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Research Article

THE PHENOMENON OF SEPARATION OF OWNERSHIP AND CONTROL IN CORPORATE LAW

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ABSTRACT

This essay discusses the phenomenon of separation of ownership and control by arguing who is the real owner of company. By discussing the different interests of members this essay identifies that company is considered as real entity which has own interest from its members. This phenomenon is supported by different cases and current legislative norms. [1] The main concern of the modern company is to find whose interest should be issued as primary purpose of the company. Some scholars argued that company and its employees should serve to desires of shareholders who are owner of the company. [2] However, this argument influences the relationship between principal and agent hence agency problems have been concerned as the most unresolved issue of company.

KEYWORDS

Phenomenon of separation, argument influences the relationship, most unresolved.

INTRODUCTION

[1] *Companies Act s 172*

[2] *M. Friedman 'The Social Responsibility of Business is to Increase its Profits' (1970) The New York Times Magazine, 33, 122*

The issue of separation ownership and control has been a controversial and much disputed subject within the field of company law. This phenomenon has been arguing as one of the key issues of modern company because now company is not a family business which brings only profit to its owners but also it is seen as a complex mechanism which effects to the economy and community as well. The main concern of the modern company is to find whose interest should be issued as primary purpose of the company. Some scholars argued that company and its employees should serve to desires of shareholders who are owner of the company. [3] However, this argument influences the relationship between principal and agent hence agency problems have been concerned as the most unresolved issue of company. Several initiatives have been created to mitigate the bad effects of agency problems in spite of its high costs. However, these mechanisms have not fully resolved the main problems of agency relationship. As a result, there was big collapses of companies which effected not only to the company but also to the community as well. These falls have signaled to the necessity of changing the behavior of agency relationship. That's why the last two decades have seen a growing trend towards team production theory which describes equal relationship toward all participants. This essay helps to understand that which kind of relationship is more beneficial for all members of company and suggests different solutions to align the interest of participants of company. Firstly, it describes the relationship, more specifically the separation between principal and agent and tries to find the main differences between theory and practice. Then shows some agency problems which influences the relationship and gives specific suggestions to mitigate its effects. Finally, it provides new theory as a solution for corporate dilemma.

Analyses on separation of ownership and control

The relationship between principle and agent

To outline the main roots of this topic it is important to understand whose interest should be promoted as a primary issue on the company. According to some scholars, the primary purpose of the company should be making profit for its shareholders. Managers should loyally serve his principals. [4] American scholar Dodd argued that managers should be granted with control but their control should be served to the interest of the shareholders. To support his idea, he emphasized the case of Dodge v. Ford Motor Co, [5] which directors were considered as fiduciaries to stockholders. However, the main weakness of his study is the failure to address the phenomenon of separation of ownership and control in practice. Because in reality shareholders are generally passive and dispersed which gives to managers much power of total control. According to another American scholar Berle, separation of ownership and control leads to the lack of accountability of managers to their investors and society as well. In his study he offers that there should be tight accountability mechanism for shareholders to control managers. [6] His findings show that managers can be seen as trustees when they are enforced to take responsibility. Another point of his suggestion is that managers should be responsible not only to

[3] *M. Friedman 'The Social Responsibility of Business is to Increase its Profits' (1970) The New York Times Magazine, 33, 122*

[4] *M. Dodd 'For whom are corporate managers are trustees?' (May, 1932) Harvard Law Review, Vol.45, No.7, 1145.*

[5] *[1919] 204 Mich. 459.*

[6] *A. Berle 'For whom are corporate managers are trustees?' (Jun., 1932) Harvard Law Review, Vol.45, No.8, 1370*

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stockholders but also other stakeholders such as employees, consumers and community as well. [7] This approach has been encouraged later by some scholars who sees the company as a team which all participants have equal rights. [8] However, Berle's analysis does not take into account the costs of accountability because one of the main concerns of agency problem is the high costs of good monitoring mechanism. According to the agency theory shareholders encourage the power of board of directors to monitor the interest of managers in order to ensure whether managers follow to the interest of stockholders. This approach has been believed to make managers more accountable. However, in practice board of directors are de facto controlled by companies' CEOs. [9] So there is one reasonable question is that who is the real owner of the company?

Who is the real owner of the company?

As it was discussed above, shareholders have the sole ownership and control over company. Because they put their own money to company to make profit. According to Dodd, although the agents manage the company on the behalf of the shareholders, the customers and creditors of the company have contract rights against the company, in reality against the shareholders. [1011] In his studies he concludes that stockholders are only residual claimants of the company. However, he offers no explanation for the distinction between the ownership of capital and ownership of company. The main idea is that the shareholders own the capital of the company but not the company itself. Additionally, the capital is used by managers as guarantee performance of the companies' contracts. [12] It means that, shareholders have no full property right over the income of the company and they are considered equal participants like other claimants. Even their interest may be put below from other creditors rights when the company goes to insolvency[13]. However, they have the right to compel the directors to make the profit for the benefit of the shareholders. [14] For instance, if the interest of the directors does not align with interest of the stockholders, they can remove the directors or sell their shares to another company which makes vulnerable the management of company. In order to make company more stable managers need to satisfy the wishes of shareholders and provide the minimal amount of profit for them. [15] However, in practice the voter rights of shareholders are relatively weak, because their decisions may not align with the interest of the company. It is clearly seen in the case of Automatic Self-Cleansing Filter Syndicate Company, Limited v Cuninghame[16] which court held that directors could not be compelled to obey the resolution of shareholders which was not benefit of

[7] *ibid 1372.*
[8] *L. Lan and L. Heracleous 'Rethinking agency theory: The view from law'. (April 2010) The Academy of Management Review, Vol.35, No2, 294-314*
[9] *E. Williamson 'Corporate board of directors: In principle and in practice' The Journal of Law, Economics, & Organization, V24 N2. 252.*
[10] *Dodd (n 2) 1145.*
[11] *Kholmirzaev U. PROBLEMS OF LIABILITY OF CONTROLLERS OF CORPORATIONS TO CREDITORS IN UZBEK LAW //Review of law sciences. – 2020. – Т. 4. – №. 2. – С. 146-154.*
[12] *F. Fama 'Agency Problems and the Theory of the Firm' (Apr, 1980) Journal of Political Economy, Vol.88, No.2, 290*
[13] *Asmussen v. Quaker City Corp [1931] 18 Del. Ch. 28*
[14] *Umarov B., Khamdambek A. The Role Of Corporate Control In Protection Of The Rights And Interests Of Shareholders //The American Journal of Political Science Law and Criminology. – 2021. – Т. 3. – №. 12. – С. 32-41.*
[15] *A. Dignam and J. Lowry, Company Law, (11the edn, Oxford University Press, 2020) 405*
[16] *[1906] 2 Ch. 34*

the company. This case confirms that the directors should manage the company according to the bona fide of the company. So, there is one suggestion is that the real owner of the company are not shareholders while company itself. That is why directors should be owed their duties to the company. [17]

Agency problems and legal solutions

The separation ownership and control influences of relationship between shareholders and directors. Both of them have own interests in the way of the corporate governance. In agency theory directors are seen as agents of principals and they should work only interest of the shareholders. [18] However, directors always do not act as a loyal servant of the principals. Mostly in practice they have much power to make profit for their interest because the opportunities of legal protection. For instance, shareholders do not have the right to compel the directors to their interest. [19] In other word, although, shareholder can appoint or remove the directors, they can't tell them exactly what to do. [20] In practice shareholders' rights are mostly weak to assure whether the directors are acting in good faith for their benefit. In order to comply the managers to the instructions of the shareholders there are some agency problems which should be resolved to avoid conflict of interest.

Opportunistic behavior of the directors

As discussed above in agency relationship principals give the instructions to agents to follow their rules and make profit for the interest of the shareholders. However, in practice, there is no opportunity for shareholders to compel the directors in their interest. Mostly, directors are free on their discretion in the market. When, they are disciplined by competition from other companies they face conflict of interests by other parties. [21] This gives much opportunity to make profit for their interest. [22] This phenomenon is one of the main concerns of agency problems which leads the breach of duties of directors. In many cases directors try to make for their own profits rather than companies' interest. This has been seen in the case of Industrial Development Consultants Ltd v Cooley. [23] In this case the director took the benefit of the company for his own interest, although, he had fiduciary duty to act in good faith for the interest of the company. That's why court held that director breached his duties which owes to the company. This case reported here illustrates the efficiency of legal mechanism which protects shareholders against from fraudulent action of directors. [24]

Information asymmetry

Another problem of agency relationship is lack of information provided by directors to shareholders because directors usually do not tell the truth what is going on the management of the company. Managers always try to assure shareholders about their loyalty for making profit. However, in practice shareholders have to wait until the general meeting which they can get reliable information. One of the legal solutions for this problem is that putting forward disclosure mechanism to obtain necessary information from the directors. It is important for principals to get

[17] *UK Companies Act 2006, s 170 (1).*
[18] *Dodge (n 2).*
[19] *Percival v Wright [1902] 2 Ch. 421*
[20] *M. Blair and A. Stout 'A Team Production Theory of Corporate Law" (Mar., 1999) Virginia Law Review, Vol. 85, No. 2, 291*
[21] *Fama (n 9) 289.*
[22] *Bhullar v Bhullar [2003] B.C.C. 711*
[23] *[1971] 1 W.L.R. 443*
[24] *UK Companies Act 2006 s 175 (1).*

information in advance in order to feel confident whether the interest of directors is aligned with their interest. In practice there are different regulatory norms to enforce disclosure systems. One of them is duty to declare interest in proposed transactions. [25] This statutory norm provides transparency of different transactions and helps to avoid conflict of interests by directors.

Agency costs and its impacts

As explained earlier, the separation of ownership and control effects to the relationship between principals and agents because the interest of the directors always is not aligned with the interest of shareholders. Usually directors want to be independent and make their name more famous to achieve higher carrier in other big corporations. So, in practice shareholders' rights are generally weak to compel the directors to their instructions. They struggle to get trustworthy information from their agents because mostly managers do not give them all the evidences of their performance. As a result, it effects their purpose of profit maximization. To make managers more accountable, shareholders have to spend much money in order to ensure whether their interests are playing primary role on the companies' affairs. For instance, principals should spend monitoring costs for financial analysts, audit procedures to monitor the performance of directors (the monitoring expenditures), remuneration costs for encouraging the directors to work loyally (the bonding expenditures) and damage costs for fraudulent actions of directors (the residual loss). [26] These agency costs significantly reduce the benefit of shareholders. Most part of their profit is spent to monitor the behavior of managers. However, these costs have not reduced the opportunistic interests of managers. Some scholars have suggested to give some shares of company to managers in order to increase the profit and align the interest of both sides. It is believed that when the directors are encouraged with ownership of the company, they will start to serve to the interest of shareholders. That is why in US many corporations changed their compensation behavior from cash-based system to equity-based system. For instance, in US at the beginning of the 1990 the equity-based compensation consisted of small deal of percent (10%) on the salary of chief executive directors (CEOs) while after a decade this percentage increased dramatically to 66 percent. [27] These findings show that if profit of the company increases, it effects annual earnings of CEOs as well. This approach has been believed the most reliable tool to align managers' interest with shareholders because this incentive has encouraged the directors to make more profit in short term. However, this approach failed to asses the effectiveness of accountability of directors because in many cases directors tried to hide the failures of the company in order to make company more attractable in front of shareholders. In order to get more options from shares directors had to make more fraudulent actions. It can be seen in the scandals of Enron and WorldCom. In both scandals the directors took the position of gamesmanship and tried to hide the debts of companies by creating loophole accounts. What is surprising that WorldCom took the name of most admired global companies of 2002 only a few

[25] *Ibid s 177.*
[26] *C. Jensen & H. Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 Journal of Financial Economics, 308*
[27] *C. Coffee 'A theory of Corporate Scandals: Why the USA and Europe differ' (2005) Oxford Review of Economic Policy, Vol. 21, No. 2, 202*

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months before its collapse. [28] These scandals showed the main weakness of the equity-based system and the importance of the new strict rules in regulation the actions of directors. After these scandals the Congress of US accepted Sarbanes-Oxley Act[29] which requires extensive periodic reports from companies. For instance, under the section of 906 of this Act every company should provide periodic report with financial statement written by companies' CEOs and section 407 requires the audit committee should include independent financial expert. These requirements are significant in two major respects. The first one helps to increases the responsibility of directors while binding them with criminal offence. The second one is important to be independent gatekeepers (auditors) in company from the pressure of CEOs.

Team production theory as a best solution

Examining the relationship between shareholder and directors

The previous studies have explored the relationship between shareholders and directors as "grand-design principal-agent" model where directors should monitor the company for the purpose of maximizing the shareholders' interests. However, in reality managers always try to maximize their own interests rather than the shareholders interest. Several lines of evidence show that the initiatives which put forward to mitigate the influences of agency relationship have not helped to solve the problem. Some scholars think that, one of the main weaknesses of agency theory is considering the directors as agents of shareholders. [30] They claim that directors should be independent from the direct or indirect command of shareholders. If the directors are under the command of shareholders, it will deteriorate the relationship between company and its stakeholders because directors seek to make profit opportunistically from the interest of other members of the company. In team production theory directors are seen as mediating hierarchs whose work is keeping the balance of different participants' claims. [31] In other words, there is not any principal-agent relationship between them because shareholders are considered one of the stakeholders of company. According to this theory company is not considered "nexus of contract" between individuals, it is considered "nexus of firm specific investment" in which every participant can contribute with their resources. [32] Some of them with their time, ideas, work experiences, others with their capital. They work together in one team to make profit and they want to get the part of their profit fairly. The main aim of this theory is to unite all the participants in one team where no vertical relationship is not allowed. Even shareholders have voting-rights to pursue directors to do some actions, the board have no duty to comply. [33] One of the main importance of this theory that the profit of company must be divided regarding the contribution of the participants. In order to ensure whether the profit have been divided fairly, the role of the board of directors should be put in the top of the company.

Different approaches on the role of directors in Team production theory

In early approaches in team production theory there was some concerns about the rent seeking of team

[28] *T. Clarke 'Introduction: Theories of Governance - Reconceptualizing Corporate Governance' (London Routledge 2004) 14*
[29] *The Public Company Accounting Reform and Investor Protection Act 2002*
[30] *Blair (n 16) 290.*
[31] *L. Lan and L. Heracleous (n 6), 298*
[32] *Blair (n 16) 275.*
[33] *Auer v. Dressel [1954] 306 N.Y. 427*

members and how to reduce the impact of their opportunistic behavior. According to some scholars it is impossible to allocate fairly the final output of team because every team member tries to get more profit even by cheating other members of the team. This concern has been discussed among some scholars. For instance, Armen Alchian and Harold Demsetz argued that someone should take the role of monitor to control the shirking behavior of participants. [34] They suggested that all participants should be paid a fixed wage which is equal to their opportunity cost. Thus, this incentive helps to reduce the cost of shirking. However, their assumption failed to take consideration of difficulties on monitoring process because it was impossible to monitor the behavior of every participant. In this approach shareholders are considered as principals who take residual income after the compensation payment to participants. However, the main weakness of this approach is that giving punishment for all team members when one participant of group has made shirking. This gives more opportunity to "budget breaker" (principals) to put limit on the output of company when the cost of shirking should be paid among participants. Budget breaker may bribe one member from team to shirk a little in order to hold all the surplus of the company to themselves. [35] According to the view of Margaret Blair and Lynn Stout, in team production theory the "budget breaker" should not be principal (shareholder) while it should be company itself. They argued that all the assets and residual outcome of company should be stored to independent entity which is called board of directors. The members of board should be outsiders who have not any relationship with the member of the team. The outsiders make control over the assets of the company, they have right to divide the profit of team among its members and even have rights to punish or fire the individual team members. As an incentive they will get nominal share from the profit of team. [36] This incentive gives them to satisfy minimum demands of their interest.

The main functions of board of directors in team production theory

In team production theory the board is considered independent entity which does not have any obligation to its members. The primary function of board is to play the role of arbitrator whose work is taking the balance of all the interests of team members. There are not any principals for directors to comply their instructions. There are several layers of hierarchy and each one has authority to solve the problem of participants. If participants have any complain about the decision of lower authority they can apply the highest hierarchy to solve the problem. [37] So, board will resolve the problem as decision making authority. Furthermore, board play important role to monitor the shirking opportunity of members. If any executive director tries to make profit for his own interest board can fire him from his job. However, board should provide minimum incentive for every member to cover his opportunity cost for remaining in the team. [38] So board has absolute control to the interest of members of the team. However, there are some concerns of team members which are arisen to regulate the interest of the board whether board does not shirk. There are some corporate mechanisms which prevent the board from the shirking their duty. Firstly, directors have their fiduciary duties to the company. They should act in

[34] *A. Alchian and H. Demsetz 'Production, Information Costs, and Economic Organization' (Dec., 1972) The American Economic Review, Vol. 62, No. 5, 780*
[35] *Blair (n 16) 269.*
[36] *ibid 274*
[37] *ibid.279*
[38] *ibid 282*

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good faith to promote the success of company. [39] They should work loyally to the interest of the company. If they breach their duties, they can be suited by company itself. However, company is not a natural person who can give claim to the court. In this situation law permits to shareholders to give derivative suit on behalf of the company. [40] Secondly, directors always try to get good position because of their reputational interest. They should be loyal to encourage the interest of the team in order to stay their position. Otherwise, they may be expelled from the board even they have strong connection with company. [41]

CONCLUSION

To conclude, this essay has discussed the phenomenon of separation of ownership and control by arguing who is the real owner of company. By discussing the different interests of members this essay identified that company is considered as real entity which has own interest from its members. This phenomenon is supported by different cases and current legislative norms. [42] From the suggestions of some scholars[43], company is considered "nexus of firm specific investment" which every participant can contribute with their own resources. Although some scholars have argued that directors should serve to desires of shareholders[44], the investigation of "grand-design principal-agent" model has shown that this approach has lost its importance. Because in reality, directors are considered the absolute decision-making authority which may use their power opportunistically for their interest. Several initiatives (disclosure requirements, equity-based systems) have been introduced in order to align their interest with company. However, those initiatives have not solved the basic problems of agency relationship yet. In contrast to the agency theory some scholars have introduced the team production theory as a modern solution to the conflict of interests. According to the American scholar Blair, the surplus of company should be allocated fairly among the all members of company with the direct monitor of board which plays the role of mediating hierarchy. [45] His findings help to protect directors from the pressure of all the stakeholders of company and lead the company to great achievements.

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[39] *Companies Act 2006 s 172*
[40] *Ibid s 260*
[41] *An example can be found in the case of Apple Computer, Inc and its founder Steven Jobs. Even Jobs has founded the company, he has been fired from the management of the company by the decision of Apple's board.*
[42] *Companies Act s 172*
[43] *Blair (n 16)*
[44] *Dod (n 2)*
[45] *Blair (n 16) 276*

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