration with those concerned, would stimulate action to improve efficiency in industrial and commercial companies where this is judged necessary" (Bank of England Annual Report 1972 at 25-6). The result was the establishment of the Institutional Shareholders' Committee (ISC), supported by the Bank of England. The Bank of England was alarmed by the fact that the law had made shareholders "technically supreme", but that they had "all but abdicated", deciding only on the success or failure of takeover bids (Charkham, 1989). New efforts were therefore made by the ISC to address the perceived problem of communication failures between institutional shareholders and corporate managers. 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). It also noted the importance of shareholders exercising their voting rights, and paying particular attention to questions of board structure, the primary concern of Cadbury's report. Institutional investor activism became a progressively more



important part of corporate governance policy, culminating in the adoption of the Stewardship Code after the 2008 financial crisis, which built on the activities of the ISC and termed institutional investors “stewards”, a function which Cadbury had originally assigned to the directors (who, following his recommendations, would mainly be NEDs).<sup>11</sup>

This phase of corporate governance policy represents another sidelining of managerial discretion, with institutional investors now having authority to offer views on strategy directly to NEDs, over the heads of managers. The separation of ownership and control allowed managers to take into account the interests of various stakeholders. As we outlined in the first part, historically, managers’ role and responsibility was critical for employees who had begun to bear risks as their capabilities were transformed by the innovative industrial regime. These social responsibilities of managers, however, were not explicitly recognized by law, making them vulnerable to reforms that reduced managerial discretion. These changes in corporate governance allowed institutional investors to have significant influence on strategy, without bearing responsibilities to employees, society or the environment.

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

In this article, we have contrasted 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 have highlighted how the rise of a distinctive management function provided some important reasons for separating ownership and control. We identified three basic rationales: the shift of the source of wealth from ownership to management, the need for

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<sup>11</sup> Cadbury, *Report*, paras 2.5, 5.1, 6.1 and 6.6

specific skill-sets, and the rise of new social responsibilities. Corporate law clearly distinguished between directors and shareholders, but managers remained either employees (with no autonomy) or directors. Progressively, reform—overlooking 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 they meant that the overall mission of management to develop new capabilities and organize innovation processes has progressively become secondary to the purpose of maximizing shareholder value. More and more authors, however, now consider that innovative strategies are essential to long term value creation, to support balanced stakeholder management and to drive sustainable economic development.

Our analysis therefore adds to the body of research on the separation of ownership and control by shedding new light on the historical status of managers. It also suggests that the law has overlooked fundamental changes in business organizations. The law has been primarily concerned with the relationship between board and shareholders and has almost entirely ignored the position of managers. A legal conceptualization of the function of management could have provided alternative foundations for a separation of ownership and control. Our article also opens new avenues for research. If we consider, as many authors do, that managerial discretion is a key condition for both collective innovation and stakeholder management, could the law integrate a conceptualization of management? Throughout the twentieth century, many proposals for reforms of corporate governance were suggested, including alternative business forms (such as cooperatives and hybrid organizations), broadening fiduciary duties (Orts, 1992), broadening participation by allowing groups other than shareholders to appoint, influence or sit on the board (Asher et al., 2005), changes to takeover regulation, and enterprise contracts (see (Wells, 2002) for a review). More recently, it has been suggested that it may be helpful to extend fiduciary duties to controlling shareholders, who have considerable influence on

management decisions (Anabtawi and Stout, 2008). Would such reforms resolve the confusion between management, directors and controlling shareholders, however?

In our view, very few proposals really aim to recognize the role of management in law. Our analysis therefore calls for further research to make the distinctive role of management more visible in law. The historical basis for management may inform new ideas for reform, and a better conceptualization of management in law might fuel new laws about enterprises. We believe that the law should recognize the role of management in ensuring companies' ongoing survival and prosperity.

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