THE CONFLUENCE OF OWNERSHIP AND CONTROL:
FIRM PERFORMANCE EFFECTS
OF
MANAGERIAL EQUITY HOLDINGS

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PREFACE

In their landmark volume *The Modern Corporation and Private Property* penned over half a century ago, Berle and Means (1932, 1968) suggest that managerial shirking is endemic within the modern corporation. Their reasoning is straightforward: separation of the ownership and control functions within the corporate enterprise is necessarily paralleled by an annulment of the relationship between property rights and the power formerly associated therewith. Berle and Means contend that a necessary condition for the efficient operation of a free-market economy is that property-owners possess direct control over the disposition of their ownership interests—or at least that trustees of owners’ interests are adequately incentived to faithfully discharge their fiduciary responsibilities. Arguing that managers cannot be trusted to act as owners—due to their self-interested natures as well as lack of ownership oversight—, Berle and Means conclude that modern corporativism has rendered the capitalist model impotent. These authors’ ultimate claim is that the ‘invisible hand’ can no longer be relied upon to bring about the ‘good society;’ rather, what is needed is radical governmental intervention securing the rights of corporate stakeholders.

The current inquiry is designed to test Berle and Means’ (1968) summation by researching the firm performance effects of managerial equity holdings. More is at stake, however, than empirical evaluation of Berle and Means’ theorizations. As if it were not enough that the corporate form of business organization might serve to enervate our capitalist economic system, if Berle and Means are correct in their assessment of managerial nature the operation of our productive resources are largely in the hands of unprincipled egoists. What has come to be known as the ‘agency problem’ has been alternatively—and rather benignly—defined as a problem of ‘lack of trustworthiness,’ or as a problem of ‘agency,’ or as a problem of ‘shirking,’ or as a problem of ‘opportunism;’ at its heart, it is a problem of human nature.
And therein lies the rub. The corporate form of business organization might be censured on a number of grounds, but this most fundamental enigma has been routinely downplayed. Economists and organizational theorists alike have focused their attention on the reasons that managers might be expected to compromise their trusteeship obligations, but such academics have seldom dared to move beyond behaviorist remedies for managerial malfeasance. Manipulating the consequences of behavior may well effect change, but it is too much to presume that such ‘treatment’ will redress the human condition. The artificial entity that is the corporation may itself provide managers the seductive delusion of absolution from personal moral culpability. The resultant transmutation of the corporation from a strictly economic venture into a pseudo-religious institution is truly ‘revolutionary.’ Perhaps Berle and Means were most accurate in their assessment that “the real revolution of our time is yet faintly perceived” (1968: xxvii); this seminal reformation seems to have escaped even their detection.

My modest hope is that the current dissertation will be read against this backdrop of moral failure. Nothing contained herein is meant to sanction a systemic escape from human tragedy; rather, the path of grace alone accords access to personal exculpation.

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In opening one of his more sobering writings, Solomon notes there is nothing new under the sun (Ecclesiastes 1:10). The current dissertation is no exception; in its essence it represents nothing more—or less—than an apprehension and synthesis of the work of others. It is to these critical thinkers that I owe my most fundamental intellectual debt.

On a more immediate level, I would like to express appreciation to my committee members—Professors Harvey C. Bunke, R. Thomas Lenz, Michael B. Metzger, and David H. Smith—for their oversight of this research undertaking. Individual committee member’s perspectives have had a substantial impact on the shaping of both the processing and content of this document. Professor Dan R. Dalton, Chairperson of the Graduate Programs Office at Indiana University, deserves special mention for his constant support. I would like to extend recognition and gratitude to all my seminar professors for the investment they have made in my intellectual growth. Finally, a special thanks to the Department of Management at San Diego State University for their confidence in my abilities—and for taking a chance on a freshly-minted faculty recruit.

My tenure at Indiana University has been a time of both personal and professional transformation. Without the support of many individuals—variously known as colleagues, friends, confidants, therapists, family, priests—the journey would have most certainly ended in tragedy. The unwavering acceptance of this community has served to clothe a more profound grace with humanity. For each of you I am sincerely and eternally grateful.

It is recollection of these ‘best of times’ at Indiana University which makes completion of this dissertation, and culmination of this degree, a truly bittersweet milestone.
ABSTRACT

This research is concerned with the firm performance consequences of the separation of ownership and control in the modern corporation. Several foundational theoretic frameworks are employed within the analysis, including trusteeship theory, classical economics, managerialism, neo-classical economics, and agency theory. The study explores each of these theoretic models in some depth, with critical attention given to conjectures regarding the effect of managerial equity holdings upon firm performance. Common themes woven throughout the literature review are concerned with the nature of reality, the nature of man, property theory, public policy implications, and the theory of the firm.

Performance effects of managerial equity holdings are predicted on the basis of the managerial, neo-classical economic, and agency theory models. Within the managerial framework, managerial equity ownership should serve to attenuate the problem of separation of ownership and control by re-uniting the two constructs. Within the neo-classical school of economics it has been argued that capital markets tend to place a higher value upon those firms enjoying lower overall levels of agency costs relative to alternative investment opportunities. Agency theory suggests that opportunism, if left unchecked, results in diminution of the value of the firm as a result of managerial ‘self-interest seeking with guile;’ similarly, firms with lower levels of opportunism ought to be more highly valued by the market. Application of each of these three theoretic models supports the theorization that there exists a significant and positive relationship between levels of managerial equity holdings and firm performance, although each model offers differing explanations as to why this is the case. The research discovered modest support for this hypothesization based upon a randomized sample consisting of approximately 180 of the top 1000 U.S. companies (ranked by stock-market valuation) for the years 1987, 1988, 1989, and 1990; LISREL analysis was employed to test for reciprocal causation.
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CHAPTER 1: INTRODUCTION

Overview of Theory

The current research is most fundamentally concerned with the firm performance consequences of the separation of ownership and control in the modern corporation. Several foundational theoretic frameworks are employed within the analysis. Each of these models undergirds the hypotheses of this study, yet each has a distinct story to tell as to why the predicted relationship(s) will hold.

Such models can generally be classified as either prescriptive or descriptive. For the purposes of the following analysis, prescriptive theory will encompass those theories which suggest the way things ‘ought’ to operate from the moral perspective. More specifically, within prescriptive theory the ‘ideal world’ is one in which managers operate the firm for the benefit of the firm’s owners without ‘inducement’ (or what descriptive theorists might call ‘agency costs’). Trusteeship theory will prove the cornerstone of such analysis.

Unlike prescriptive theory, descriptive theory focuses upon the way things ‘really’ are rather than upon how they ‘ought’ to be. Such theories hold that the ideal state of fully-exercised trusteeship obligation is unavailable due to the human condition of (managerial) self-interest. Given their assumption that mankind tends to be self-serving, descriptive theorists are compelled to abandon the trusteeship view. Rather, it is assumed that—given opportunity—managers will appropriate corporate assets for their own ends. To the extent corporate ownership is diffuse, such
opportunity exists. The inescapable conclusion is that the firm will perform worse under conditions of managerial control than under conditions of some ‘ideal world’ (such as ownership control); however, each descriptive theorist offers a differing rationale as to why this relationship holds.

A discussion of classical economics will provide the backdrop against which descriptive theories might be understood. The classical economist treats the firm as a ‘black box,’ assuming that–given the operation of a free market–organizational efficiency quite naturally evolves. Descriptive theorists primarily focus upon whether managers, who are themselves self-interested, can be reasonably expected to faithfully exercise their fiduciary responsibility to the firm’s owners. At its most fundamental level, therefore, the debate is cast in terms of moral duty.

The perspective of managerialism suggests that, whenever gainful, managers breach their agency obligations. The managerial model considers owner-control of corporations—in which trusteeship concerns are moot—to be ‘the best of all possible worlds.’ Assumptions with respect to human nature precludes the possibility of an ‘ideal’ state characterized by managers faithfully serving owners. The managerial view, while correctly noting the potential for breach of fiduciary responsibility, fails to consider the benefits of managerial expertise which might attach to management-control in the ‘real’ world.

Two theoretic streams—neo-classical economics and agency theory—take explicit account of the fact that management-control might be preferred to owner-control by the market. Specifically, it is held that in the ‘real’ world one may be willing to tolerate breaches of fiduciary responsibility if the costs of same are outweighed by some other benefit. Within each of these models, the ‘ideal world’ of trusteeship—in which managers costlessly operate the firm so as to fulfill their fiduciary responsibility—is of no relevance: the assumption of gross self-interest shared by both classical economics and managerialism precludes taking such a view seriously. Rather, it is assumed the
‘best of all possible worlds’ occurs quite naturally—although the two perspectives offer somewhat different accounts as to why the existing structures are ‘best.’

As with classical economics, the firm is treated as a ‘black box’ within the neo-classical economic model. Although the assumption of managerial self-interest is far from abandoned, capital market considerations are seen as placing limits upon the exercise of managerial discretion. Given the condition of perfect knowledge on the part of investors, neo-classical economic theory posits that the level of expertise which professional managers bring to the firm necessarily outweighs any ‘slack’ which might result from misappropriation of organizational resources. Were this not the case, it is presumed efficiency considerations would demand the natural evolution of firms characterized by owner-control. Given the predominance of management control, such organizational arrangements must represent the ‘best of all possible worlds.’

Unlike the foregoing models, agency theory does not treat the firm as a ‘black box;’ rather, agency theory suggests manager-control may be preferred to owner-control because of the operation of the intra-firm capital market. Structuring decisions are implicitly made with an eye toward minimization of those transaction costs attending the principal-agent relationship.\(^1\) While the benefits of managerial expertise are assumed to outweigh the costs of shirking within manager-controlled firms, both opportunism as well as moral hazard are viewed as chronic organizational problems to be defeated through a variety of structural mechanisms.

The current study will explore each of these theoretic models in some depth, with critical attention given to conjectures regarding the effect of managerial equity holdings upon firm performance. Beyond merely providing an overview of each theory, the critical assumptions underlying each

\(^1\) It ought to be recognized that under the ‘ideal world’ of trusteeship theory, in which the altruistic perspective is preeminent, such transaction costs would be non-existent—making consideration of performance differentials between owner-control and management-control moot.
perspective will be unearthed. Several common threads will therefore be woven throughout the
literature review. These themes are concerned with the nature of reality, the nature of
personhood, property theory, public policy implications, and the theory of the firm. The first
of these, being common to all theories contained herein as well as of foundational importance to
an understanding of how ‘good’ science is conducted, will occupy the next section of this
manuscript.

Nature of Reality

“Science has two faces: one that knows, the other that does not know yet” (Latour, 1987: 7). On
the one hand, scientists are realists in that they believe observable consequences (Nagel, 1979:
79-82) are ‘judged’ by “the only independent referee there is, Nature” (Latour, 1987: 98). On the
other hand, these same scientists are relativists in that they believe observable consequences
are ‘judged’ only among themselves and their broader research community, absent the weight of
independent and impartial referees. Thus scientists speak “two languages at once: the left
mouth speaks about settled parts of science,² whereas the right mouth talks about unsettled

Such is the perspective of the sociologist of science. While this view has both intellectual appeal
as well as descriptive merit, we will henceforth be concerned only with the realist ontology—and, in
particular, the realist ontology as represented in the writings of Popper (1965). Popper’s (1965)
most fundamental concern is to differentiate science from pseudo-science, or metaphysics.
Popper (1965) is unwilling to concede the victory of instrumentalism over the ‘naive realism’ of
early physicists. In making his argument, Popper criticizes both the essentialist and
instrumentalist views. He does so on the basis of three doctrines:

² Although one must wonder if any part of science is ever fully settled…
The scientist aims at finding a true theory or description of the world..., which shall also be an explanation of the observable facts. The scientist can succeed in finally establishing the truth of such theories beyond all reasonable doubt. The best, the truly scientific theories, describe the ‘essences’ or ‘essential natures’ of things—the realities which lie behind appearances. Popper, 1965: 103-104

Essentialism rests upon doctrines (2) and (3). Popper contests the essentialist “doctrine that science aims at ultimate explanation” (1965: 105). Popper (1965) argues that whether or not ‘essences’ exist, the belief in them is likely to hamper scientific inquiry; therefore, there is no reason to assume their existence. Popper (1965) criticizes the instrumentalist by noting the difference(s) between computational rules, the domain of the instrumentalist, and ‘pure’ theories, which imply some representation of objective reality. He thus makes an argument on the basis of science, rather than meaning. Theories are tested by attempts to refute them, while the instrumentalist’s computational rules maintain some utility—albeit within the bounds of their applicability—even after limitations are discovered (Popper, 1965: 111-14).

Having argued that instrumentalism is no more acceptable than essentialism, Popper advances a third view (1965: 114-19). Doctrine (1) is embraced, while the possibility of doctrine (2) is denied. With regard to doctrine (3), Popper (1965) describes multiple levels of reality, none of which are more ‘real’ than any other. However, the concept of falsification designates points at which reality is touched, since in such cases theory has clashed with something (presumably ‘reality’) which refutes it. In Popper’s view, scientific theories are therefore “genuine conjectures—highly informative guesses about the world which although not verifiable (i.e., capable of being shown to be true) can be submitted to severe critical tests” (1965: 115). The problem of induction is avoided through adherence to logical deduction (Nagel, 1979: 29-46).

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3 There is some question as to whether or not theory falsification necessarily works in favor of a realist stance. While Popper argues this point rather persuasively, an instrumentalist would note that an abandoned theory simply had been supplanted by one having greater utility—without saying anything about the realism issue.
Popper (1965) is clearly convinced that objective reality exists. Believing himself to have satisfactorily argued for this position, of foremost concern to Popper (1965) is the issue of epistemology: the means by which humans are able to access ‘truth’ (with ‘truth’ perhaps being best defined as facts isomorphic with reality). At this point Popper draws a common distinction between episteme, or knowledge, and doxa, or belief (1965: 14). Popper refers to doxa as “in fact a method of interpretation…the method of conjecture or hypothesis,” and identifies himself as a “convinced advocate” of this method of truth identification (1965: 14).

Popper supplants the question of the sources of knowledge “by the entirely different question: ‘How can we hope to detect and eliminate error?’” (1965: 25). Popper (1965) describes the process as ‘critical rationalism’–the heart of his theory of scientific inquiry. While quick to defend the position that objective truth must exist if scientific knowledge is to have meaning, Popper (1965) is equally abrupt in his denial of the existence of objective episteme: rather, knowledge is strangely tainted by belief, or doxa. It is in light of the sullied nature of knowledge that detection of error takes on paramount importance. Only as theory is able to be subjected to critical review can it be identified as scientific. Popper answers the afore-quoted question ‘How can we hope to detect and eliminate error?’ and the question of ‘distinguish[ing] between science and pseudo-science’ with the same thesis: “the criterion of the scientific status of a theory is its falsifiability, or refutability, or testability” (1965: 37). The falsifiability of a theory is directly dependent upon its ability to conflict with possible observations (Popper, 1965: 39).

This reasoning is at the heart of Popper’s (1965) argumentation. Only if one were able to sample the entire subject population would theory verification be possible; as Latour (1987: 78) points out, “enough is never enough.” While induction may at best lend support to a theory, Popper’s

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4 Interestingly, not a few philosophers have made a move toward synthesis of episteme and doxa by defining knowledge as ‘justified true belief’–i.e., by defining episteme in relation to (true) doxa (see, e.g., Goldman’s Epistemology and Cognition [1986] and Audi’s Belief, Justification, and Knowledge [1988]). Even within such perspectives, however, one is left with the problem of determining, through the application of some objective mechanism, just what constitutes ‘true’ belief.
(1965) reasoning renders theory \textit{verification} a practical impossibility. The ‘fitness’ of a theory is only able to be assessed as ‘less fit’ theories are eliminated (Popper, 1965: 52). Theory refutation occurs as unfit theories ‘bump up against’ objective reality and are found wanting—or, in other words, as the logically deducible consequences of a theoretical position are, upon observation, found to be untrue (Nagel, 1979: 79-90). Returning to the words of Popper:

\begin{quote}
Only the falsity of the theory can be inferred from empirical evidence, and this inference is a purely deductive one...the overwhelming majority of our theories, of our freely invented ideas...do not stand up to searching tests, and are discarded as falsified by experience...a very few of them succeed, for a time, in the competitive struggle for survival.
\end{quote}

1965: 55, 96

The current discussion of philosophy of science would be incomplete absent reference to the writings of Kuhn (1970). Despairing of discovering theories completely resonant with reality, Kuhn (1970) is willing to establish as a criteria for the ‘goodness’ of a theory the degree to which said theory fits the facts. This logical move allows Kuhn (1970) to adopt an instrumentalist stance with regard to competing theories. Since absolute proof or error is not the issue, outdated paradigms may continue to have some utility—and therefore be used by “a few elderly hold-outs” (Kuhn, 1970: 159). Kuhn (1970) therefore views scientific evolution in a non-teleological sense. This implies scientific inquiry as a \textit{process} is not moving toward some objective reality. Does suggesting science does not have some goal set by nature in advance imply an abandonment of realism? Not necessarily. Kuhn (1970) draws a clear distinction between his discussion of the \textit{advancement} of scientific thought and inquiry into the world at large. Noting there may not be “one full, objective, true account of nature” (Kuhn, 1970: 171) is not the same thing as saying there is not one full, objective, true world.

Kuhn further suggests scientific revolution may not be progressive, but rather merely the victory of one scientific community over another (1970: 166). In stating his ‘first principle,’ Latour offers evidence of his concurrence with this view: “[t]o sum up, the construction of facts...is a collective process” (1987: 29). However, Kuhn (1970) has presented scientific advancement as the
process by which ‘better’ theories (in terms of ‘fit’ with the real world) supplant their less-powerful predecessors. While progress may be accompanied by claims of victory on the part of new theorists, such claims ought not detract from the progress which—by definition—must have occurred as a requisite to scientific revolution.

Commitment to both an ontological as well as an epistemological framework have profound implications for the choice of research methodology (Guba & Lincoln, 1986). In this regard the role of observation within scientific inquiry deserves further explication. Popper (1965) argues against the (purely) inductive method, noting that as humans we tend to impose order upon our world not simply through the mechanism of observation but also as a result of our own doxa (e.g., prior experiences, education, biases). Popper (1965) concludes it would be unreasonable to develop a theory of scientific knowledge which presupposes simple and objective amalgamation of observation into theory. Conversely, however, observation is able to serve as a method of assessing theory validity, as ‘good’ theory (i.e., theory which is able to be falsified) involves the prediction of observable, verifiable consequences. As Popper states:

…the role of logical argument, of deductive logical reasoning, remains all-important for the critical approach; not because it allows us to prove our theories, or to infer them from observation statements, but because only by purely deductive reasoning is it possible for us to discover what our theories imply, and thus to criticize them effectively.

1965: 51

Few philosophers would be so naïve as to permit induction alone to qualify as the sum of scientific inquiry. The comprehensive role of science demands utilization of such conjectures as a means of deducing predictive, measurable, and testable hypotheses. The current research is designed to subject the managerial, neo-classical economic, and agency theory models to empirical testing through application of the hypothetico-deductive method. Such an approach bears the potential to cull those theories which, in spite of their elegant formulation or popular acceptance, do not fit reality.
Property Theory

The three foundational models of managerialism, neo-classical economics, and agency theory each make critical assumptions regarding the role of private property in the operation of a market economy. All models would hold that:

The fundamental requirement for a successful economy is a fully working system of property rights. “Fully working” means more than tidy, clear laws about who owns what. It means that people believe in the spirit of the law as well as its letter, and behave accordingly.


Even Friedman, while delimiting the appropriate domain of governmental activity to five factors, concedes "the organization of economic activity through voluntary exchange presumes that we have provided, through government,…the definition of the meaning of property rights" (1982: 27).

According to the doctrine of John Locke, “the rights of the individual are safeguarded through property rights, which extend both to body and estate” (Lodge, 1986: 64). This belief can be said to permeate all of Western Civilization. Among the spectrum of organizational constituencies, only corporate shareholders are the bearers of property-based rights. Such property ownership interests grant shareholders the exclusive right to the use and enjoyment of their interests in the corporation, so long as said use does not infringe upon the rights of others. In spite of the restrictive intent of this final clause, the interests of property-owners have often been afforded primacy in cases of rights conflict.

The rationale for such partiality can be traced to the assumptions underlying free-market capitalism. Naïve readers of Adam Smith have concluded it is as individual persons pursue economic self-interest that the good of the community is maximized. This rather elegant

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5 It should be noted that several states now permit boards of directors to 'count' the interests of non-owners in their decision calculus—with at least two states currently requiring explicit consideration of the impact of board decisions on non-owners.

6 Smith can more accurately be taken to say that self-interest is a reliable principle around which to organize an economy.
formulation belies centuries of debate concerning the conflict between private gain and the public welfare. Were one to grant this first premise of capitalism, individuals would never need engage in moral reflection: it could safely be assumed that through the single-minded pursuit of self-interest the best possible society would be spontaneously created. Consider, however, the words of Smith himself: “[M]an…ought to regard himself, not as something separated and detached, but as a citizen of the world, a member of the vast commonwealth of nature…to the interest of this great community, he ought at all times to be willing that his own little interest should be sacrificed [emphasis added]” (as cited in Sen, 1987: 22-3).

What economists have been able to demonstrate is that pursuit of individual wealth within a free-market system, if not creating a good society, produces a wealthy one. It is only as wealth is equated with ‘goodness’—as in the tradition of John Calvin—that one might reasonably conclude the best possible state of affairs to result from giving self-interest its fullest expression. Just such an equation has resulted in the interests of shareholders scoring ‘trump’ within the corporate arena. Given this formulation, granting due consideration to disparate stakeholder interests would amount to nothing less than stripping the firm’s owners of their foundational property rights. Ultimately, all countervailing interests are naturally subordinated to the claims of shareholders due to the conviction that such an ordering results in ‘the greatest good for the greatest number’—as well as maximum liberty.

One must be left more than a trifle uncomfortable with the above reasoning in light of the general principle that rights entail responsibilities. It has already been noted that fixed to property rights is the strong condition that the exercise of such privilege does not infringe upon the rights of others. While it may not be entirely clear how resolution is to be attained within any specific case of conflict among rights, what is known is that the privilege of property-owners does not hold unconditional sway. Legal rights are seldom, if ever, absolute. One might fairly conclude that as moral agents the firm’s owners—and by extension their duly-elected trustees—bear an ethical
obligation to evaluate whether or not operation of the corporate enterprise encroaches upon the rights of other ‘stakeholders.’ Under conditions of diffuse stock ownership, however, shareholders seldom ponder the duties attached to ownership; rather, stock holdings are often viewed strictly as impersonal investments.

In his preface to *The Modern Corporation and Private Property*, Berle takes special note of the abdication of shareholder moral responsibility attending the increased scope of business enterprise:

Increased size and domination of the American corporation…splits the personality of the individual beneficial owner away from the enterprise manager…This raises a problem of social ethics that is bound to push its way into the legal scene in the next generation. Why have stockholders? What contribution do they make, entitling them to heirship of half the profits of the industrial system, receivable partly in the form of dividends, and partly in the form of increased market values resulting from undistributed corporate gains? Stockholders toil not, neither do they spin, to earn that reward. They are beneficiaries by position only. Justification for their inheritance must be sought outside classic economic reasoning.

Berle & Means, 1968: xix, xxiii

Berle and Means (1968) abandon Locke’s notion of property, arguing instead that ‘property’ necessarily implies the joint requirements of nominal ownership as well as power. Berle and Means’ further claim is that these interests are separable within the modern corporate context:

[The quasi-public corporation may fairly be said to work a revolution. It has destroyed the unity we commonly call property—has divided ownership into nominal ownership and the power formerly joined to it. Thereby the corporation has changed the nature of profit-seeking enterprise.]

1932: 6-7; as cited in Hessen, 1983: 282

These authors further suggest that operating one’s property *in extremis* through the mechanism of agency changes not only the very character of property, but its associated moral rights as well.

Once power is stripped from ownership and transferred to management, one is left to wonder:

Does the traditional logic of property still apply? Because an owner who also exercises control over his wealth is protected in the full receipt of the advantages derived from it, must it necessarily follow that an owner who has surrendered control of his wealth should likewise be protected to the full? May not this surrender have so essentially changed his relation to his wealth as to have
changed the logic applicable to his interest in that wealth? An answer to this question cannot be found in the law itself. It must be sought in the economic and social background of law.


This radical view of property permeates the theory of managerialism. Coase (1937) as well as others have focused upon how specification of individual rights determines the way in which costs and rewards will be allocated among the participants in any organization—a matter of grave concern within the managerial model. Neo-classical economists argue specification of rights is generally effected through contracting, both implicit as well as explicit—with individual behavior dependent upon the nature of these contracts (Jensen & Meckling, 1976: 307-8).

While all models of the firm reviewed within the current dissertation—with the notable exception of managerialism—endorse Lockean property theory, it would be a mistake to neglect explicit consideration of at least one alternative view of property. Johnson (1981) uses homiletic argumentation to counter the traditional bent of self-interest as applied to accumulation of wealth. In the process, Johnson (1981) notes that those things we claim to ‘own’ have only been entrusted to us for a season. Consider his words:

If the earth is [God's]…there is not, in the final analysis, a sense in which we truly possess anything…What a confusion there is in our hearts when we think that we not only “own” things, but can find in what we own our life and security.

Johnson, 1981: 58

Johnson maintains that "[m]aterial possessions must be seen as lying within this continuum of being and having, which is an essential aspect of human somatic existence [emphasis added]" (1981: 39). While possessions are capable of bringing a sense of ease to our lives, it is too much to ask that they define who we are. Thus the reverence we accord our possessions is of fundamental importance:

The real difficulty regarding possessions lies in what they mean to us. The real mystery concerning possessions is how they relate to our sense of identity and worth as human beings. The real sin related to possessions has to do with the willful confusion of being and having.

Johnson, 1981: 40
To expect too much of one’s possessions is to allow them to supplant the rightful place of the Creator in one’s life, for “[i]dolatry, in simple terms, is the choice of treating as ultimate and absolute that which is neither absolute nor ultimate…Diagnostically, I can tell what my god is by seeing what it is around which the patterns of my life organize themselves” (Johnson, 1981: 49). Increasingly, all spheres of the lives of those in ‘modern’ society are ordered by economic concerns (Schwartz, 1986). This realization bears profound implications for the way in which society is structured.

Public Policy Implications

Assumptions with respect to the nature of personhood and the theory of the firm will be explored within the context of each theoretic model. All of these models, however, are most fundamentally concerned with the relationship between the firm and its broader community. While the current work is only tangentially involved with societal prescriptions, it is imperative that the public policy implications of a reconceptualization of the role of the corporation within society be at least briefly considered.

It has been previously noted that at its most essential level the current research addresses the matter of trust, or fiduciary responsibility—a distinctly moral concern. Given that the foundational charter of management is to act on behalf of others, explicit consideration must be given to identification of those constituencies to whom management bears some responsibility. Of the variety of stakeholder groups (Freeman, 1984), it is only a firm’s owners who bear a property ownership interest in the firm.⁷ Management has an unequivocal duty—both moral as well as legal—to serve the interests of the firm’s shareholders. Classical economists have vehemently argued only property interests ‘count’ within the corporate calculus (see, e.g., Friedman [1982]).

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⁷ It might be argued that a firm’s secured debtors also hold—albeit indirectly—a property interest in the firm.
Within the traditional economics framework it is not at all clear on what moral-theoretic basis non-property interests may lay claim to organizational attention.

Berle and Means (1968) conclude the separation of ownership and control within the modern corporation deals a fatal blow to the reasoning of the classical economist. So long as property interests are not ‘trump,’ the self-interest of those controlling–albeit not owning–business enterprise cannot be relied upon to actuate efficient market conditions. On the final pages of their treatise, a new concept of the corporation is presented in which the interests of ‘community’ are given primacy:8

Neither the claims of ownership nor those of control can stand against the paramount interests of the community. The present claims of both contending parties now in the field have been weakened by the developments described in this book. It remains only for the claims of the community to be put forward with clarity and force…It is conceivable,—indeed it seems almost essential if the corporate system is to survive,—that the “control” of the great corporations should develop into a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream on the basis of public policy rather than private cupidity [emphasis added].

Berle & Means, 1968: 312-13

Berle and Means (1968) are not alone in their conviction that the role of the corporation within modern society must be reconceptualized if the complex problems associated with managerial moral assessment are to be resolved. Lodge advances three sources of the right to manage:

[1] The right to manage can come from property rights of ownership…
[2] A second source of the right to manage is the consent of the managed…
[3] Then there is a third possibility of the community, generally through government, according the right to manage to those who are doing things that need to be done.

1986: 61

Lodge (1986) argues for the third source. Grounded historically in the legal-creator conception of the corporation (De George, 1986: 153), socio-political organizational theory represents a radical

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8 Emerging social contract theories of organizations (see, e.g., Keeley [1988]) bear mention in this regard. An alternative view of the organization as a social institution imbedded within a broader community is enjoying renewed attention. Such a perspective is very much in the spirit of Berle and Means’ closing comments herein cited. While there has been a paucity of empirical evidence to support such theoretic frameworks, the potential for explanatory power is tremendous.
departure from the collective ownership view of the classical economist. Since the creation of humankind, not a few commentators have contended that created beings owe their principal allegiance to the bestower of life. Adherents of the strict legal-creator view appropriate this metaphor, arguing that since corporations have no ‘life’ outside the law society has the most basic claim against the corporation. As corporate formation is legally sanctioned primarily for societal ends, by extension the government—in its role as guardian of the general welfare—is accorded the foremost role in the establishment of organizational mission.

Within such an organizational framework corporate governance structures come to mirror political rather than economic systems. One of the principle charters of political structures is a ‘just’ distribution of collective resources. Stakeholder management theorists are sympathetic to such a view. Windsor states “[u]nder the corporate accountability concept, business arises out of a social franchise, not out of constitutionally protected or natural property rights” (1983:3). While recognizing corporate authority has traditionally been justified on the basis of property rights, Taucher suggests “[t]he true legitimacy of the corporation—the practical source of its power to act—is derived... from the consent of a much wider body of stakeholders” (1984: 18).

Certain writers within this tradition have noted the inherent inadequacies of such an approach to corporate governance. Freeman in particular is concerned that power—a necessary concomitant of political systems—will not provide for an equitable distribution of organizational outcomes:

There is, of course, a broader notion of legitimacy which is at issue here. Do all stakeholders have an equally ‘legitimate’ claim to the resources of the corporation? Is the problem of the distribution of the goods and services of the corporation to be left up to the marketplace? Or, is it to be solved in virtue of the political ‘clout’ of various stakeholder groups?

1984: 45

Freeman and Reed suggest a comprehensive stakeholder perspective may require synthesis of economic and political analyses: “[I]ssues which involve both economic and political stakes and power bases must be addressed in an integrated fashion” (1983: 96). These authors note the
long tradition of applying economic analysis to policy questions, and endorse recent discourse on the topics of codetermination and quality of working life applying political concepts to economic issues.

It should be apparent such reconceptualizations of the standing of the firm within society imply sweeping community reforms. At least as far as Berle and Means (1968) are concerned, such prescriptions are based on the conjecture that managerial control of the modern corporation defeats the classical economic motivation to operate the business enterprise in the most efficient manner possible. This is a matter for empirical investigation. The research herein contained constitutes such an examination.

The Effect of Managerial Equity Holdings

Before concluding this theoretic overview, the performance effects of managerial equity holdings will be predicted on the basis of the managerial, neo-classical economic, and agency theory models.

Within the managerial framework, managerial equity ownership should serve to attenuate the problem of separation of ownership and control by re-uniting the two constructs. The level of managerial ownership necessary to accomplish such a confluence of interest might be considerably less than that needed to secure absolute control of the firm—a fact Berle and Means (1968) fail to take into account. Given this model, the prediction is that the higher the level of managerial equity holdings the better the firm performance.9

Within the neo-classical school of economics—and adopting the firm-centric view—it has been argued that efficiency considerations serve to equilibrate agency costs: the costs of structuring

9 This prediction represents a refinement to the work of Berle and Means (1932, 1968), who modeled ownership and control as dichotomous, rather than continuous, variables.
contracts and monitoring agent-managers is roughly equivalent to (but not in excess of) the potential for residual losses on the part of owners as a result of managerial shirking. The possibility for residual losses is reduced commensurate with the level of managerial equity holdings.\textsuperscript{10} Within the market-centric view, it is argued capital markets tend to place a higher value upon those firms enjoying lower overall levels of agency costs relative to alternative investment opportunities. Since managerial ownership tends to reduce both the potential for residual losses as well as related contracting costs, firms characterized by higher levels of managerial equity holdings ought to perform better (i.e., be valued more highly by the market) than those with lower levels.

Agency theory suggests opportunism is manifest when incentives are inharmonious (e.g., owners and managers prefer conflicting organizational outcomes), contracts are not fully specified (the condition of uncertainty), and a small numbers condition inheres (conversely stated, if a large number of investment options are both available and recognized by owners, the possibility for opportunism is diminished). Opportunism, if left unchecked, results in diminution of the value of the firm as a result of managerial 'self-interest seeking with guile;' similarly, \textit{ceteris paribus} firms with lower levels of opportunism ought to be more highly valued by the market. As the trio conditions of inharmonious incentives, uncertainty, and small numbers are each \textit{necessary} (albeit not \textit{sufficient}) for the rise of opportunism, if any of these conditions do not exist—or exist only minimally—the potential for opportunism is restricted. Specifically, to the extent managerial equity holdings serve to defeat the condition of inharmonious incentives, opportunism is diminished.

Application of straightforward deductive reasoning allows for the inference that firms with higher levels of managerial equity holdings, and thereby lower levels of opportunism, ought to perform better (i.e., be valued more highly by the market) than those firms distinguished by little or no managerial ownership.

\textsuperscript{10} Such holdings might in fact represent monitoring costs to the firm's owners—a point to be addressed in the discussion of reciprocal causality.
It is apparent application of each of these three theoretic models supports the theorization that there exists a significant and positive relationship between levels of managerial equity holdings and firm performance (at least as such performance is evaluated by the market), although it is acknowledged each model offers rather differing explanations as to why this is necessarily the case. The current research has been designed to test just such an hypothesization.

**Literature Overview**

The literature review which follows in Chapter 2 will focus on the managerial, neo-classical economic, and agency theory models, including presentation of empirical findings associated with each paradigm. Consideration will here be given to an abridged overview of the writings on trusteeship and classical economics, offered only by way of establishing the ‘ground’ for such subsequent comprehensive reviews.

**Trusteeship: The Moral Perspective**

“In a trust relationship, one party acquires legal title over wealth or property and controls its use on behalf of the equitable owners, who are the beneficiaries of the trust’s assets” (Hessen, 1983: 278). Within the corporate domain, the board of directors assumes the role of trustee on behalf of the firm’s owners (or shareholders), who are the trustors; managers, as hired agents of the board, bear derivative trust obligations to the shareholders:

Following the traditional logic of property, however, it is clear that these powers [of management] are not absolute. *They are, rather, powers in trust.* The controlling group is, in form at least, managing and controlling a corporation for the benefit of the owners [emphasis added].

Berle & Means, 1968: 294
Persons are not the exclusive bearers of rights within the corporate realm, however. In the notable words of Chief Justice Marshall penned in 1819 with reference to the case of Dartmouth College vs. Woodward, the corporation is in the unique position of being “an artificial being, invisible, intangible, existing only in contemplation of law…Being the mere creature of law, it possesses only those properties which the charter of creation confers upon it, either expressly, or as incidental to its very existence.” Contemporary judicial rulings have increasingly granted corporations the legal status of personhood. Such standing has guaranteed the corporation certain rights at law, including the right to autonomy, to economic freedom, and even to freedom of speech. Progressive corporate officers—as trustees of both the corporate entity as well as its owners—have intensified their claim that the business enterprise(s) which they manage are the appropriate beneficiaries of such a specific set of rights.

The situation regarding corporate rights is much more complex than the above formulation would suggest, however. While the corporation may be granted personhood status at law, from an ethical perspective it is not at all clear the corporation may justifiably be held morally culpable for its actions.\(^{11}\) In order for corporate legal claims to be justified they must have a moral basis (Werhane, 1985: 3, 7-8). It is a gross oversimplification to assume corporations must be morally responsible based upon the observation that law finds its justification in morality, for moral accountability additionally entails the capacity for volitional action. Corporations are not able to act absent the actions of those trustees who ‘cause’ them to perform; in this regard the business enterprise is no more than an instrument in the hands of corporate decision-makers.

Neither the view that corporations are devoid of moral responsibility, nor the view that such enterprises are afforded the status of persons and therefore bear full moral culpability, seems to offer an adequate elucidation of corporate accountability. Thankfully, there exists a third option

\(^{11}\) for a dissenting opinion, see Goodpastor & Matthews (1990)
serving to reconcile these two disparate images. Corporations might be seen as the beneficiaries of collective rights. On this view, “the rights of organizations such as corporations are derived from, dependent upon, and secondary to, individual rights…[t]herefore corporate rights claims entail obligations to respect the equal rights of other individuals” (Werhane, 1985: 60). Simply by virtue of being rational moral agents, individuals possess a set of primary rights. Consistent with the view that corporations are not strictly moral agents, such rights do not directly inhere to the corporation. However, although corporations are not capable of primary, or volitional, action, they nonetheless engage in secondary ‘actions’ as they are moved to perform such deeds by corporate decision-makers. Corporate rights and duties are thereby logically derived from the corporation’s capacity to perform such secondary actions—in part explaining the legal accountability of the corporate enterprise. One of the fundamental characteristics of secondary rights is that, being derived from personal moral rights, such derivative rights may not take precedence over individual rights (Werhane, 1985: 62). Corporations are therefore subject to reciprocal obligations—including the duty to respect the equal rights of both individuals as well as other discrete corporations.

The above exposition with respect to rights is central to the concept of trusteeship. Debate concerning for whose benefit managers ought to operate the corporation continues among organizational theorists. Moral philosophers cast the dialogue in terms of competing rights claims. If trustee self-interest is closely wedded to the interest(s) of the trustor and/or the beneficiary, little ground exists for conflict between the trustee’s preferences and his/her fiduciary duty. This is not the usual case. Given that the trustee is charged with fulfilling duties which regularly run counter to the dictates of self-interest, trust is best conceived of as a moral phenomenon.

There exists an interesting twist to trusteeship theory which warrants elaboration. For centuries transfers of property which split legal title from its beneficial use have enjoyed the force of law
(Fraher, 1989). In the early 1200s certain newly-founded mendicant orders, the most notable of which being the Franciscans, applied this principle to their advantage. By appointing lay trustees to oversee the disposition of Church offerings, the friars were able to fulfill the letter of their vows of poverty (by not taking legal title to property), while at the same time positioning themselves as the beneficiaries of the use and enjoyment of such gifts. Collectively, the friars became a corporate entity organized under a charter granted by the sovereign:

...ecclesiastical property-holding [thereby] gave birth to modern corporation theory. In trying to explain the roles of bishops, lower clergy, and laity, medieval lawyers ultimately decided that each church was an entity distinct from the persons who made up the church. The fictional person, the corporate entity, theoretically lived forever, and theoretically this fictional person had property rights and interests of its own. Vis-à-vis the corporate church, the clergy were agents...subject to fiduciary duties. Hence the direct conveyance to the church ultimately produced legal rules that look to the modern reader like a combination of corporation law and trust law.

Fraher, 1989

Managers are fiduciaries as they occupy “a position of trust or confidence in relation to another person or his property” (Corley & Robert, 1975: 960). When trusteeship is framed within the organizational context, it becomes readily apparent the fiduciary relationship between manager and owner implicitly allows for the possibility of use and enjoyment privileges being appropriated by managers for their own benefit— with legal title to such property remaining resident in the hands of corporate shareholders. Managers often find themselves in an untenable position: they are both trustees for the interests of enterprise shareholders and, within their role as corporate employees, beneficiaries of their own trusteeship dispositions. Couple this conflict with the recognition that managers possess gross power within the modern corporation and it becomes apparent that the managerial choice of whether or not to behave opportunistically is at least in part a function of personal moral constitution. While the inherent problem of trusteeship has been debated for literally centuries, the controversy has recently been reintroduced within the management literature under a fresh locution: ‘the agency problem.’

Adam Smith: The Classical Economic Perspective
“At the core of most economic analyses of industrial behavior is the proposition that the managers of an enterprise guide its activities in such a way as to maximize the monetary well-being of its owners” (Lewellen & Huntsman, 1970: 710). The economic model of the firm presupposes managers are the trustees of shareholder interests. Friedman, as radical a free-market capitalist as one is likely to encounter, clearly agrees: “The corporation is an instrument of the stockholders who own it” (1982: 135).

It was Smith’s view that the ills of society were a direct consequence of the failure of the economic system to be structured for the advantage of those who toiled within it. During the mid-eighteenth century, Great Britain was largely a land of poverty. As Collins (1988: 12) notes of Smith:

In searching for a culprit for the destitution, Smith did not blame the moral sentiments of individuals as others had done. The mercantilists blamed the poor for their own misfortunes. The utopians blamed the selfishness of the wealthy for the misfortunes of the poor. Smith…believed that the culprit was the economic system itself.

Nature of Personhood

Classical economics is probably best known for its assumptions concerning the nature of personhood. Smith is credited with the view that “[t]he famous homo economicus is a rational, self-interested, instrumental maximizer with fixed preferences” (Hirsch et al., 1987: 32). Interestingly, this is far from a complete rendering of Smith’s image of human nature. Smith is explicit concerning his debt to Stoic moral philosophy (MacIntyre, 1984: 234; Sen, 1987: 22-8). Both sympathy and self-discipline are central to Smith’s conception of good behavior: “[O]n Smith’s view knowledge of what the rules are, whether the rules of justice or of prudence or of benevolence, is not sufficient to enable us to follow them; to do so we need another virtue of a
very different kind, the Stoic virtue of self-command which enables us to control our passions when they distract us from what virtue requires” (MacIntyre, 1984: 235). While Smith viewed persons as self-interested, he also saw humankind as bearing the capacity to overcome such self-interest in pursuit of the common good.

At a more fundamental level, however, Smith’s philosophy relies upon self-interest itself to create the ‘good’ society. “As a professor of moral philosophy, Smith understood the necessity for moral justification of the individual pursuit of self-interest, and that the new social contract he would eventually construct could not be contrary to morality or human nature” (Collins, 1988: 122). To that end, Smith penned *The Theory of Moral Sentiments* (1759). In this treatise, Smith argues individuals temper their innate selfishness as moral judgments are formed. Individuals are not therefore enslaved by their self-interested passions as many contemporaries of Smith continue to argue. Rather, while Smith concedes “each person ‘naturally prefers himself to all mankind’ and ‘is much more deeply interested in whatever concerns himself, than in what concerns any other man,’...Smith labels *self-interest as the most basic virtue* [emphasis added]” (Collins, 1988: 124).

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<th>Virtue</th>
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<td>Self-interest</td>
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As can be seen from this schema, the presence of self-interest is not worthy of praise—after all, it is merely a characteristic of the human condition. However, the lack of the ‘virtue’ of self-interest is worthy of blame. Justice is of foundational importance within Smith’s framework, for it is the only virtue which—depending upon its presence or lack thereof—can attract either praise or blame.
Smith is concerned with motives, actions, and consequences in the assignment of praise and blame, though he concludes consequences are the ultimate source of both glory and shame. The reasoning is straightforward:

In a perfect society, one intends, acts and then the consequences arise. Under these conditions, the praise and blame should be ultimately attributed to *motives* and *intentions* because they causally generated the consequences. However, in the ambiguous world of everyday affairs, there are many deviant causal chains. A harmful intention may yield a beneficial consequence, or a beneficial intention may yield a harmful consequence. In such an impure laboratory as that of society, Smith argues, *consequences are held to be more prominent than motives* [emphasis added].

Collins, 1988: 125

Smith’s logic undeniably favors consequentialist moral reasoning. Given one reading, actions are to be assessed solely on the basis of their ‘utility,’ a word appropriated from moral philosophy by the classical economist. Ultimately, neither motivations nor independent actions have relevance for the profferal of praise or blame.

Before leaving this point, it should be noted several moral philosophers have attempted to unite the deontological and consequentialist systems. Brady (1985), for example, has suggested the relation of formalist and utilitarian ethics is not zero-sum, but is more like the division of labor: each is relevant within moral discourse. Similarly, Cavanagh et al. (1981) and Boal and Peery (1985) favor synthesis of various ethical frameworks, with the latter offering the following ethical prescription:

First, a socially responsible decision should have utility, that is, it should lead to economically beneficial results...Secondly, a socially responsible decision should seek to avoid harm even at a cost to the maximization of profit...Thirdly, a beneficent decision might seek to positively affect society, that is, promote social justice...Fourthly, decisions that influence different stakeholders differently should seek to balance those interests in a just manner...The ethical reasoning in distributive justice may be of paramount importance to those corporate decision makers who wish to be socially responsible...

Boal & Peery, 1985: 80

Public Policy Implications
The importance of the concept of justice should be evident within the preceding discussion of Smith’s moral theory. However, justice is additionally a social phenomenon—and the state is often called upon to create and preserve the just society. It would seem, therefore, at least a portion of any governmental charter would incorporate explicit concern for production of the ‘good’ society—a fact lost to many a confrere of Smith, who persist in their argument that market forces alone are sufficient to bring about the best possible state of affairs.

This was clearly not Smith’s view. Below are the terms of Smith’s social contract:

(i) Liberty to pursue one’s own economic self-interests should be permitted as long as there is a corresponding (though it could be unintentional) improvement in social welfare.
(ii) If liberty to pursue one’s own economic self-interests does not improve the social welfare, then government intervention is justified.
(iii) If liberty to pursue one’s own economic self-interests improves the social welfare, but harms are also generated, then intervention by either the government or the justice system is justified…

Collins, 1988: 130

Defenders of the private enterprise system usually pay exclusive homage to a weak version of the first provision; critics usually contest the first provision in ignorance of the second and third. Smith supports the first provision in The Wealth of Nations (1776), in which he documents the many instances in which individual pursuit of economic self-interest improves the social welfare. Violations of the canons of justice prove the only cause for governmental intervention in the affairs of industry. “Smith argues that ‘every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest, his own way, and to bring both his industry and capital into competition with those of any man or order of men’ [emphasis added]” (Collins, 1988: 131). Administration of justice, along with national defense and maintenance of certain public works, constitute the only appropriate intervention functions of government (Collins, 1988: 132).
Friedman (1982) expresses a similar proposition. Friedman’s “major theme is the role of competitive capitalism—the organization of the bulk of economic activity through private enterprise operating in a free market—as a system of economic freedom and a necessary condition for political freedom” (1982: 4). As with Smith, Friedman (1982) sees economic freedom as the ‘ground’ and governmental intervention as the ‘figure.’ In the closing paragraph of *Capitalism and Freedom*, Friedman explicitly allies himself with Smith (and against a ‘strong’ government): “As Adam Smith once said, ‘There is much ruin in a nation’” (1982: 202).

Unlike Smith, Friedman (1982) has been witness to a movement favoring greater societal accountability for the corporation—a progression which strikes at the heart of his strictly economic view of business enterprise. Friedman is less concerned than Smith with ‘justice,’ and therefore takes a firm stand against such contemporary notions of corporate social responsibility:

> The view has been gaining widespread acceptance that corporate officials and labor leaders have a “social responsibility” that goes beyond serving the interest of their stockholders or their members. This view shows a fundamental misconception of the character and nature of a free economy. In such an economy, there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits *so long as it stays within the rules of the game,* which is to say *engages in open and free competition, without deception or fraud…* Few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their shareholders as possible. This is a fundamentally subversive doctrine [emphasis added].

1982: 133

This passage serves to illustrate what is perhaps the most fundamental distinction between the perspectives of Friedman (1982) and Smith: Friedman reckons ‘the rules of the game’ to allow for any activity which is devoid of “deception or fraud,” while Smith deems ‘the rules of the game’ to require fostering “improvement in social welfare.”12 These are vastly different views of corporate freedom in modern society. Friedman’s (1982) concern is not limited to the economic arena, however; it will be remembered he argues for *economic* freedom as the only means of achieving

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12 Smith’s social contract requires joint consideration of economic productivity and human liberty.
political freedom. The logical converse must hold: encroachment upon economic liberty has deleterious effects upon political freedom. It should not be surprising, therefore, to find that in Friedman's opinion “the doctrine of ‘social responsibility’ involves the acceptance of the socialist view that political mechanisms, not market mechanisms, are the appropriate way to determine the allocation of scarce resources to alternative uses” (Mulligan, 1986).

Interestingly, one can find a parallel for Friedman's (1982) concerns in the writings of Dostoevsky (1948). In the Inquisitor’s judgement, “men are continually driven to shirk meaningful choices,” for freedom necessitates responsibility (Rahv, in Wasserman, 1970: 54). Since humankind lacks both the ability and the motivation to govern him/herself, it is only natural institutions such as the Church—or government, or the corporation itself—should emerge to fill this role. In the Inquisitor’s eye, persons prefer happiness to other ‘goods.’ Due to their nature, however, persons are not happy so long as they are saddled with responsibility— including the duty to make moral decisions. Happiness and freedom are therefore cast as mutually exclusive ‘goods.’ Consistent with his view of the nature of personhood, the Inquisitor believes mortals “will marvel at us [Church leadership]...because we are ready to endure the freedom which they have found so dreadful and to rule over them” (Dostoevsky, in Wasserman, 1970: 18). “[M]en cannot choose between good and evil, because it is so extremely difficult to know which is which, especially in crucial cases...[s]o let the specially gifted few make the decision between good and evil...[a]nd let the many accept the decision, with gratitude, and bow down to the few, in the hierarchy” (Lawrence, in Wasserman, 1970: 103). Such usurpation of individual liberty by a social institution is exactly Friedman’s concern. Friedman would resist governmental intervention to make the populace ‘happy’ at the expense of their ‘freedom’—even though the citizenry themselves might prefer such mediation rather than endure personal accountability for their actions.

Theory of the Firm
Within classical economics, “[t]he firm is a “black box” operated so as to meet the relevant marginal conditions with respect to inputs and outputs, thereby maximizing profits, or more accurately, present value” (Jensen & Meckling, 1976: 306-7). The actions of individuals within the firm are of no relevance; it is simply assumed managers operate the corporation strictly for the benefit of the firm’s owners. Market competition is seen as restricting the airing of managerial self-interest. For the classical economist, this is the end of the story.

An alternative view conceives of the corporation as by design a humanistic organization grounded in rationality—in principle no different from the Church as embodied in the person of the Grand Inquisitor. One of the primary attractions of a corporate governance structure is the legal protection afforded individuals within such organizations. Leaders within corporations are generally relieved of legal liability for their actions so long as their activities are taken on behalf of the company and do no exceed the bounds of authority established by the corporation.\(^\text{13}\)\(^\text{14}\)

This legal construction has profound moral implications. It is clear our social conscience is decidedly influenced by legislative processes. Corporations may be held in violation of statutes through the actions of leadership moving the firm into illegal practices, while these same decision-makers assume no personal liability for the misdeeds of the firm. On its surface, this is patently a legal theme. However, to the extent such managers are also seen to be relieved of their moral responsibilities in such cases this becomes an ethical issue as well. The corporation—a fiction of the state—thereby serves to mediate the bond between persons and their conscience.

It would be fair to deduce that the corporation and the Church share a common view of the nature of personhood. Such institutions may well represent humankind’s best attempt to secure relief from moral guilt. Commitment becomes the means by which one is initiated into the justificatory

\(^\text{13}\) And of course are not acts for which they bear personal criminal or civil liability.

\(^\text{14}\) It should be noted that several recent court cases have begun to call this doctrine into question (see, e.g., the recent allegations surrounding both directors and management within the Beech-Nut case).
schema. The Inquisitor might as well be speaking to corporate employees with the voice of management when he says, “[r]eceiving bread from us, they will see clearly that we take the bread made by their hands from them, to give it to them, without any miracle…[t]oo, too well they know the value of complete submission! And until men know that, they will be unhappy” (Dostoevsky, in Wasserman, 1970: 23).

As noted previously, one lesson learned from the legend is that one cannot be both free and happy. This dichotomy would not hold, however, were persons permitted to pursue happiness while avoiding the consequences of their ‘sin.’ Difficult choices are shunned because freedom implies accountability. Were these two concepts disjoined, one would be able to pursue happiness while commensurately experiencing freedom. In providing such a disjuncture, the legal notion of corporativism may be seen to provide an escape from human tragedy. The free-market economic system seems to support this view: not only are persons relieved of responsibility within the corporate realm, but their personal pursuit of happiness unintendedly serves the betterment of society at large.

Proponents of managerialism, neo-classical economics, and agency theory would all concur “the assumptions underlying the [classical] economic model are not only very simple, they are also very strong and wildly unrealistic…The cost is that economic policy premised on [such] simple assumptions often leads to unintended—and dysfunctional—consequences” (Bower, 1983; as cited in Hirsch et al., 1987: 317). Such inadvertent consequences are evident in the discussion of both public policy implications as well as corporate social responsibility outlined above. Even within the classical economic framework, however, the inherent problem of trusteeship is acknowledged:

The directors of such [joint-stock] companies, however, being the managers rather of other people’s money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their
master’s honour, and very easily give themselves a dispensation from having it. *Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company* [emphasis added].


It is just this final point which the models covered in the following literature review are designed to address.
CHAPTER 2: LITERATURE REVIEW

Introduction

These ideas have given rise to two interdependent streams of thought: managerial theories of the firm and agency theory. The first focuses on the motivations of managers and the extent to which these differ from the entrepreneurial homo economicus of classical economics, whose nature it is to ‘truck and barter’ and who is governed primarily by the economic rationality of personal self-interest. The second reformulates the behavioural assumptions of classical economics, collapsing the notion of the firm into its constituent, stakeholder interests. Both schools expound a theory of managerial motivation in which the major goals of managers include preferences for variables other than profits [emphasis added].

Green, 1988: 27

Managerialism, neo-classical economics, and agency theory are each concerned with the conjecture that managers routinely violate their trusteeship obligations to the owners of their employing firms. Each theory maintains classical economic reasoning advances an incomplete account of corporate enterprise. The following literature review is designed to provide a comprehensive overview of those studies which are both written within the managerial, neo-classical economic, or agency theory traditions and which address the issue of the separation of ownership and control.\(^{15}\)

\(^{15}\) No attempt is made to synthesize all literature germane to each theoretic base, for each model is global enough in scope as to bear implications for scholarship unrelated to the current research question.
This literature review will commence with an overview of Berle and Means’ (1968) theoretical thesis along with its assumptions and implications, to be followed by a review of both their as well as subsequent empirical examinations of the managerial hypothesis.

**Managerialism: Theory and Implications**

Berle and Means (1968) are credited with first demonstrating that under conditions of ownership diffusion managers are provided a strong incentive to breach their fiduciary responsibility to the firm’s owners in favor of advancing more personal agendas. One need look no further than any given evening’s news coverage of the current Savings and Loan ‘crisis’ to unearth ample anecdotal evidence in support of this thesis. Berle and Means (1968) suggest that separation of the ownership and control functions within the modern corporation has served to work a revolution in our understanding of property theory; no longer are the ‘use and enjoyment’ privileges of property possession tied to the provision of ‘ownership.’ These authors maintain that ‘property’ necessarily implies the joint requirements of nominal ownership as well as power, and conclude that the corporate governance form has served to effectively severe these two imperatives.\(^{16}\) Hessen similarly argues that “[i]f—by definition—control is inherent in the concept of ownership, then an illicit dissolution has taken place” (1983: 285; see also Steiner & Steiner, 1985: 84-86). Galbraith (1971) concurs with the separation premise: “The decisive power in modern industrial society is exercised not by capital but by organization, not by capitalist but by the industrial bureaucrat” (as cited in Zeitlin, 1974: 1076-77). At its extreme, the separation issue is embodied in the following quote:

\(^{16}\) In spite of the force of their arguments, at least one set of writers note the absence of well-developed theory in *The Modern Corporation and Private Property*: “Means’ work was nakedly empirical: he had no systematic theory of the causes or consequences of the separation of ownership and control” (Stigler & Friedland, 1983: 258). The work of Berle and Means is full of assumptions and conjectures; a causal link between ownership structure and corporate performance is never conclusively demonstrated. However, if their work is viewed as exploratory—a view Berle and Means would no doubt deplore—each assumption and conjecture can prove fodder for rich empirical research.
Why have stockholders? What contribution do they make, entitling them to heirship of half the profits of the industrial system, receivable partly in the form of dividends, and partly in the form of increased market values resulting from undistributed corporate gains? Stockholders toil not, neither do they spin, to earn that reward. They are beneficiaries by position only. Justification for their inheritance must be sought outside classical economic reasoning.

Berle and Means, 1968: xxiii

However, it is classical economic reasoning with which Berle and Means (1968) are concerned. Consistent with the view of human nature subscribed to by Smith and his followers, Berle and Means (1968) accept the premise that persons habitually act in their own interest(s). As applied within ‘managerialism,’ the postulate of self-interest suggests managers seek to operate the firm for their own benefit rather than for the benefit of the firm’s shareholders—shareholders with whom the manager stands, at least theoretically, in an agency relationship. When conjoined with traditional property theory, such self-interest seeking on the part of managers is seen to weaken the property-rights foundation undergirding much of this country’s legal system. In closing their treatise, Berle and Means conclude “[i]t follows from all of the foregoing that the shareholder in the modern corporate situation has surrendered a set of definite rights for a set of indefinite expectations [emphasis added]” (1968: 244).

The macro-economic implications of the self-serving managerial hypothesis are of paramount concern to Berle and Means (1968). Within classical economics, it is demonstrated that the mechanism of the ‘invisible hand’ is in evidence, and that individual owners pursuing their own interest(s) will at least to some extent—albeit unreflectively—also serve the common good. It is not clear, however, that in the absence of property ownership—as is the case when agent-managers pursue their own interests—private gain promotes public welfare. On the basis of the preceding argumentation both property theory and economic theory are rejected by Berle and Means (1968) as adequate models of corporate distributive justice. It is worth quoting Berle and Means at some length on this point:

Whereas the organization of feudal economic life rested upon an elaborate system of binding customs, the organization under the system of private
enterprise has rested upon the self-interest of the property owner—a self-interest held in check only by competition and the conditions of supply and demand. Such self-interest has long been regarded as the best guarantee of economic efficiency. It has been assumed that, if the individual is protected in the right both to use his own property as he sees fit and to receive the full fruits of its use, his desire for personal gain, for profits, can be relied upon as an effective incentive to his efficient use of any industrial property he may possess...

In the quasi-public corporation, such an assumption no longer holds...Those who control the destinies of the typical modern corporation own so insignificant a fraction of the company’s stock that the returns from running the corporation profitably accrue to them in only a very minor degree...The explosion of the atom of property destroys the basis of the old assumption that the quest for profits will spur the owner of industrial property to its effective use...

The surrender of control over their wealth by investors has effectively broken the old property relationship and has raised the problem of defining these relationships anew. The direction of industry by persons other than those who have ventured their wealth has raised the question of the motive force back of such direction and the effective distribution of the returns from business enterprise...

The shifting relationship of property and enterprise in American industry here described, raise in sharp relief certain legal, economic, and social questions which must now be squarely faced. Of these the greatest is the question in whose interests should the great quasi-public corporations...be operated [emphasis added].

1968: 9, 8, 4, 293

It should be apparent that Berle and Means’ (1968) reconceptualization of corporate theory has far-reaching public policy implications. It is argued that the complexion of property ownership has evolved as business capital has increasingly been translated from the sole proprietor or partnership ownership form into the corporate structure; furthermore, corporate shareholders are viewed as being much less concerned than owner-managers with participation in either the rights or responsibilities fixed to ownership. In questioning whose interests ‘count,’ Berle and Means

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17 As has been noted previously, in his treatise on a Theory of Moral Sentiments Smith argues for the dissenting view that the individual virtues of benevolence and justice play a central role in the harnessing of self-interest.

18 Private enterprise has often been romanticized by those observing such evolution; consider, for example, the words of Sheehan:

Exponents of the private way of life contend that they are closer, somehow, to the traditional pattern of American business than the managers of big public companies. They point out that the classic conformation of American business was the family enterprise, with pride in the family name over the door and on the product. They are not of a mind to open the way for outsiders to share in the direction, the honors, and above all the profits of the enterprise...
conclude corporate enterprise is most appropriately modeled as a political system—a view which has found support within the writings of numerous organizational theorists. Those writing in the tradition of Perrow (1977) “...define organizations...as intentional human constructions wherein people and groups within and without the organization compete for outputs of interest to them under conditions of unequal power...” (as cited in Gaertner & Ramnarayan, 1983: 102; see also Pfeffer & Salancik, 1978). Dye notes “managerialism underlies a great deal of writing in organizational theory (Etzioni, 1964; March & Simon, 1958; Simm, 1967; Thompson, 1967) which explains why firms tend to seek satisfactory profits, stable growth, and environmental adaptation, rather than profit maximization alone” (1985: 10). The account of corporate ‘behavior’ given by such organizational theorists counters the classical economists’ chronicle of business enterprise as solely profit-maximizing institutions. This writer finds the descriptive merit of the organizational theorists’ viewpoint compelling.

When the corporation is conceived as a forum for the exercise of power, the doctrine of the separation of ownership and control can be viewed as a specific manifestation of a broader issue: the emergence of power within one group when another experiences erosion of power. This is a matter of some interest only as the two groups under consideration have differing organizational preferences. Berle and Means assume both that the interests of owners and managers diverge and that it is managers who acquire power under conditions of diffuse ownership (see also Bothwell, 1980; Boudreaux, 1973; Monsen, Chiu, & Cooley, 1968):

The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappear...“Management” may be defined as that body of men who, in law, have formally assumed the duties of exercising domination over the corporate business and assets.

1968: 7, 196

1966: 224

As opposed to a property-based or an economic system...
The notion of power-sharing suggests neither owners nor managers have complete discretion in the assignment of organizational outcomes. Empirical examinations of managerial preferences support the view that executives pursue objectives relating to size, sales growth, growth of the firm’s assets, and span of control (Amihud & Kamin, 1979; Amihud & Lev, 1981; Baumol, 1959; Pass & Witt, 1985; Stano, 1976). “These objectives are considered to be important in terms of management welfare in so far as they determine the level of executive remuneration, and managers’ power, status and prestige…[h]owever, these growth objectives are constrained by the competing desire to preserve managers’ job security by maintaining satisfactory profit levels, dividend payouts and share values” (Pass & Witt, 1985: 68). Managerial pursuit of these latter (shareholder) objectives suggests the market serves to restrict managerial self-interest.

At its most fundamental level, however, the theory of managerialism counters classical economic reasoning. The history of trusteeship explored earlier was not lost to Berle and Means (1968). These writers explicitly acknowledge that:

…corporation law becomes in substance a branch of the law of trusts. The rules of application are less rigorous, since the business situation demands greater flexibility than the trust situation. Probably the requirements as to motive and clean-mindedness on the part of persons exercising the powers are substantially similar. The requirements of exactitude in apportioning or assessing ratable differences must yield to the necessary approximations which business entails. But the fundamental requirements follow similar lines [emphasis added].

Berle & Means, 1968: 242

Trusteeship theory has as its foundation ‘the traditional logic of property,’ which dictates corporate profits should go to owners. Running counter to this imperative, however, is ‘the traditional logic of profits,’ which requires managers receive profits as incentive to run the firm efficiently (Berle & Means, 1932: 333-344; as referenced in Hessen, 1983: 276). Adherents to the managerial view are concerned the logic of profit has taken precedence, with the effect that shareholder self-interest can no longer be relied upon to bring about the ‘good’ society. Berle and Means (1968) conclude the very nature of property has been revolutionized, for “[i]t is the management…
[through the mechanism of] ‘control’ which is now wedded to the physical property…[t]he owner has no direct personal relation to it and no responsibility toward it” (Berle & Means, 1968: 250).20

Berle and Means (1968) believe both owners and managers are responsible for the changes which have taken place in the nature of corporate property. Although the logic of their discourse fails at this point,21 Berle and Means argue the changing character of property (premise) virtually demands corporations be accountable to all of society (conclusion):

On the one hand, owners of passive property, by surrendering control and responsibility over the active property, have surrendered the right that the corporation should be operated in their sole interest,—they have released the community from the obligation to protect them to the full extent implied in the doctrine of strict property rights. At the same time, the controlling groups, by means of the extension of corporate powers, have in their own interest broken the bars of tradition which require that the corporation be operated solely for the benefit of the owners of passive property [as trusteeship theory would hold]…[in so doing,] the control groups have…cleared the way for the claims of a group far wider than either the owners or the control.22 They have placed the community in a position to demand that the modern corporation serve not alone the owners or the control but all society [emphasis added].

1968: 311-12

20 The argument that shareholders have no responsibility for the actions of the corporations in which they hold an ownership interest would be disputed by most writers concerned with the notion of corporate social responsibility. As (anecdotal) evidence that at least some shareholders have a strong sense of moral consciousness where their investments are concerned, consider the current popularity of those investment funds which restrict their holdings to ‘green’ corporations, or companies not having a South African presence, or businesses rated highly on any number of societal issues. The popularity of such funds persists in spite of the fact that there is no demonstrated link between ‘good’ corporate citizenship and profitability.

21 In an age of historical revisionism, one need not look far to find those who interpret business history differently than did Berle and Means. In his new book *Scale and Scope: The Dynamics of Industrial Capitalism*, Chandler (1990) argues that separation of ownership and control have worked to the advantage of the firm’s owners—a view shared by the neo-classical economist and, to a lesser extent, the adherents of agency theory:

*Scale and Scope* continues Chandler’s analysis of what happened when the visible hand of management replaced “the invisible hand” of the market as the force driving corporate organization and strategy…What it says will upset some people’s pet theories. Wall Street mavens and economists of most stripes, for example, argue that what ails U.S. companies is that the managers running them aren’t owners. But Chandler shows that America’s industrial triumph from the 1880s to the 1940s depended on the separation of ownership and control. As a group, managers invested to assure their companies’ long-term profit and growth. By contrast, Britain’s owner-managers seem to have been more concerned with providing themselves with a steady cash flow. Britain declined in part because of a failure to invest long and heavily [emphasis added].

Business Week, July 9, 1990: 12

22 ‘The control’ is Berle and Means’ euphemism for ‘management.’
Organizational theorists make a similar, yet distinct, claim: “Complex organizations exist ultimately as agencies of their environments, acquiring resources in exchange for outputs and, in the final analysis, obtaining technologies from environments...[t]he fact that organizations exist with the consent of their environments does not automatically subject them to societal control [emphasis added]” (Thompson, 1967: 162; see also Pfeffer & Salancik, 1978). It is on this final point that Berle and Means (1968) and such organizational theorists would disagree. Berle and Means (1968) make a deductive leap in concluding not only that corporations are responsible to all of society, but additionally that in the absence of the operation of a free market grounded in clearly established property ownership rights the polity becomes the appropriate mechanism for insuring corporate responsibility. As noted in the writings of Thompson, organizational theorists generally rely upon the mechanism of power—whether formalized in the institution of government or not—to arbitrate rights disputes:

**Proposition 8.1:** In modern societies, the content of the inducements/contributions contract is determined through power (political) processes...

**Proposition 8.3:** Inducements/contributions contracts at contingent boundaries of the organization are determined by (a) the power of a task-environment element and (b) the individual’s ability to handle the organization’s dependence on that element.

1967: 106, 111

Classical economists are joined by at least some sociologists in their concern over the conclusions drawn by Berle and Means (1968). Marxist sociologists in particular have expressed concern with managerialist reasoning because it contradicts sociological class theory, which is based upon familial ownership of property: if the means of production are not controlled by owners, class theory fails. Such sociologists reject Berle and Means’ (1968) claim that the interests of owners and managers diverge; rather, it is suggested owners and managers are co-conspirators in the ongoing class struggle. Zeitlin has devoted a great deal of effort to reevaluating Berle and Means’ (1968) analysis, and concludes “[i]t is precisely this relationship between propertied interests and the bureaucracy, and between ‘capitalists’ and ‘managers,’ which has received at best inadequate and usually no attention among those who report that they
have seen a ‘corporate revolution’ silently abolish private ownership in the means of production’ (1974: 1078).

Zeitlin is not ignorant of the fact that “[i]f the separation of ownership and control has not occurred, then ‘managerial’ theories are without foundation” (1974: 1073). After having examined earlier works and having found interconnections pointing to some degree of familial control of the means of production, Zeitlin comes to “believe that the ‘separation of ownership and control’ may well be one of those rather critical, widely accepted, pseudofacts with which all science occasionally found themselves burdened and bedeviled” (1974: 1107). Whether one holds to his socio-political agenda, Zeitlin’s recommendations for more rigorous research into the phenomenon are worth noting:

Rather than limiting analysis to the relationship between the “management” and principal shareowners of a given corporation, the analysis must focus on the multiplicity of their interconnections with other “managements” and principal shareowners in other large corporations, as well as the owners of other forms of large-scale income-bearing property…Most important, were “managers” and “owners” to be found to occupy a common “class situation” (Weber 1968, p. 927), the theory that ownership and control of the large corporations reside in the same social class would be confirmed.

1974: 1079-80

The concept of private property lies at the core of Zeitlin’s argumentation. Adherents to the Marxist view believe if “…the self-alienation of belief in God and the self-alienation inherent in private property were overcome,…human society could at last establish individuals in the proper human freedom…[t]he historical manifestations of Marxism, however, have shown that human possessiveness operates quite as readily with power as with property…[emphasis added]” (Johnson, 1981: 86). The egalitarian view necessarily fails if its application is limited to possessions and not extended to position as well. Devotees of the egalitarian rhetoric would do well to consider the reasoning of the earliest of philosophers, who were enlightened to the fact that at its core inequality has less to do with outcomes than with the essential nature of personhood:
Aristotle placed his finger squarely on the essential deficiency in Plato’s thought regarding possession. He saw that the problem of human possessiveness would not go away with the structural equalization of property, for the problem lay not in property but in human desire…The pooling of goods would not by itself effect a spiritual transformation…Given the state of human nature, Plato’s ideal could not be realized.

Johnson, 1981: 124-25

Weber similarly despairs discovering an objective mechanism for producing equality: “Questions of ends are questions of values, and on values reason is silent; conflict between rival values cannot be rationally settled. Instead, one must simply choose—between parties, classes, nations, causes, ideals” (MacIntyre, 1984: 26).

Managerialism: Review of Empirical Work

The original work of Berle and Means (1968) was conducted under the premise that three categories of ownership diffusion existed:

1) Owner-controlled, characterized by a single-largest stock position of greater than 20 percent;
2) Neither owner-controlled nor manager-controlled, characterized by a single-largest stock position of less than 20 percent but greater than 5 percent;
3) Manager-controlled, characterized by a single-largest stock position of less than 5 percent.

It is worth noting the above guidelines were not strictly enforced. Berle and Means claim “[i]n the process of classification, certain arbitrary judgements had to be made…The dividing line between minority and management control was drawn roughly at 20 per cent…Cases falling between the 20 and 5 per cent were usually classed as joint minority-management control. Perhaps others should be classed in this category [emphasis added]” (1968: 108-9). What is more disturbing than the casualness with which the criteria were applied, however, is the arbitrariness of the criteria themselves. Nowhere in their treatise do Berle and Means (1968) offer any theoretical rationale for their classificatory schema, leading at least one researcher to charge that Berle and Means (1968) have “simply assumed away the analytical issues in the concept of control by their
operational definitions…a specific minority percentage of ownership in itself can tell little about the potential for control that it represents” (Zeitlin, 1974: 1090-91). Furthermore, Zeitlin is unwilling to concede that in the absence of owner-control power necessarily passes to management: “[Berle and Means] have merely assumed, rather than demonstrated, that once a cohesive ownership interest having at least a minimum specified proportion of the stock...disappears, the corporation slips imperceptibly and inevitably under ‘management control!’” (1974: 1090). And even if this were the case, as Thompson correctly notes management can not be counted on to be of a single mind: “A...major limitation on the administrative process lies in the diffusion of power to the point where no inner circle emerges with sufficient stability to give direction to the organization” (1967: 153).

In spite of the popularity of Berle and Means (1968) criteria within the literature on separation of ownership and control, there are those researchers who have ‘rushed in where angels fear to tread,’ developing research agendas calling into question the role of ownership control within the modern corporation. Leech (1987a) is among those who have pried open the ‘black boxes’ so many researchers have merely appropriated as first premises. Using Berle and Means own data, Leech (1987a) demonstrated it is possible for companies having less than the twenty per cent concentration criteria employed by Berle and Means to nonetheless be dominated by a small number of leading shareholders—if such groups have formed controlling coalitions. Leech (1987b) has conducted an investigation of the top two hundred nonfinancial corporations for the year 1937 using his game-theoretic perspective. The relationship between ownership concentration and the voting power of leading coalitions was explored. Leech’s (1987b) findings show control by small coalitions of shareholders is feasible for the majority of firms on the basis of observed levels of ownership concentration. Leech (1987b) offers this discovery as counter-evidence against the general assumption of a pervasive separation between ownership and control. It should be noted, however, that although focused control may have been feasible in those firms which Berle and Means (1968) classified as management-controlled, Leech (1987b) is unable to demonstrate
such coalitions *in fact* existed. Finally, in their study of corporate takeovers Shleifer & Vishny (1986) show that minority shareholders with ownership interests significantly less than twenty per cent have the ability to exercise tremendous control over managerial behavior—and thereby bring about value-increasing changes in corporate policy.

While the above writers have accepted that ownership represents control, albeit at levels different than those suggested by Berle and Means (1968), other researchers have linked ownership to participation in decision-making—a more focused construct than generic control. Dye (1985) specifically tested this hypothesis, and concluded strategic ownership interests among both the Fortune 500 as well as the nation's largest financial institutions had as their chief end participation in corporate decision making. These findings imply control is not an end in and of itself; rather, strategic ownership affords the investors a better opportunity to fulfill their personal effectiveness agenda. Similarly, French (1987) found an increased likelihood for dissatisfied employees to use their ownership position in their employing firm as an influence mechanism—and this in spite of the fact that such employees' initial goal in stock ownership may have been investment. In a similar vein, Fombrun (1984) draws a distinction between formal and governance structures. It is his contention that organizations ought to be viewed as polities, for in so doing control issues can be assessed *directly*, rather than indirectly—as is the case when control is assumed to be a function of ownership.

At least two authors have focused on the role of stockholder voting. In the spirit of Berle and Means, Hall (1985) is concerned with the control which attends voting shares of stock. Hall (1985) offers an analysis of the recent ownership restructuring among numerous prominent corporations. In such cases, it appears management has been able to effectively dilute the voting rights of common classes of stock by issuing specially weighted offerings as a defensive device. On one view, such recapitalization amounts to free leveraged buyouts that give inside managers total control of 'their' enterprises—with no accompanying financial risk. This reading is elegantly
consistent with the separation thesis: in the absence of some degree of goal consensus between owners on the one hand and their agents on the other, self-serving managers adopt adversarial mechanisms designed to artificially diffuse ownership, thereby insuring managerial control. Easterbrook & Fischel (1983) take quite a different tack. In what amounts to support for the current legal statutes surrounding voting issues of stock, Easterbrook & Fischel (1983) argue the common law rules governing shareholder voting can be justified as attempts to reduce agency costs. The authors see this as decidedly opposed to the flowering of stockholder democracy which has accompanied widespread acceptance of Berle and Means’ (1968) separation theory. Easterbrook & Fischel (1983), while seeming to have rare insight into the gross societal reform(s) suggested by the work of Berle and Means, argue against the urgings of these authors’ contemporaries that the solution to the separation dilemma is shareholder empowerment. Whether they would agree with Berle and Means on the point that social control of corporations would resolve the separation dilemma, Easterbrook & Fischel (1983) find economic support for current shareholder voting law.

The above-cited research has generally held owner-controlled firms are better performers than are manager-controlled firms, for “[c]oncentrated ownership serves to reduce the incidence of pursuit of individual goals at the expense of firm goals” (Williamson, 1981). Beyond strict performance benefits, however, the separation of ownership from control secures ownership liquidity: “It is the management and ‘control’ which is now wedded to the physical property…[t]he owner has no direct personal relation to it and no responsibility toward it” (Berle & Means, 1968: 250).

The assumptions underlying the managerial model are of greater relevance to the research here proposed than are the findings of prior research. Individually, such assumptions are necessary for the managerial hypotheses to hold; collectively, such assumptions fulfill the condition of sufficiency. With respect to human nature, the managerial thesis presumes humankind to be
hopelessly self-serving—a view endorsed by most organizational theorists: “…we will work with a very simple assumption—that individuals exercise discretion whenever they believe it is to their advantage to do so and seek to evade discretion on other occasions…We can assume that where alternatives are perceived to have equal [or possibly even detrimental] consequences for the organization, the individual will select that alternative which favors his sphere of action” (Thompson, 1967: 118, 123; see also Demsetz & Lehn, 1985; Hill & Snell, 1989; Jensen & Meckling, 1976; Krause, 1988). This condition extends to not only the firm’s owners, but to its managers as well, who are expected to appropriate corporate wealth for their own ends to the extent this is possible. Direct empirical support has been offered for this assumption: “When 889 ‘executive managers’ were asked to rate the importance of 16 different stakeholders in management decision-making, the overall results showed ‘myself’ as second only to ‘customers’…’stockholders’ were far down (the list)” (Posner & Schmidt, 1984; as cited in Preston & Sapienza, 1989: 7).

A second set of assumptions centers on the premise that the interests of owners and managers diverge. However, “[t]he actual incentives and behavior of corporate officials received no systematic attention in the entire volume [of Berle and Means The Modern Corporation and Private Property]” (Stigler & Friedland, 1983: 238; see also Hessen, 1983: 277). It has been argued manager’s personal goals include security, power, prestige, advancement and personal income—items purported to be of little interest to shareholders (Gordon, 1961; Kaysen, 1960; in

23 Self-interest often gives way to self-aggrandizement, or idolatry. Consider once again the words of Johnson:

The tradition [of which we are a part] recognizes as well that we are creatures who invariably center our lives on that which we perceive to be ultimate; we are so constructed. It also recognizes that, left to ourselves, our fear of nonbeing is so great that we tend to center our lives in some fashion on a power that is less than truly ultimate but that we can possess and thus ensure and control our own worth. In a word, we tend to be idolaters [emphasis added].

1981: 114

Both possessions and power—the ‘lust of the eyes’ and the ‘pride of life’—represent common idols around which self-interested individuals tend to center their lives.
Benston, 1985: 67). It is noteworthy that the view of unilateral managerial action is inconsistent with the basic organizational proposition of interdependence. Thompson represents such a view:

> We have asserted, with Cyert and March (1963), that organizational goals are established through coalition behavior. We have done so on grounds that organizations are interdependent with task-environment elements and that organizational components are also interdependent with one another. Unilateral action is not compatible with interdependence [emphasis added].

1967: 132

Lewellen (1968, 1969) suggests executive compensation has changed substantially since the era of Berle and Means’ scholarship. His own research supports the finding that “deferred executive compensation increased dramatically during the 1950s and 1960s as a result of tax legislation favoring such postponement and concluded that so much of a CEO’s [Chief Executive Officer’s] yearly compensation in large firms was traceable to long-term income that the interests of managers and stockholders could not be easily differentiated” (Gomez-Mejia et al., 1987: 66).

A corollary to the assumption of interest divergence is the supposition that managers do not have significant equity holdings in the firms which they manage (Stigler & Friedland, 1983: 238). Several studies sustain this proposition. Tsussig and Barker (1925) “found that executives usually owned little stock, especially in large corporations...[furthermore,] salaries were a much larger fraction of invested capital in companies, the larger the share of stock held by the executives (as referenced in Stigler & Friedland, 1983: 249). This finding was appropriated by Samuel Rayburn, chairman of the House Commerce Committee, as support for the necessity of landmark legislation—the Securities Act of 1933: “The management of these big corporations, as a rule, own an insignificant percentage of the outstanding stock” (as cited in Stigler & Friedland, 1983: 243). Empirical support is available as well. In Business Leadership in the Large Corporation, Gordon (1936) presents data on the stockholdings of 107 listed New York Stock Exchange industrial companies demonstrating “the median share voting stock held by all officers and directors was less than 10 percent and was less than 4 percent in the largest corporations...[more importantly,] the market value of the major officers’ holdings had a median
value of only $137,000 (as referenced in Stigler & Friedland, 1983: 245). Consistent with Berle and Means (1968) summation, and of critical relevance to the current proposal, Gordon (1945) concludes "the traditional reward of the business leader—profits arising from business ownership—is not a primary incentive to the majority of top executives in our largest corporations...[n]either dividend income nor possibilities of appreciation in the value of their negligible stockholdings can compare with compensation as a source of income [emphasis added]" (as cited in Stigler & Friedland, 1983: 246). Berle and Means are adamant about the hazards of employing non-owner managers:

As their [i.e., managers'] proportion of the holdings decrease, and both profits and losses of the company accrue less and less to them, the opportunities of profiting at the expense of the corporation appear more directly to their benefit. When their holdings amount to only such fractional per cents as the holdings of the management in management-controlled corporations, profits at the expense of the corporation become practically clear gain to the persons in control and the interests of a profit-seeking control run directly counter to the interests of the owners [emphasis added].

1968: 114-15

The fact that all of the above works are concerned with the percentage of equity held by management, rather than the value of such holdings in absolute dollar terms, will become increasingly critical as the current thesis is developed.

A second corollary to the condition that owner and manager interests diverge is the assumption that these are the only two claims which ‘count:’ control is exhibited through either managerial or ownership power. Berle and Means limit their discussion to three positional stakes: “that of having interests in an enterprise, that of having power over it, and that of acting with respect to it

24 At least one writer makes the fundamental observation that owner-managers might be as liable as 'professional' managers to engage in non-profit-maximizing behavior:

Because a good part of a real owner-manager's life is on the job, he very well may decide in favor of on-the-job consumption...It is clearly an error to suppose that a firm managed by its only owner comes closest to the profit-maximizing firm postulated in the model firm of economic theory. The owner-manager of such a firm may or may not be motivated only by the search for profit. He may habitually consume on the job [emphasis added].

Demsetz, 1983: 379, 382-83

This point has been routinely ignored by supporters of the managerial view, who have adopted the economic-man perspective that owners—whether in 'control' or not—are consumed with profit-seeking.
While Berle and Means (1968) acknowledge individuals are not precluded from simultaneously filling more than one of these roles, this possibility is not explicitly addressed in their empirical work. Of the three functions, Berle and Means clearly consider power to be of critical importance—and they define this construct quite narrowly:

In most cases, however, if one can determine who does actually have the power to select the directors, one has located the group if individuals who for practical purposes may be regarded as ‘the control’…control will tend to be in the hands of those who select the proxy committee by whom, in turn, the election of directors for the ensuing period may be made. Since the proxy committee is appointed by the existing management, the latter can virtually dictate their own successors. Where ownership is sufficiently sub-divided [diffuse], the management can thus become a self-perpetuating body even though its share in the ownership is negligible [emphasis added].

Ownership control is therefore of little import given the condition of widespread shareholding. For Berle and Means (1968), this conclusion is of no small consequence. Not only does the diminution of the role of shareholding violate the most basic tenets of property theory; additionally, in consideration of this fact the very nature of social architecture itself is suspect:

Most fundamental of all, the position of ownership has changed from an active to that of a passive agent…

It follows from all of the foregoing that the shareholder in the modern corporate situation has surrendered a set of definite [property] rights for a set of indefinite expectations. The whole effect of the growth of powers of directors and “control” has been steadily to diminish the number of things on which a shareholder can count; the number of demands which he can make with any assurance that they must be satisfied. The stockholder is therefore left as a matter of law with little more than the loose expectation that a group of men, under a nominal [trusteeship] duty to run the enterprise for his benefit and that of others like him, will actually observe this obligation…

The only example of a similar subjection of the economic interests of the individual to those of a group which appears to the writers as being at all comparable, is that contained in the communist system [emphasis added].

Pfeffer and Salancik (1978), Thompson (1967), and Emerson (1962; as referenced in Thompson, 1967) all make the point that dependence can be seen as the obverse of power. Within the

25 The role of the board of directors, while not central to the current proposal, will nonetheless be briefly addressed momentarily.
current context, managerial power engenders shareholder dependence—exacerbating the fundamental problem of separation of ownership and control. While owners never fully surrender their ownership rights and their attendant power, neither are they likely to intervene with management unless managers have gone seriously astray. The latent power of owners may therefore be best understood as a constraint on management decision-making, rather than an active involvement in the affairs of the firm (Dye, 1985: 11; see also Jones et al., 1989).

Given the limited view that only owners and managers have power with respect to the firm, absent owner-control managers rule by default (Marris & Mueller, 1980; Scott, 1979; see Pitelis & Sugden, 1986 for a dissenting view). One might argue that the proper functioning of boards of directors serves to obviate this concern, for directors are clearly charged with operating the firm for the benefit of its owners—and at least theoretically are overseers of management as well. The failure of boards of directors to fulfill their responsibilities has been most often attributed to the conjecture that boards are “creatures of the CEO” (Patton & Baker, 1987). Numerous researchers have documented the fact that boards have traditionally been passive participants in the corporate governance process (Anshen, 1980; Douglas, 1934; Galbraith, 1968; Mace, 1971). The reasons cited for board passivity center on the observation that CEOs play a significant role in the design and leadership of the board and, consistent with the managerial perspective, as such do not seat directors who are likely to challenge managerial authority.

While the managerial thesis has enjoyed acceptance across a number of scholarly disciplines, ranging from organizational theory to sociology to philosophy, were one to complete such a list the functional discipline of economics would be strangely absent. Economists have been hesitant to embrace Berle and Means’ (1968) work largely because in their view the theory fails to account for the role of market control as a mechanism for reining managerial self-interest. Even Berle and Means concede the need of the corporation to sell securities to raise additional capital “sets a very definite limit on the extent to which those in control can abuse the suppliers of capital” (as
cited in Stigler & Friedland, 1983: 239). This concession has given rise to the neo-classical economic perspective next considered.

**Jensen and Meckling: The Neo-classical Economic Perspective**

FitzRoy and Mueller have duly noted “…in the 1970s…the separation of ownership from control problem was rechristened the principal-agent problem, and became the focal point of analysis for a large and rapidly growing number of neoclassical economists, as part of a new, generalized neoclassical economics that emphasizes transactions costs” (1984: 25). The work of Jensen and Meckling (1976) has come to be most closely associated with such a view. By their own admission, these authors “focus almost entirely on the positive aspects of the theory” of agency (Jensen & Meckling, 1976: 310 [emphasis added]). While such a bias has left neo-classical economists little concerned with how the contractual relation might be structured so as to provide adequate incentives for the agent to make choices serving to maximize the principal’s welfare—a point central to the current research—, as a general theory of the firm such thinking represents a fundamental advancement in our understanding of corporate behavior.

**Neo-classical Economics: Theory, Implications, and Review of Empirical Work**

The study of neo-classical economics is grounded in characterization of the firm as “a nexus for a set of contracting relationships among individuals” (Jensen & Meckling, 1976: 310).

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26 It is recognized that at law corporations are not strictly reducible to contractual terms:

A corporation is not a nexus of actual contracts...[however], courts often declare and enforce [implied] rights and duties between contracting parties that relate to matters neither party actually contemplated or bargained about [emphasis added].

Clark, 1985: 59
“it is impossible to specify fully by [explicit] contract the duties of and limitations on each actor [within the organizational context],” neo-classical economists have routinely extended their definition of ‘contract’ to include implicit as well as explicit arrangements (see, e.g., Easterbrook and Fischel, 1983: 401). Conceiving of organizations as the interstices of implicit and explicit contracts among organizational constituencies represents a fundamental reconceptualization of the nature of the firm (Klein, 1983: 373). It is argued the constitution of such contracts is a defining characteristic of the corporate form:

Conceptually, we can only define a corporation by referring to the set of contractual relationships existing among the persons [stakeholders] involved in the corporate activities. Theoretically, consideration of the nature of the contractual terms defining relationships among participants will be sufficient to distinguish the corporate type from relationships of other types of human association such as partnerships or marriages.

Skidd, 1988: 80-1

This view of corporate enterprise departs from the classic conceptualization of the corporation as a ‘legal fiction’—and bears strong implications with respect to a theory of corporate moral accountability. Historically, the corporation has been held to be “an artificial being, invisible, intangible, and existing only in contemplation of law” (Dartmouth College vs. Woodward, as cited in De George, 1986: 152). Not only does this legal opinion allow the corporation to act, hold property, and be sued; additionally, courts have generally extended constitutional protections—including the legal right to equal protection, due process, freedom of the press, and freedom from self-incrimination—to the corporation as if this ‘legal fiction’ were a person (Werhane, 1985: 33). Among the detractors from those adopting the ‘moral personhood’ view of corporate responsibility are philosophers viewing corporations as associations—a position closely akin to that of neo-classical economists:

[A] corporation is in fact an association of individuals who are entitled to the same rights and legal protections which apply to all other individuals and organizations.

Hessen, 1979: xv; as cited in Werhane, 1985: 40

To the extent that these are not matters specified and fixed by voluntary and actual agreement, such understandings fall short of fulfilling the legal requirements for contractual arrangements.
Within this framework the corporation has no rights of its own; rather, such institutions are nothing more or less than an aggregate of individuals having voluntarily committed themselves to a collective purpose. “The term ‘corporation’ is merely a mental construct or convention used to describe the particular legal contractual relationship represented by the voluntary association [emphasis added]” (Werhane, 1985: 40; see also Hesson, 1979; Pilon, 1979).

Neo-classical economists refine their theory of the corporate firm to include the necessary distinguishing feature of “the existence of divisible residual claims on the assets and cash flows of the organization…” (Jensen & Meckling, 1976: 311). “When the form of ex post or contingent payment is tied not to specific measures of performance but instead to a share of net cash flows or ‘profits,’ the factor [shareholder] is said to be a ‘residual claimant’” (Klein, 1983: 368). As residual claimants, shareholders possess both “[t]he right to make all decisions not otherwise provided by contract—whether the contract is express or supplied by legal rule” as well as “the appropriate incentives (collective choice problems to one side) to make discretionary decisions” (Easterbrook & Fischel, 1983: 402, 403). Consistent with the managerial view, neo-classical economists argue the contract structure of corporate organizations serves to separate the ratification and monitoring of decisions (under the purview of owners—or their duly-elected representatives) from initiation and implementation of the decisions (within the control of management) (Fama & Jensen, 1983a: 302). Given this division, the role of agency takes on critical importance.

Jensen and Meckling define an agency relationship as “a contract under which one or more persons (the principals [shareholders]) engage another person (the agent [manager]) to perform some service on their behalf which involves delegating some decision making authority to the agent” (1976: 308).27 “[T]he heart of principal-agent theory is the trade-off between (a) the cost of

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27 Managers are not strictly speaking the agents of shareholders. It must be understood that the concepts of agency and fiduciary are not synonomous. The core legal concept of agency implies a relationship in which the principal retains the power to control and direct the activities of the agent. By statute in every state, the board of directors of a corporation—and most notably not the shareholders—has the
measuring behavior and (b) the cost of measuring outcomes and transferring risk to the agent” (Eisenhardt, 1989: 61). Within the neo-classical economic framework, organizational structure is presumed to attenuate the problem of managerial shirking:

Agency theory suggests that, given the costs of measurement of performance and enforcement of rules to constrain agents, the organizational structure will be devised to minimize the attendant rent dissipation.

North, 1983: 269-70 (commenting on Stigler & Friedland, 1983)

Researchers in this tradition draw upon agency theory to argue separation of ownership and control cannot adversely affect ownership interests, for “owners’ decisions to loosen control over management are made in awareness of the costs and benefits to themselves” (Bilimoria, 1988: 4). Similarly, Demsetz notes what should be an obvious contradiction between the ‘agency problem’ and traditional economic assumptions: “In a world in which self-interest plays a significant role in economic behavior, it is foolish to believe that owners of valuable resources systematically relinquish control to managers who are not guided to serve their [i.e., the owners’] interests” (1983: 390). Ultimately, it is the operation of the market which serves to align the interests of owners and managers:

Agency theory is...similar to political models of organizations. Both agency and political perspectives assume the pursuit of self-interest at the individual level and goal conflict at the organizational level...The difference is that in political models goal conflicts are resolved through bargaining, negotiation, and coalitions—the power mechanism of political science. In agency theory they are

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power and duty to manage or supervise its business; stockholders’ powers in a public corporation are limited to voting for or against candidates for directorships (Clark, 1985: 56-7). According to the Corporate Director's Guidebook, “the fundamental responsibility of the individual corporate director is to represent the interests of the shareholders as a group [emphasis added]” (as cited in Kesner & Johnson, 1978: 46). Consider the following points of law:

(1) corporate officers like the president and treasurer are agents of the corporation itself;
(2) the board of directors is the ultimate decision-making body of the corporation (and in a sense is the group most appropriately identified with “the corporation”);
(3) directors are not agents of the corporation but are sui generis;
(4) neither officers nor directors are agents of the stockholders; but
(5) both officers and directors are “fiduciaries” with respect to the corporation and its stockholders.

Clark, 1985: 56

While both officers and directors bear a fiduciary responsibility to the firms' owners, this is not to say that managers are the legal agents of stockholders. Neo-classical economists give the term 'agency' the broadest of readings.
A fundamental trusteeship obligation permeates the covenant between manager and owner. As Justice Douglas has noted, the power of the manager “is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary [manager] to the exclusion or detriment of the cestuis [owner]” (as cited in Clark, 1985: 76). On the pragmatic level both Ouchi (1977) and Durkheim (1964) argue there exist strong societal norms against excessive ‘slack,’ for economic activity is possible only because it is embedded in a social and normative context that constrains opportunistic behavior (as referenced in Maitland et al., 1985: 63). Such restrictions are clearly antithetical to managerial self-interest. As Jensen and Meckling note:

If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal. The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent [emphasis added].

1976: 308

Managerial shareholdings should serve to reduce the agency problem by uniting the interests of owners and managers; in fact, not a few neo-classical economists “are concerned with the survival of organizations in which important decision agents do not bear a substantial share of the wealth effects of their decisions” (Fama & Jensen, 1983a: 301). Furthermore, the agency problem is only evident within those firms whose “decision managers…are not the major residual claimants and therefore do not bear a major share of the wealth effects of their decisions” (Fama & Jensen, 1983a: 304).

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28 Even owner-managers may prefer on-the-job consumption to growth in their equity positions. Several methods have been proposed which serve to restrict the opportunity for owner-managers to capture non-pecuniary benefits, including “auditing, formal control systems, budget restrictions, and the establishment of incentive compensation systems which serve to more closely identify the manager’s interests with those of the outside equity holders” (Jensen & Meckling, 1976: 323).

29 It will be argued elsewhere that managers need not be the “major residual claimants” if the agency problem is to be overcome; rather, managerial equity holdings need only represent a substantial portion of the manager’s personal wealth holdings.
In the language of neo-classical economics, the expense to shareholders of managerial shirking—inclusive of the outlay for avoiding same—has been termed ‘agency costs.’ “Agency costs include the costs of structuring, monitoring, and bonding a set of contracts among agents with conflicting interests, plus the residual loss incurred because the cost of full enforcement of contracts exceeds the benefits” (Fama & Jensen, 1983b: 327). Dyl notes ‘excessive’ levels of executive compensation also constitute agency costs (1988: 22). While one would expect to observe both bonding and external monitoring activities in most corporations, “the incentives are such that the levels of these activities will satisfy the conditions of efficiency” (Jensen & Meckling, 1976: 327). Rationality demands agency costs be expended only to the extent that such expenses do not exceed their utility in terms of increased market value of the firm. The natural result is that the firm is not run in a manner so as to maximize its value (Jensen & Meckling, 1976: 327). 30

Berle and Means noted this propensity for suboptimization, and in their closing arguments conclude this tendency is sufficiently problematic to necessitate a redefinition of private property—to be paralleled by more expansive governmental involvement in corporate affairs:

...if...the men in control of a corporation can operate it in their own interests, and can divert a portion of the asset fund of income stream to their own uses, such is their privilege. Under this view, since the new powers have been acquired on a quasi-contractual basis, the security holders have agreed in advance to any losses which they may suffer by reason of such use. The result is...that the existence of the legal and economic relationships giving rise to these powers must be frankly recognized as a modification of the principle of private property [emphasis added].

1968: 311

Narayanan’s (1985) analysis offers some support for this view. Given that information is asymmetrically distributed within the organization, with managers benefiting from direct access to

30 It has been argued that satisficing behavior is as much a function of cognitive limits as agency costs:

The complexity, if fully faced, would overwhelm the organization, hence it must set limits to its definitions of situations; it must make decisions in bounded rationality...This requirement involves replacing the maximum-efficiency criterion with one of satisfactory accomplishment, decision making now involving satisficing rather than maximizing...

Thompson, 1967: 9; see also Simon, 1957
corporate intelligence, shareholders are left with few facts upon which to judge managerial competence. If compensation is linked to accounting (as opposed to market) measures of performance, a systematic managerial preference for quick payback projects is likely to occur, as such endeavors serve to improve managers’ reputations—and boost their salaries. However, financial theory suggests pursuit of short-term projects does little to secure the long-term interests of the firm. The neo-classical economist offers a ‘middle ground’ serving to reconcile these opposing views: given efficient market mechanisms, residual claimants’ losses as a result of managerial short-term biases are necessarily less than the cost of fully specifying and monitoring contracts.

Vickers extends this line of reasoning to its natural conclusion: “if control of my decisions is in the hands of an agent whose preferences are different from my own, I may nonetheless prefer the results to those that would come about if I took my own decisions [emphasis added]” (1985: 138; see also Demsetz & Lehn, 1985: 1156). Vickers’ (1985) theory of strategic delegation takes explicit account of the fact that the expertise of the managerial team is secured on behalf of the firm’s owners—a matter often overlooked in the managerial literature. Vickers (1985) masterfully demonstrates there may exist substantial overlap between the preferred outcomes of residual claimants and management (see also Demsetz, 1983); furthermore, even if such goal congruence is not evident the positive effect(s) of structuring a corporation for competitive advantage—a function of managerial expertise—may far outweigh the costs associated with the separation of ownership and control. Jensen and Meckling further note non-agency considerations, including most notably the advantage of limited liability attending the corporate form, may serve as alternative explanations for the ownership structure of the firm (1976: 331-2).

It is worth examining the varieties of agency costs in somewhat greater detail. Due to the costs associated with structuring a set of contracts, such agreements are seldom fully specified: “contracts are incomplete because particular contractual performance, such as the level and form
of energy an employee is to devote to a complex task, may be prohibitively costly to measure and hence to specify contractually” (Klein, 1983: 367). *Bonding costs* serve to unite the interests of owners and managers, and are therefore of critical importance to the research herein undertaken—especially where managerial stock ownership functions as the bonding mechanism.

Perhaps Benston states this premise most succinctly:

> the [managers] of large corporations with diversely-held shares tend to own a sufficiently large amount of shares in their companies to give them a considerable incentive to make decisions that tend to increase the market value of those shares…it appears, therefore, that stock ownership is an important means by which the managers are induced or bonded to act in the interest of shareholders [emphasis added].

1985: 82; see also Demsetz & Lehn, 1985

*Monitoring costs* are incurred by the principal as a means of reducing managerial shirking. This principle was not lost to Thompson: his ‘Proposition 9.4’ reads “Organizations seek to guard against deviant discretion by policing methods” (1967: 122). Shirking has a specific meaning within neo-classical economics:

> We may interpret the amount by which on-the-job consumption, given positive monitoring cost, exceeds the amount of consumption that would take place when modeled with zero monitoring cost as shirking...shirking can be reduced and both employer and employees made better off if the monitoring cost required to reduce shirking is less than the value of the resources consumed in shirking [emphasis added]

Demsetz, 1983: 380-81

Given their assumptions of rationality on the part of residual claimants and efficiency on the part of capital markets, neo-classical economists conclude managerial shirking exists only when its prevention is prohibitively expensive (Jensen & Meckling, 1976: 324). It is interesting to note that given this construction monitoring costs may be so high as to make otherwise inefficient contractual arrangements viable.

Beyond their assumption that humankind is quite rationally self-serving, neo-classical economists speculate that economic efficiency is a naturally-occurring phenomenon—a view shared by adherents of the natural-systems organizational perspective: “Central to the natural-system
approach is the concept of homeostasis, or self-stabilization, which spontaneously, or naturally, governs the necessary relationships among parts and activities and thereby keeps the system viable in the face of disturbances stemming from the environment” (Thompson, 1967: 7). This line of reasoning is extended to arrive at the following critical conjecture: “agency costs too are minimized by market forces [emphasis added]” (FitzRoy & Mueller, 1984: 25). While Berle and Means (1968: 311) suggest one “might elect the relative certainty and safety of a trust relationship in favor of a particular group within the corporation, accompanied by a possible diminution of enterprise [emphasis added],” neo-classical economists are unequivocal on this point: institutional arrangements favoring management control of organizations exist only because such forms are more efficient from the standpoint of the market than are their owner-controlled complements. In his later writings Means concedes the corporate form has had a profound wealth-creation impact on the broader economic community:

[T]here are many situations in which corporations can be more efficient than unincorporated enterprise...It is quite possible that, in the last hundred years, the corporate revolution has contributed as much to the increase in the efficiency of labor and capital as was contributed by the Industrial Revolution.

1983: 299

Fama and Jensen similarly argue the usual case is one in which management-control is more efficient than owner-control: “In complex organizations, the benefits of diffuse residual claims and the benefits of separation of decision functions [control] from residual risk bearing [ownership] are generally greater than the agency costs they generate...” (1983a: 309; see also Demsetz & Lehn, 1985).

Such efficiency arguments have clear implications for the evolution of organizational forms (Aldrich, 1979). Whether or not one strictly adheres to the doctrine of environmental determinism, it would be difficult to dispute the view that “[t]he form of organization that delivers the output

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31 It is worth noting that in the non-economic disciplines this argument has routinely been called into question: “...whereas economic models take the market as an unchallengeable independent force beyond the control of individual investors and corporate actors, sociology has been very receptive to conceiving the market as easily manipulated by corporations and commercial banks” (Hirsch et al., 1987: 329).
demanded by customers at the lowest price, while covering costs, survives…” or “[h]aving most uncertainty borne by residual claimants has survival value because it reduces the costs incurred to monitor contracts with other groups of agents” (Fama & Jensen, 1983a: 302-3). A necessary condition for this thesis to hold is the existence of a large number of competitors in the capital market (Hessen, 1983: 288). The external monitoring of a stock market specializing in pricing common stocks and transferring them at low costs has the benefit of exerting pressure to orient a corporation’s decision processes toward the interests of corporate shareholders (Fama & Jensen, 1983a: 313).

One might counter that in the larger corporation each individual shareholder’s cost of monitoring agents’ activities becomes prohibitively expensive relative to the amount of their invested capital. Given such circumstances self-interested managers could reasonably be expected to engage in ‘shirking’—resulting in erosion of firm value. The classical economic assumption of perfect knowledge plays a strong role in the neo-classical economists reasoning, however; the price mechanism of the market is presumed to both anticipate and correct for such shirking. The rationale is straightforward: “Prospective minority shareholders will realize that the owner-manager’s interests will diverge somewhat from theirs, hence the price which they will pay for shares will reflect the monitoring costs and the effect of the divergence between the manager’s interest and theirs” (Jensen & Meckling, 1976: 313; see also Demsetz, 1983: 386). In short, “when there are many residual claimants, it is costly for all of them to be involved in decision control and it is [therefore] efficient for them to delegate decision control [to managers] [emphasis added]” (Fama & Jensen, 1983a: 309). In efficient markets residual losses traceable to managerial shirking are more than offset by gains associated with avoiding excessive monitoring costs.

The role of managerial equity holdings is critical to the current research. Throughout their writings Jensen and Meckling (1976) suggest business organizations naturally evolve from sole-
proprietorships to the corporate form—but additionally assume at least some ownership is maintained by the original owner-managers for the express purpose of maintaining organizational control. If the assumption of managerial ownership is relaxed, the neo-classical model would predict gross suboptimization on the part of management. Furthermore, Jensen and Meckling “have assumed that all outside equity is nonvoting” (1976: 351). Finally, while “[m]any specific legal rules and doctrines are based on the behavioral assumption of the interested and attentive shareholder” (Easterbrook & Fischel, 1983: 421), neo-classical economists argue that, given their primary interest in dividends and/or capital gains rather than control, the majority of shareholders intend to exercise control only in extremis (Pass & Witt, 1985: 64; Pitelis & Sugden, 1986: 76). The solution? “If owners aren’t behaving like owners, with the result that managers aren’t managing well, one remedy is to turn managers into owners [emphasis added]” (The Economist, May 5, 1990). The verity of this hypothesis can be best tested through empirical examination.

Williamson (1984) claims the ‘generic’ theory of neo-classical economics advanced by Jensen and Meckling (1976) is restricted in its generalizability due to these authors’ focus upon the entrepreneurial firm. It is argued there exist substantive differences between such firms, in which managers hold a substantial equity position, and the very large hierarchical organization in which management and ownership are decidedly separate (Williamson, 1984: 67). By way of remedy, Williamson “presents his theory as a general one applicable to most large firms [emphasis added]” (Hill, 1985: 749).

Williamson: The Integrative Perspective

Drawing from his studies in business history, organization theory, and economics, Williamson concludes “efficiency is served by hierarchy” (Williamson, 1983: 352, 365). While agency theory has singled out ownership structure for special consideration, Williamson spans both the managerial and agency theory schools of thought (Green, 1988: 28). Believing the separation
premise to be faulty in that managerial discretion is ignored, Williamson (1983) prefers to model the corporation as a miniature economic system; however, “Williamson…has been unwilling to conclude that existing markets and institutions resolve all normative issues raised by agency cost problems” (FitzRoy & Mueller, 1984: 25). On this view, corporations—whether owner- or management-controlled—depart from strict profit maximization due to the problem of moral hazard. While Williamson (1983) offers a comprehensive theory of the firm, his doctrine of moral hazard—a close complement to the neo-classical notion of ‘shirking’—is most relevant to this dissertation, and is therefore appropriately a focus of the current review.


While Williamson would align himself more closely with neo-classical economics than with managerialism, he offers notable refinements to neo-classical economic theory:

A second strand of the property rights argument is that institutions evolve in the service of efficiency (Alchian, 1969; Demsetz, 1967). This is closer to the approach taken here, in that transaction costs are admitted and efficiency considerations are emphasized, but the human and environmental factors, and particularly the interactions that exist between these factors, which are responsible for transaction costs are incompletely developed [emphasis added].

Williamson, 1975: 252

As a business historian, Williamson (1983) notes most large corporations in 1932 were organized as unitary (‘U-form’) firms, characterized by functional departmentalization. The period 1945-60 witnessed rapid adoption of the multidivisional (‘M-form’) structure, distinguished by semiautonomous operating divisions (Williamson, 1983: 352). “It could be argued that, as a consequence of these organizational structure changes, the corporate control issues to which Berle and Means referred have been significantly alleviated since” (Williamson, 1983: 360). In Williamson’s assessment changes in internal organization, rather than market forces, have had the effect of mitigating concerns surrounding the separation of ownership and control:

Berle and Means…noted that a separation in ownership from control existed and inquired: ‘…have we any justification for assuming that those in control of the
modern corporation will also choose to operate it in the interests of the stockholders?" (Berle and Means, 1932, p. 121). I submit, however, that organizational innovations, which in the 1930's were just getting underway, have mitigated capital market failures by transferring functions traditionally imputed to the capital market to the firm instead. Not only were the direct effects of substituting internal organization for the capital market beneficial, but the indirect effects served to renew the efficacy of capital market controls as well...

Viewed in contractual terms, the M-form conglomerate can be thought of as substituting an administrative relation between an operating division and the stockholders where a market relation had existed previously...the substitution of internal organization can have beneficial effects in goal pursuit, monitoring, staffing, and resource allocation...the general office can be regarded as an agent of the stockholders whose purpose is to monitor the operations of the constituent parts...To be sure, managerial preferences (for salary and perquisites) and stockholder preferences (for profits) do not become perfectly consonant as a result of conglomerate organization and the associated activation of the capital market...Changes in internal organization have nevertheless relieved these concerns...The relief and alleviation to which I refer do not, of course, mean that continuing concern over corporate control is unwarranted [emphasis added].

Williamson, 1983: 135-36, 363-4

Ichiishi (1985) similarly forges a link between the theory of the firm and pure economic theory; in his review of empirical work concerned with the separation of ownership and control within contemporary corporations, Ichiishi offers an explanatory model of intra-firm market economy.

Several assumptions are critical to Williamson's (1983) analysis, the first having to do with human nature. Williamson acknowledges the critical need for “all complex organizations...to come to terms with the attributes of human nature as we know it...” (Williamson, 1983: 365). His ‘organizational failures framework’ is distinctive in “that it expressly acknowledges the importance played by human factors in attempting to grapple with the problems of economic organization” and “expressly introduce[s] the notion of opportunism and...the ways that opportunistic behavior is influenced by economic organization” (Williamson, 1975: 2, 7). The construct of opportunism extends well beyond mere self-interest:

The assumption that individuals behave in a self-interested way is so commonplace to economics that it would seem scarcely to warrant separate attention. Opportunism, however, is more than simple self-interest seeking. It is self-interest seeking with guile: agents who are skilled at dissembling realize transactional advantages. Economic man, assessed with respect to his
transactional characteristics, is thus a more subtle and devious creature than the usual self-interest seeking assumption reveals [emphasis added].

Williamson, 1975: 255

Managerial opportunism is the antithesis of the trusteeship perspective as introduced early in this disquisition. Williamson is very explicit in his rejection of the notion that organizational agents can be expected to faithfully execute their trusteeship obligations on behalf of the firms’ owners:

…the assumption that the firm is operated in the stockholders’ best interests requires that, either voluntarily or of necessity, managers can be relied upon to behave in this ideal manner. Since the conditions of necessity are not ubiquitous, such an assumption obviously involves a contradiction with an impressive array of evidence. Indeed, there would appear to be little need to cite further grounds for developing a model of the firm that replaces unfailing stewardship behavior with a degree of self-interest seeking…

…the absence of vigorous competition in the product market and where the separation of ownership from control is substantial, there is no compelling reason to assume that the firm is operated so as to maximize profit. On the contrary, such behavior would appear to require an unusual variety of rationality—and one not widely found in human affairs—namely, a complete detachment of individual interests from occupational decision making. A more moderate position has been suggested.

1964: 3, 55

Williamson makes the case that managerial discretion models of organizational behavior are most appropriately applied to studies of those business firms operating within product markets in which competition is not typically severe (1964: 59). If instead competitors are numerous and market entry is easy, Williamson argues the profit maximization assumption holds and firm behavior can be predicted on the basis of traditional economic models (1964: 72). Such a bifurcation is compromised in those specific instances in which managers hold equity positions in their employing firms:

Consider the case of the manager-stockholder first. As a manager he may be inclined to attend to certain nonprofit objectives. As a stockholder, profit is the main source of satisfaction. Combining these roles of manager and stockholder suggests that profit will be more highly valued than it would in the role of manager alone, but not necessarily to the extinction of all other objectives. That is, the shift in the manager’s preference function towards profit could be expected, but not necessarily domination by the profit component.

Williamson, 1964: 24
At the heart of Williamson’s (1975) theory of markets and hierarchies is the critical conjecture that changes in organizational structure evolve naturally and serve to mitigate concerns over the separation of ownership from control.\(^{32}\) Williamson concurs with the basic premise of neo-classical economists that “specialized governance structures arise in response to the efficiency needs of each type of organization” (1983: 351). This argument is far from new; Coase (1937) made the similar projection that activities would be included within the firm whenever the costs of using markets were greater than the costs of using direct authority. While organizational structuring considerations may be presumed to serve the objective of efficiency, this is not the only relevant consideration:

…agency-costs literature focuses only on the effects of organizational form on allocative efficiency, that is, on how the hierarchy or the market minimizes these costs. But the separation of principal from agent, of ownership from control, raises distributional as well as efficiency issues. It is from the distributional consequences of hierarchy that the conflicts between one factor group and another stem, and it is these distributional conflicts that often lead to demands for state intervention in corporate governance [emphasis added].

FitzRoy & Mueller, 1984: 26

Concern over distributional disparities parallels the issue of suboptimization, or satisficing, alluded to earlier (Simon, 1957). While hierarchy may be preferred by the market, given the implicit role of managerial discretion—with its attendant ‘shirking’—within organizations allocational inequities are virtually assured. It is on this point Williamson (1983) and Ouchi (1980) part company. Much like Smith, Ouchi (1980) presumes individuals naturally temper self-interest with equity considerations, or at least norms of reciprocity. Conversely, Williamson “assumes that the [contractual] parties’ motivation is not to determine a fair price but to obtain the best price

\(^{32}\) At least one set of authors vehemently disagree with this premise:

The separation of principle-from-agent problem is in essence a free-rider problem. Like all free-rider problems, the existence and extent of the problem is dependent on the number of riders, that is the number of principals relative to the agent. Given that the agent arbitrates the contract, he has an incentive, ceteris paribus, to increase the number of principals, to reduce the incentive of each principal to gather information and police the agent. Thus, agents (managers) have an incentive to expand and diversify the firm beyond any efficiency gains from expansion. This incentive to grow may explain why reinvested cash flows in large corporations earn returns far below stockholder opportunity costs…and why corporations continue to make large, risky acquisitions in the face of considerable evidence of modest if not negative returns from these investments.

FitzRoy & Mueller, 1984: 43-44
available—by means of guile and cheating in some nontrivial number of cases [emphasis added]” (Maitland et al., 1985: 62). Managerial opportunistic behavior is intensified as managers hold information not readily available to shareholders. Such “[i]nformation impactedness…exists when true underlying circumstances relevant to the transaction, or related set of transactions, are known to one or more parties but cannot be costlessly discerned by or displayed for others” (Williamson, 1975: 31).

Several authors have begun to use Williamson’s (1983) transactional paradigm to identify circumstances under which employee ownership is the preferred organizing mode (see, e.g., Butler, 1983; Jones, 1983; Ouchi, 1980; as referenced in Russell, 1985: 217). The ‘failure’ of conventional organizing modes has been advanced as one explanation for the emergence of employee ownership. In the case of professional associations, sheer economic advantages of size may make ownership coalitions attractive. Moreover, systems of internal ownership may serve to overcome monitoring difficulties by providing performance incentives through creation of strong links between effort and rewards (Russell, 1985: 223-233; see also Cherrington et al., 1971). This line of reasoning has profound implications for the present inquiry.

Of particular interest within Williamson’s (1983) framework is the concept of moral hazard. “Moral hazard refers to lack of effort on the part of the agent…the agent is shirking” (Eisenhardt, 1989: 61; see also FitzRoy & Mueller,1984: 38-41). Several necessary preconditions support the ascendancy of moral hazard. The first of these is inharmonious incentives, or the incongruity of managerial rewards and shareholder objectives—a condition presumably moderated by managerial ownership. Moral hazard is secondly a function of uncertainty, which “implies the existence of a large number of possible contingencies…it may be extremely costly to know and

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33 This is not to imply that Williamson is oblivious to non-economic considerations; he explicitly notes “modes of organization or practices which would have superior productivity consequences if implemented within, and thus would be adopted by, a group of expected pecuniary gain maximizers, may be modified or rejected by groups with different values” (1975: 39)—a point to be returned to momentarily when the issue of trust is explored.
specify in advance responses by the transacting parties to all of these possibilities [thereby rendering contracts incomplete]” (Klein, 1983: 367). The final precondition is small numbers of competitors; occasion for ‘shirking’ is diminished to the extent competitive market rivalry exists. Opportunism—“a lack of candor or honesty in transactions, to include self-interest seeking with guile…” (Williamson, 1975: 9)—quite naturally emerges as inharmonious incentives, uncertainty, and small numbers preconditions are conjoined:

...merely to harbor opportunistic inclinations does not imply that markets are flawed on this account. It is furthermore necessary that a small-numbers condition prevail. Absent this, rivalry among large numbers of bidders will render opportunistic inclinations ineffectual

Williamson, 1975: 27

Williamson concedes opportunism is “[a] chronic problem with which economic organization must contend” (1975: 98). Moral hazard, or ‘shirking,’ is the passive manifestation of opportunism; active indications of opportunism include seeking to improve bargaining position “by misrepresenting future intentions or deceiving…partners” (FitzRoy & Mueller, 1984: 26). Opportunism may therefore be seen as the converse of cooperation, one means by which moral hazard is reduced:

Cooperation obviously is superior to individual action at achieving virtually all goals, from moving a large stone to operating a complex production facility. However, given that people have incongruent (or at least only partially congruent) goals, how can that cooperation be achieved and maintained?…In Ouchi’s view, the sufficient condition for cooperation is some mechanism for allocating tasks and rewards between the parties in a way that is perceived to be equitable. In Williamson’s view, on the other hand, parties cooperate or abstain from cooperation based purely on a calculation of the expected returns to themselves.

Maitland et al., 1985: 59

Thus the inherent problem of trusteeship is revisited. Williamson (1983) is one of the few organizational theorists to explicitly acknowledge the fact that trust, however rare an attribute, can attenuate the incidence of opportunism. It is Williamson’s view that the incidence of trust is a function of market considerations:

Businessmen operating in competitive industries in a high trust culture who insist on contractual completeness and exacting execution will find that such
transactional attitudes result in excessive costs and render their businesses nonviable...

It cannot be safely concluded...that business trust is so great and pervasive that the costs of interfirm contracting are negligible...To be sure, trust is important and businessmen rely on it much more extensively than is commonly realized. Interfirm trading nevertheless incurs bargaining costs and trading risks which might be mitigated if instead the transaction were to be integrated...

Williamson (1983) faces the dilemma of “how individuals can cooperate, to their mutual advantage, when they cannot trust one another and when no contract can be drawn up that can exhaustively fix their mutual rights and obligations under all conceivable circumstances” (Maitland et al., 1985: 61). Organizational well-being is at stake if resolution of this perplexity fails:

The transactional dilemma that is posed is this: it is in the interest of each party to seek terms most favorable to him, which encourages opportunistic representations and haggling. The interests of the system, by contrast, are promoted if the parties can be joined in such a way as to avoid both the bargaining costs and the indirect costs...

Although it is in the interest of each worker, bargaining individually or as a part of a small team, to acquire and exploit monopoly positions, it is plainly not in the interest of the system that employees should behave in this way. Opportunistic bargaining not only in itself absorbs real resources, but efficient adaptations are delayed and possibly foregotten altogether.

Williamson, 1975: 27, 73

Williamson extends this line of reasoning by noting managers are legally restricted from appropriating profit streams for their own ends (1975: 204). Furthermore, in Williamson’s view “the internal compliance machinery to which the firm (agency) has access is vastly superior to and more delicately conceived than the policing machinery that prevails between organizations,” leading him to conclude “[i]nternal organization thus arises in part because of its superior properties in moral hazard respects” (1975: 204).

The “compliance machinery” of the firm and the “policing machinery” of the market can be united in the cause of opportunism reduction as managers hold equity positions in their employing firms. Consistent with the predictions of managerialism and neo-classical economics, one logically
deducible consequence of the theory of transaction cost economics is that there exists a
significant positive relationship between managerial equity holdings and firm performance. The
following exploration is designed as a rigorous test of just this conjecture.
CHAPTER 3: RESEARCH HYPOTHESES, DESIGN, AND METHODS

Research Overview

The preceding chapter has developed the managerial, neo-classical economic, and transaction cost economic models in some depth. As noted throughout, each of these models predicts performance differentials between those firms in which managers hold substantial equity holdings and those firms in which managers’ weal is not directly tied to the fortunes of the corporations under their control. Attention will now focus upon research designed to test just such an hypothesis. Critical examination of empirical literature bearing specific relevance to the current inquiry will provide the grounding for this study.

Critiquing Extant Theory

Heise (1989) has suggested *critical* research focuses upon the explanatory power of competing theories. In the case at hand, the several theories outlined above share Berle and Means’ (1968) basic premises, yet their logical framework(s) demand divergent conclusions—at least from the standpoint of societal efficiency. Such analyses, rather than suggesting a radical restructuring of our view of the corporation in society, interpret findings in light of alternate theoretical models. Additionally, Latour (1987) notes theory criticism appropriately proceeds from identification and critique of those ‘black boxes’ which researchers have unreflectively accepted, and therefore left unchallenged. ‘The word ‘black box’ is used by cyberneticians whenever a piece of machinery or a set of commands is too complex…no matter how controversial their history, how complex their
inner workings, how large the commercial or academic networks that hold them in place, only their input and output count” (Latour, 1987: 2-3). Assumptions are by definition ‘black boxes.’

By looking only at [statements] and at their internal properties, you cannot decide if they are true or false. These characteristics are only gained through incorporation into other statements...Confronted with a black box, we take a series of decisions. Do we take it up? Do we reject it? Do we reopen it? Do we let it drop through lack of interest? Do we make it more solid by grasping it without any further discussion? Do we transform it beyond recognition? This is what happens to others’ statements, in our hands, and what happens to our statements in others’ hands.

Latour, 1987: 29

Followers of Berle and Means have suggested separation of ownership from control in corporations characterized by widely dispersed ownership makes the corporation vulnerable to managerial coups d’état.34 Given their self-interested natures, managers are presumed to be principally concerned with advancing personal agendas at the expense of their agency responsibilities to corporate ownership interests. The preferences of owners and managers have been considered to be mutually exclusive, making distribution of corporate gains a zero-sum game. The final deductive move allows the conclusion that corporations having highly diffuse ownership will be poorer performers than their closely-held counterparts—at least on criteria appropriate to stockholder wealth creation.

Several ‘black boxes’ are apparent in the above argumentation. The following are articles of faith:

(1) ownership dispersion necessarily leads to a loss of control on the part of shareholders—in spite of collective efforts on the part of stockholders to influence corporate activity; (2) humankind is consistently self-serving—and this consideration overrides any countervailing fiduciary obligations;

34 The role of the board of directors in the separation of ownership from control, while not the topic of the current inquiry, ought nonetheless to be explicitly acknowledged:

The common apex of the decision control systems of organizations, large and small, in which decision agents do not bear a major share of the wealth effects of their decisions is a board of directors...that ratifies and monitors important decisions and chooses, dismisses, and rewards important decision agents. Such multiple-member boards make collusion between top-level decision management and control agents more difficult, and they are the mechanism that allows separation of the management and control of the organization’s most important decisions.

Fama & Jensen, 1983: 323
(3) the interests of owners and managers are incommensurable–irrespective of what the literature on consensus-building might suggest; and (4) the only appropriate corporate effectiveness criterion is some measure of return to shareholders–regardless of the plethora of alternative motives for stock ownership. Acceptance of each of these ‘black boxes’ is critical to supporting the hypothesis that a performance differential exists between those corporations having diffuse rather than focused ownership; theory refinement, however, might entail opening each ‘black box’ in turn in the search for mediating and/or moderating variables. Furthermore, attempts to test the above hypothesis have consistently relied on ‘standard’ measures of ownership and control; the conventions of ownership and control operationalization have come to constitute yet another set of ‘black boxes.’ Few researchers have called into question the premise that a distinct threshold can be established separating those firms which are closely held from those characterized by ownership diffusion; the logically preferred position might be to view ownership concentration as a continuous, rather than dichotomous, variable.

While the hypothesis that owner-controlled firms will outperform management-controlled corporations has enjoyed widespread popularity among management researchers, refutation of this conjecture would be seen to deal a fatal blow to the inferential structure of Berle and Means’ (1968) arguments. Friedman (1968) notes a theory cannot be tested by the realism of its assumptions (as referenced in Maitland et al., 1985: 64). Yet Popper (1965) has demonstrated a theory can be defeated if the necessary conditions upon which it rests fail under empirical scrutiny. As critical assumptions constitute one set of necessary theoretic conditions, the potential for theory falsification is borne through defeat of such undergirding assumptions–providing reasoning crucial to hypotheses construction.

While affirming separation of ownership from control creates the managerial organization, managerial theories of the firm typically move on to consider how factors other than ownership–such as conflicting objectives–lead to non-profit-maximizing behavior (Green, 1988: 27). Given
this formulation, shared objectives should serve to reduce the deleterious effects of managerialism. Stigler and Friedland (1983) have suggested the separation problem ought to have implications for the incentive structure of large corporations. In his empirical investigation, Dyl (1988) found a relationship between management compensation and corporate control; it seems the percentage reduction in ‘excessive’ management compensation attributable to monitoring by major shareholders (who represent some measure of control) may be substantial. Dyl’s (1988) research suggests there is some optimal level of ownership concentration consistent with agency considerations. This thesis holds promise for further investigation into the general problem of aligning managers’ interests with those of the shareholders.

**Purpose and Rationale**

The study herein reported is designed to empirically test the relationship between managerial equity holdings and firm performance, while recognizing that “in an ultimate sense ownership and control cannot be separated” (Stigler & Friedland, 1983: 248). Consistent with prior literature, it is predicted managerial ownership has a positive effect upon firm performance:

Reversing the arguments [of Berle and Means and their followers], a number of positive attributes of ownership can be adduced. First, collective ownership will reduce the incentive on each manager to cheat or shirk...Second, owner-managers may be expected to devote more effort to seeking out innovative projects...Third, as a consequence of shirking and risk averse behaviour, firm performance in owner-managed firms will on average (given positive monitoring costs) have higher profit rates than manager-controlled firms

Green, 1988: 28

Ichiishi (1985) and Williamson (1984) have pointed out the value of a coherent theory of firm behavior. Each argues in turn that rather than modeling the corporation as a profit-maximizing ‘black box,’ the impact of intra-firm issues on both ownership and control ought to be given explicit consideration. Pondy (1969) notes the role of managerial discretion in this respect, while Vickers (1985) suggests managerial expertise may serve to counteract the ill effects of ownership and control separation. Benston (1985), Gomez-Mejia et al. (1987), and Lewellen et al. (1985)
suggest consideration of whether or not managerial compensation is tied to corporate performance—either through stock ownership or intra-firm control mechanisms—is fundamentally important to analysis of the separation thesis. In its generic form, this argument suggests that the interests of owners and managers might be more closely allied than is commonly thought—a thesis subscribed to by Demsetz (1983) among others.

Fama and Jensen have suggested that restricting ownership to top-level managers serves to resolve the agency problem, although they are concerned resultant efficiency costs may erode any gains accomplished through such a move:

A feasible solution to the agency problem that arises when the same agents manage and control important decisions is to restrict residual claims to the important decision agents. In effect, restriction of residual claims to decision agents substitutes for costly control devices [i.e., bonding and monitoring costs] to limit the discretion of decision agents. Restricting residual claims to decision makers controls agency problems between residual claimants and decision agents, but it sacrifices the benefits of unrestricted risk sharing and specialization of decision functions. The decision process suffers efficiency losses because decision agents must be chosen on the basis of wealth and willingness to bear risk as well as for decision skills.

1983a: 306

With respect to the issue of efficiency, these same authors conclude “[w]hen it is efficient to combine decision management and control functions in one or a few agents, it is efficient to control agency problems between residual claimants and decision makers by restricting residual claims to the decision makers” (Fama & Jensen, 1983a: 322). To limit ownership to managers may be overstating the case; efficiency might be served by some degree of ‘compensatory ownership’ at levels much lower than those suggested by the neo-classical economist. Such ownership incentive structures would encourage mutual monitoring among decision agents (Fama & Jensen, 1983b: 332). In the current context this inference is tested by representing managerial ownership as a continuous variable, for such a rendering represents an advance over prior operationalization.
Several implications support the critical importance of this line of inquiry. Managerialism, neo-classical economics, and agency theory each have profound implications for development of both a comprehensive theory of the firm as well as public policy recommendations. Although the separation thesis has been debated for well over half a century, such discourse has largely been directed at the level of theory. Compounding the paucity of empirical research into the topic is concern that rigorous research which has been conducted has relied upon simplifying assumptions which call into question its very relevance (Schwenk, 1982). Furthermore, “there exists little evidence that relatively simple, unidirectional causal relationships among the constructs examined account for organizational performance…simple cause-effect linkages blur into a pattern of evolving interdependencies among objective realities and human perceptions that collectively influence organizational performance [emphasis added]” (Lenz, 1981: 141, 148).

This dissertation is designed to settle such incertitude, thereby making a contribution to our collective understanding of corporate administration.

Beyond its contribution to academic knowledge, such research is of practical merit to practitioners within the corporate setting. The matter of executive inducements and compensation is of ongoing concern to corporate directors. As fiduciaries for corporate stockholders (Clark, 1985), directors bear major responsibility for assuring the corporation is operated in a manner consistent with principles of wealth maximization. In this role an understanding of the effects of the separation of ownership from control is critical; of even greater import, however, would be insight into the potential for reversing negative consequences of the agency problem. Research into firm performance effects of managerial equity holdings provides such understanding.

Construct Definition: Theoretical

Theoretical definitions of the constructs involved in the current research will prove foundational to an understanding of the hypotheses which follow. Schwab has defined a construct as “nothing
more or less than our mental definition of a variable” (1980: 6). Kerlinger differentiates between
the term ‘concept,’ “an abstraction formed by generalization from particulars [the process of
induction]”, and ‘construct,’ “a concept...[with] the added meaning...of having been deliberately
and consciously invented or adopted for a special scientific purpose [emphasis added]” (1973:
28-9). This distinction has implications for the way in which constructs and variables are defined.
“A constitutive definition defines a construct with other constructs,” while “[a]n operational
definition assigns meaning to a construct or a variable by specifying the activities or ‘operations’
necessary to measure it” (Kerlinger, 1973: 30-1). We are here concerned with constitutive
definitions of the constructs under consideration.

The following distinction—with which the reader is no doubt intimately familiar—will be used to
frame discussion of both theoretical and operational definitions of variables:

The most important and useful way to categorize variables is as independent and
dependent. This categorization is highly useful because of its general
applicability, simplicity, and special importance in conceptualizing and designing
research and in communicating the results of research. An independent variable
is the presumed cause of the dependent variable, the presumed effect. The
independent variable is the antecedent; the dependent is the consequent.
Kerlinger, 1973: 35

Independent Variables

Following the convention of Berle and Means (1968), researchers exploring the separation of
ownership from control have typically split their sample into owner-controlled and manager-
controlled firms and tested for performance differentials between the two groups. Several
reasons might be offered for the lack of conclusive findings obtained through application of such
an approach. As noted in the discussion of managerialism, no theoretical rationale has been
offered as to why an arbitrary threshold characterizes a firm as either owner- or manager-
controlled. Few researchers have attempted to measure control directly; rather, the preferred
approach has been to assume managers gain control in those corporation's lacking at least one large shareholder. Both neo-classical economists and agency theorists have generally concurred with this approach, for their theory bases suggest only large shareholders have enough capital at risk to make bearing the costs of monitoring managerial behavior sensible.

The current research modifies these traditional assumptions. Rather than merely testing for differences as outlined above, the approach involves reversing the inferences and examining the relationship between the confluence of ownership and control—as evidenced by managerial stock ownership—and firm performance. Within this framework several independent variables, or presumed causes of 'good' firm performance, bear elaboration.

The issue of control is still a matter of some concern. As Zeitlin has argued, most studies have “simply assumed away the analytical issues in the concept of control by their operational definitions...a specific minority percentage of ownership in itself can tell little about the potential for control that it represents” (1974: 1090-91). Abandoning such simplistic approaches to the issue of control, Dye (1985) purports to measure the capacity to participate, or ‘strategic position:’

Strategic position refers to a role in the corporation which permits the occupant to participate in key corporate decisions. Strategic positions in the corporation include (1) ownership of a large block of common voting stock; (2) membership on the board of directors; (3) holder of significant corporate debt; (4) senior corporate management.

1985: 11

In contrast to control, strategic position is defined as a measure of ownership serving to insure participation in corporate decision-making or, alternatively, as operational as distinct from financial control (Dye, 1985: 13). Stigler and Friedland similarly argue if owners occupy key administrative posts, or are responsible for appointment to same, they can be presumed to in some measure control the firm—although these researchers readily admit “[d]irect information on actual control over the selection of directors is usually not public knowledge, although often a matter of street gossip” (1983: 247). Cubbin and Leach further suggest control has two
dimensions: the location of control—a discrete variable—and the degree of control—a continuous variable; both are crucial to proper testing of managerial theory (1983, 354-55).

In light of such debate it is understandable researchers have made simplifying assumptions where the matter of control is at issue. Rigorous empirical research can hardly rely on ‘street gossip’ as the means of defining a critical variable, nor is ‘degree of control’ easily quantifiable. Consistent with the overwhelming majority of prior research, it will be assumed both that managers are in practical control of the modern corporation and that managerial ownership serves to effectively resolve the agency problem, with the following concession to the managerial literature: managerial equity holdings can be expected to have their greatest positive effect on organizational performance in those firms characterized by highly diffuse ownership structures.

The current research is most centrally concerned with the issue of managerial ownership rather than ownership diffusion, however. Several reasons have been offered as to why managers would hold stock in the companies they manage, including associated cash flow and voting rights (DeAngelo & DeAngelo, 1985: 33). Additionally, it is not uncommon for managers to be offered stock options or matching contribution plans as bonuses for performance improvements. Drawing from the work of neo-classical economists, Kim et al. conclude ‘insider [managerial] ownership is a new statistically significant variable that is associated with abnormal returns…Jensen and Meckling…argue that the degree to which managers exert their talents to maximize shareholders’ wealth varies with the managers’ percentage of equity ownership in the firm” (1988: 53-4). While self-interest might prove the rationale for referring to such managerial ownership as an incentive, “by removing various constraints, ownership may well allow managers to perform their tasks better, which is quite different to suggesting that it acts as an incentive on

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35 Non-empirical, or qualitative, research might appropriately give credence to such ‘soft’ measures; such is not, however, the preferred mode of inquiry for the majority of dissertations. The current treatise is no exception.
them to become better managers” (Green, 1988: 29, 33). Whatever the motivation, firm performance improvements can be expected to accompany managerial stock ownership.

Among their suggested means for boards of directors to gain greater accountability from corporate CEOs, Jensen and Murphy recommend CEOs hold substantial amounts of company stock (as referenced in Clark, 1990: A14). Their study has shown that with respect to pay for performance CEO compensation is getting worse:

The most powerful link between shareholder wealth and executive wealth is direct stock ownership by the CEO. Yet CEO stock ownership for large public companies, measured as a percentage of total shares outstanding, was 10 times greater in the 1930s than in the 1980s. Even over the last 15 years, CEO holdings as a percentage of corporate value have declined.

as referenced in Clark, 1990: A14

The importance of such an observation pales, however, in light of Masson’s “alternative hypothesis—that it is not whether the management owns a great enough proportion of company stock to have control which makes a difference, but whether the management owns enough stock to have a vast proportion of its [i.e., management’s] financial return depend upon stock ownership [emphasis added]” (Masson, 1971: 1279 [footnote 1]). This insight is nothing short of profound, and demands traditional inquiry into the separation of ownership from control be reconsidered. At issue is not whether there is some threshold level of stock ownership which assures its owner-manager practical control of the firm; rather, Masson (1971) suggests the concern is the extent to which managerial fortunes are wed to market performance of the firm. This shift in focus from a firm-centric perspective to a manager-centric view almost certainly implies that separation of ownership from control is not the considerable problem predicted by Berle and Means (1968) and their followers—and suggests that their Draconian interventionist public policy prescriptions may have been misguided.

If inquiry is to focus upon managerial ownership, one is left to consider the constitution of the population. Since management is presumed to be in practical control of the corporation,
discretion is of key importance; the population ought to comprise those individuals possessing the latitude to most directly affect firm performance. Berle and Means argue “[a]t the very pinnacle of the hierarchy of organization in a great corporation, there alone, can individual initiative have a measure of free play” (1968: 307). Fama and Jensen suggest organizational structuring characteristics reduce the severity of the agency problem, reasoning that hierarchical partitioning of the decision process, in which higher level agents ratify and monitor the decision initiative of lower level agents, “makes it more difficult for decision agents at all levels of the organization to take actions that benefit themselves at the expense of residual claimants” (1983a: 310). Given the passive role of most boards of directors, on this formulation the CEO is imbued with virtually full discretion (see, e.g., Brady & Helmich, 1984; Day & Lord, 1988; Glover, 1976; Smith et al., 1984; Thomas, 1988; Weiner & Mahoney, 1981). As this research is more than tangentially concerned with executive compensation—including salary, bonuses, and equity-related income—, there is empirical as well as theoretical support for focusing upon the CEO. Henderson has found “salaries and other compensation arrangements at each level in an organization tend to be related to those of the next highest level,” making CEO pay a useful surrogate for the overall level of management compensation (1982: 461; as referenced in Dyl, 1988: 22). Lewellen and Huntsman draw a similar conclusion:

While it may seem more appropriate that the remuneration of all the senior policy-making individuals in a corporation be tested for a relationship to company performance, it happens that the pay of a firm’s top man is a suitable surrogate for the pay of his closest subordinates in terms of their relative standing vis-à-vis corresponding officials in other firms...When the sample corporations were ranked in selected years first according to the total compensation of their top executive alone, then the total for their top three executives combined, and finally

36 “the board is not an effective device for decision control unless it limits the decision discretion of individual top managers...[when this is not the case] [t]he decision processes of...open corporations seem to be dominated by an individual manager, generally the chief executive officer” (Fama & Jensen, 1983: 314).

37 Several writers would counter the CEO has little impact on firm performance (see, e.g., Hollander, 1986; House, 1988; Meindl, 1990; Yukl, 1989). In a general sense those who argue for the “contextualist” view, in which management’s ability to impact organization outcomes is governed by environmental forces, conclude CEOs’ impact on firm performance is minimal (see, e.g., Aldrich, 1979; Hambrick & Mason, 1984; Hannan & Freeman, 1977; Pfeffer & Salancik, 1978). One shared premise underlying managerialism, neoclassical economics, and agency theory, however, is that management does make a difference; it is therefore appropriate that the current research proceed in this tradition.
the total for their top five executives combined, the Spearman rank correlation coefficients between the three schedules were consistently on the order of .95 and were significant at the .0001 level in all instances.

1970: 714, footnote 9

Following Lewellen et al., CEO compensation will incorporate aggregate direct current corporate remuneration, including salary, cash and stock bonus awards, and any other cash income received currently but excluding pension contributions, stock option exercises, and all deferred pay items (1985: 215; see also Lewellen & Huntsman, 1970; Masson, 1971; and Antle & Smith, 1985 [as referenced in Dyl, 1988: footnote 2). While it might seem reasonable to control for CEO tenure and firm size in that a correlation between these constructs and CEO compensation might be expected (Dyl, 1988: 23; Krause, 1988: 31), there is no suggestion in either the theoretical or empirical literature that the relationship between ownership and control varies across these dimensions. Random selection of sample corporations can therefore be expected to effectively resolve these as well as any other supposed systematic biases.

**Dependent Variables**

"[W]ith reference to organizational strategy research, Hambrick (1984) and Lenz (1981)...argue that the most obvious and useful research question should address the factors and linkages that influence performance" (Podsakoff & Dalton, 1987: 426). The issue of **effectiveness** has been a constant theme for organizational researchers:

[T]he most interesting questions in this area are not technical, they are conceptual: not how to measure effectiveness or productivity, but what to measure...Models that recognize the complexity of these issues tend to differentiate at least three kinds of “effectiveness:” (a) task effectiveness or goal attainment, including output, results, efficiency, etc. [see Etzioni, 1964; Price, 1972; as referenced in Cameron & Whetten, 1981]; (b) appropriate organizational structure and process, including organizational characteristics, member satisfaction, motivation, communication links, internal conflict resolution, absence of strain between subgroups, etc. [see Bennis, 1966; Nadler & Tushman, 1988; as referenced in Cameron & Whetten, 1981]; and (c) environmental adaptation, including flexibility in the face of change, resource acquisition, longer-term adaptation and survival [see Yuchtman & Seashore, 1967; Aldrich, 1979; as referenced in Cameron & Whetten, 1981]...as Campbell
(1977) pointed out, *effectiveness criteria must be chosen with reference to the purpose of the measurement* [emphasis added].
Kanter & Brinkerhoff, 1981: 321, 322

The fact that “...goals exist at a variety of levels and may be differentially pursued by various parts of the organization” (Kanter & Brinkerhoff, 1981: 328) represents the foundation of the separation thesis: managers can be expected to more vigorously pursue objectives of personal, rather than organizational, relevance. Once the issue of control, or power, is introduced, “[e]ffectiveness appears to be less a scientific than a political concept” (Kanter & Brinkerhoff, 1981: 344). Kanter and Brinkerhoff are concerned “classic definitions of organizational effectiveness and models of measurement often favored, implicitly if not explicitly, some constituencies over others,” noting the traditional focus on profitability “makes paramount the interest of owners” (1981: 324).

There currently seems to be no consensus on what constitutes an appropriate set of dependent variables to define corporate performance (Chakravarthy, 1986), perhaps in part accounting for the numerous recommendations that simultaneous treatments of multiple dependent variables be utilized (see, e.g., Cochran & Wood, 1984; Maupin, 1987; also see Bray & Maxwell, 1985; Cohen & Cohen, 1983; Kerlinger & Pedhazur, 1973; Levine, 1977; Thompson, 1984; as referenced in Podsakoff & Dalton, 1987: 428). Weiner and Mahoney have gone so far as to argue “…the number of corporate performance measures that could serve as dependent variables is almost infinite” (1981: 456), while Bourgeois concludes “…adoption of any particular set of indicators embroils the researcher in the quagmire of problems of quantification and dimensionality, not to mention the issue of validly choosing the set of indicators which meets universal acceptance” (1980: 235).

Such equivocation on the part of organizational researchers belies the fact that there is a strong precedent in business research for measuring effectiveness at the organizational level (Yuchtman
& Seashore, 1967). Such an approach is demanded where managerialism, neo-classical economics, and agency theory provide the framework for inquiry in that these models explicitly predict a relationship between managerial ‘shirking’ and the marketplace value of the firm. While a number of measures could reasonably serve as indicators of firm performance, as Cochran and Wood (1984) have observed performance indicators fall into two broad categories: investor returns and accounting measures. While “[m]ost of the tests [of the separation thesis] have concentrated only on accounting rates of return, and all have ignored the relationship between ownership control, stock performance, and systematic risk” (Krause, 1988: 30), a focus upon marketplace value of the firm clearly favors some measure of shareholder return on investment—a logic to be developed more fully in the section on construct operationalization. Consideration of firm growth and survival might additionally be justified by the literature herein outlined.

Recognition that the same construct may serve as a dependent variable in one study and an independent variable in another calls into question the direction of causation. Green (1988: 28) suggests “[p]erformance levels constitute an input of information to managers which may cause them to modify policies and action,” thereby implying performance may be an independent as well as a dependent variable. Child (1974, 1975) would concur:

Performance is not simply an end-product, a dependent variable. The fact that the level of performance is found to relate to a feature of organization does not of itself tell us how much performance is the consequence or the cause of that feature.

as cited in Green, 1988: 28

Tests of reciprocal causation are designed to deal with such contingencies. All such methods require time-series data:

Heise (1970), Bohrnstedt (1975), and Liker, Augustyniak, and Duncan (1985), among others, have noted that longitudinal studies not only permit one to examine the directionality of the relationship between two or more variables but also their degree of mutual dependence.

Williams & Podsakoff, 1989: 248

Several researchers (Bohrnstedt, 1975; Fleishman, 1973; Kerr & Schriesheim, 1974; Kimberly, 1976; Liker, Augustyniak, & Duncan, 1985; Sashkin & Garland,
1979) have noted the advantage of longitudinal research to the study of social and organizational phenomenon. Such studies facilitate a researcher's attempts to establish causal priorities between variables, as well as the degree of mutual dependence of the relationships between two or more variables.

Podsakoff & Dalton, 1987: 428

This investigation utilizes analytic techniques specifically designed to test for causal priority.

**Hypotheses**

Given its central role in organization inquiry, the issue of causation warrants further elaboration. In a 'tidy' world causes and effects would be both easily isolated and clearly discernible. Neither the 'real' world nor the world of the experimental scientist are so constructed. Rather than representations of underlying reality, therefore, the terms 'cause' and 'effect' have alternatively been understood as labels assigned to actions in an attempt to impose order on chaotic events. Whatever one's ontological framework, it should be apparent that causes and effects have meaning only as they are grounded in a broader system:

"We do not have a simple event A causally connected with a simple event B, but the whole background of the system in which the events occur is included in the concept, and is a vital part of it."

...in fact what we refer to as 'causes' are theory-loaded from beginning to end.

Causes certainly are connected with effects; but this is because our theories connect them, not because the world is held together by cosmic glue. The world may be glued together by imponderables, but that is irrelevant for understanding causal explanation.

Hanson, 1965: 50 [citing Bridgman], 54, 64

Science is concerned with the prediction and control of events. In this respect "[t]he primary reason for referring to the cause of x is to explain x" (Hanson, 1965: 54).38 Such explanations are seldom derived from linear inferential structures; rather, "[e]ffect and 'cause,' so far from naming links in a queue of events, gesture towards webs of criss-crossed theoretical notions, information,

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38 Hanson goes on to argue "[t]here are as many causes of x as there are explanations of x" (1965: 54). In so doing he seems to have fallen prey to the logical fallacy of affirming the consequent; at a minimum, Hanson has failed to recognize that all explanations are not concerned with causal inference (Nagel, 1979: 47-49).
and patterns of experiment” (Hanson, 1965: 64). Hypotheses need to be formulated with such a view in mind.

The literature so far reviewed contains a limited number of conjectures suggesting managerial equity holdings and firm performance are positively correlated:

To encourage honesty and attain efficient cooperation, rewards must be tied to performance to penalize shirking or free-riding.

FitzRoy & Mueller, 1984: 25

…there would seem to be a demand for an ongoing supervision of management or for a linking of the interests of management to those of shareholders…supplied by correlating managerial wages and corporation performance.

…managers’ shareholdings create a substantial linkage between the financial interests of management and those of outside shareholders.

The picture painted by management shareholdings, the importance of stock-based managerial income, and the size of minority shareholdings is that of a strong linkage between management and ownership interests.

Demsetz, 1983: 387, 389, 390

A primary purpose of contingent profit-sharing contracts is to create appropriate economic incentives.

Klein, 1983: 368

The inducements/contributions contract sets limits to the behavior that the individual is to exhibit in the organizational context, thereby further reducing the expression of heterogeneity of humans (Gouldner, 1957; Weber, 1947).

Thompson, 1967: 106

In concert with the theoretic frameworks of managerialism, neo-classical economics, and agency theory, it is predicted managerial equity ownership has a main effect upon market performance of the firm.  

\[ H_{1a}: \text{There is a positive correlation between market value of the CEO's equity interest in the firm and capital yield of the firm's stock.} \]

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39 Earnings per share, while not strictly a market measure of firm performance, are nonetheless included as a performance variable in the present analysis: it is argued that increasing corporate earnings is the most direct means available to managers for the attainment of growth in share value.
$H_{1b}$: There is a positive correlation between *market value of the CEO’s equity interest in the firm* and *earnings per share of the firm’s stock*.

It is here argued CEO equity interests are at least in part explanations, or *causes*, (Hanson, 1965: 54), of favorable firm performance. Given that simple correlations do not imply causal priority (see, e.g., Child, 1974, 1975, as referenced in Green, 1988: 28), the following corollaries to the above hypotheses are offered:

$H_{1c}$: *Capital yield of the firm’s stock* is in part a function of *market value of the CEO’s equity interest in the firm*.

$H_{1d}$: *Earnings per share of the firm’s stock* is in part a function of *market value of the CEO’s equity interest in the firm*.$^{40}$

It will be recalled prior research has been principally concerned with measuring the value of ownership positions relative to the overall value of the firm. The above hypotheses depart from this tradition by stating ownership value in absolute dollar terms rather than as a percentage of firm value. It will also be remembered Masson (1971) has argued the most important issue is *not* whether managers own a controlling interest in the firms which they manage but rather the extent to which such equity holdings represent a major portion of their personal financial portfolios. Unfortunately, CEO tax returns are not readily accessible. However, a close surrogate *is* available; the ratio of CEO income derived from corporate equity sources to CEO direct current corporate remuneration is easily computed from published data. The following hypotheses captures Masson’s (1971) inference:

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$^{40}$ The managerial assumption that *ownership* leads to *control* is illustrative of this point. Pitelis and Sugden (1986) dispute Berle and Means’ criteria for classifying firms as owner- or management-controlled. Their most interesting assertion is that causality runs from *control* to observed *shareholdings*—and that such holdings usually suffice to give a subset of owners control of the firm. The argument is largely historical. As corporations developed, it would be likely that those already in positions of control would seek to maintain their influence. This could be done while acquiring capital if the firm’s original owners were to maintain a majority ownership position. Over time, however, it came to be realized that a very small stock holding could serve as an effective control mechanism. Pitelis and Sugden (1986) argue that those who historically owned business enterprises have not allowed their control to be diffused through the issuance of stock; rather, minority positions substantial enough to insure continued organizational control have been maintained. Thus, *control* has led to *ownership*, rather than vice versa.
H$_{2a}$: The higher the ratio of CEO income derived from corporate equity to CEO direct current corporate remuneration the greater the capital yield of the firm's stock.

H$_{2b}$: The higher the ratio of CEO income derived from corporate equity to CEO direct current corporate remuneration the greater the earnings per share of the firm's stock.

Again a simple correlation is implied; consistent with H$_{1c-d}$ causal priority is additionally hypothesized:

H$_{2c}$: Capital yield of the firm's stock is in part a function of higher ratios of CEO income derived from corporate equity to CEO direct current corporate remuneration.

H$_{2d}$: Earnings per share of the firm's stock is in part a function of higher ratios of CEO income derived from corporate equity to CEO direct current corporate remuneration.

Finally, it is recognized a contingency, rather than a universalistic, theory might be appropriate (Child, 1974, 1975). Dyl suggests that “…in relatively closely held firms certain owners have an economic incentive to engage in monitoring activities and…by engaging in these activities, these owners are able to reduce ‘excessive’ levels of management compensation that would otherwise occur due to the agency [problem]” (1988: 23). Consistent with this insight Gomez-Mejia et al. hypothesize “long-term [corporate] income will be a greater proportion of total CEO compensation in owner-controlled firms than in management-controlled firms,” for cash compensation will have been reduced as a result of monitoring (1987: 56). However, Gomez-Mejia et al. additionally suggest “long-term [corporate] income as [a] proportion…of total CEO compensation will be more highly related to performance in owner-controlled firms than in management-controlled firms”

41 In Dyl's (1988) study, the corporate control variable is significant at the 0.05 level and has the anticipated negative relationship to the level of management compensation.
(1987: 56). The latter theorization is counterintuitive; one ought to expect the effect of managerial equity ownership in general, and percentage of the CEO’s income derived from long-term corporate sources in particular, to have a greater effect in those corporations lacking significant ownership oversight. Applying the argument of an interaction effect to both $H_{1a}$ and $H_{1b}$ results in the final pair of hypotheses:

$$H_{3a}$$: The effect of market value of the CEO’s equity interest in the firm upon capital yield of the firm’s stock is greater in firms characterized by high levels of ownership diffusion than in firms characterized by low levels of ownership diffusion.

$$H_{3b}$$: The effect of market value of the CEO’s equity interest in the firm upon earnings per share of the firm’s stock is greater in firm’s characterized by high levels of ownership diffusion than in firms characterized by low levels of ownership diffusion.

It has been a failing of managerial research that only marginal attention has been accorded those managers holding substantial equity interests in the corporations which they control. By definition, no distinction has been drawn between those corporations whose managers are also owners and those corporations whose managers hold little if any company stock.\(^{42}\) Not only does the present analysis hold promise for explaining performance differences among firms; additionally, lessons may be drawn concerning the validity of stock option offerings and profit sharing as rewards for effective management.

The single delimitation of the current study is that findings may be safely generalized only to what Berle and Means (1968) have referred to as ‘the modern corporation;’ that is, large corporate

\(^{42}\) Historical research may suggest why this issue has not been given more attention: using SEC data on officers’ compensation collected in the 1930s, Gordon (1961) concludes “the traditional reward of the business leader—profits arising from business ownership—is not a primary incentive to the majority of top executives in our largest corporations...[n]either dividend income nor possibilities of appreciation in the value of their negligible stockholdings can compare with compensation as a source of income” (as cited in Stigler & Friedland, 1983: 246). Although such broad statements are unsubstantiated by Gordon’s (1961) empirical work, his ‘findings’ have nonetheless enjoyed widespread acceptance.
enterprises. A discussion of limitations will be addressed in the section of this chapter devoted to methods and analysis. At this juncture the minimal extant research specifically concerned with the relationships outlined in the above hypotheses will be reviewed.

Review of Specific Literature

The following studies have been selected for review because they provide a foundation for the investigation which follows. Each study will be discussed in sufficient detail to make its relevance entirely clear. The ways in which these studies contribute to the dissertation research will be explicitly noted, with close attention given to conceptual and theoretical formulations that are explicit or implicit within the selected studies. Particular attention will be given to a critical analysis of previous methodology and exposition of the advantages and limitations inherent in various approaches in the balance of the chapter concerned with construct operationalization and methods and analysis.

Several studies have addressed the relationship between form of executive compensation and firm performance. Lewellen and Huntsman (1970) examined the relationship between executive compensation and company performance at three-year intervals, beginning with 1942 and ending with 1963. They found strong support for the hypothesis that top management’s remuneration is heavily dependent upon the generation of profits, suggesting separation of ownership from control is not an issue. With respect to the debate surrounding market vs. accounting measures of firm performance,

the results of the study persistently indicate that both reported profits and equity market values are substantially more important in the determination of executive compensation than are sales...the clear inference is that there is a greater incentive for management to shape its decision rules in a manner consonant with the shareholder interests than to seek the alternative goal of revenue maximization.43

43 Lewellen and Huntsman (1970) implicitly assume there is a link between managerial self-interest and sales maximization.
In a follow-up study Lewellen et al. (1985) have shown managers with significant stock holdings are less likely to engage in acquisition or merger activities which serve to erode stockholder interests. Lewellen et al. (1985) argue managers lacking large stock holdings are little concerned with erosion of shareholder interests; rather, such managers judge acquisition opportunities as generally favorable based on the resultant expansion of managerial control. “[F]indings suggest the presence of a consistently positive relationship between acquiring-company abnormal stock returns and the three measures of the degree of own-company managerial stock ownership,44 for all executive categories” (Lewellen et al., 1985: 225).

In a paper based upon his dissertation Masson further builds upon the work of Lewellen (1971: 1290). The primary hypotheses tested were “that firms with structures of executive financial returns more closely related to stockholder returns performed better in terms of stock performance, and...that they performed better in terms of profits performance in this period” (Masson, 1971: 1286). From the results of confidence testing “[e]xecutive financial incentives are found to be primarily related to firm stock market performance...sales performance of the firm has no consistent positive or negative effect on executive financial return...firms with executives whose financial rewards more closely paralleled stockholders' interests performed better in the stock market over the postwar period” (Masson, 1971: 1278). This study lends support to the hypothesized relationship between managerial ownership and market performance of the firm. “Lewellen’s findings and this study both suggest that the separation of ownership and control in the large corporation need not lead to managerial objectives widely divergent from present-value [i.e., shareholder wealth] maximization” (Masson, 1971: 1290). The rationale for these conclusions is that the typical managers’ rewards are sufficiently tied to stock price so as to compel managers to operate the firm in the interest of its shareholders.

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44 The number of own-company shares owned, the number of such shares due to be received by the executives pursuant to deferred stock compensation awards made to date, and the number of shares outstanding under stock option grants not yet exercised (Lewellen et al., 1985: 215).
Green “presents the results of an investigation into whether owner-managers see ownership encouraging greater vigilance, enthusiasm and commitment to shared goals, and whether it incentives them to work harder, shirk less or become more innovative” (1988: 26). Green’s (1988) qualitative approach involved exploring perceptions of the ways in which managerial ownership affects motivation, values, and behavior during corporate buy-outs. Reliance upon managerial self-reports may have introduced a social desirability concern: to concede that ownership leads directly to corporate performance would constitute an admission of ‘shirking’ absent such ownership. Green suggests ownership does not provide alignment of ownership and managerial incentives so much as it serves to relieve performance constraints:

The overwhelming feeling among buy-out teams was that they had been liberated from what they perceived as the ‘deadweight hand of corporate control’...The removal of corporate constraints was seen both as a major motivating factor and one accounting for the turnaround or improvement in the performance of the bought out company...The prospect of financial rewards or losses arising out of ownership was neither the prime motivator nor the main determinant of improved organizational processes or improved firm profitability. Nevertheless, ownership was seen to exert strong positive influences on the firm. 1988: 32

Chacko (1990), on the other hand, purports to find no systematic relationship between management’s stock ownership and firm performance. While Chacko (1990) was careful to address the potential for lag effects, a careful reading of his research reveals several areas of concern, the first having to do with construct operationalization. Consistent with the work of Berle and Means (1968), Chacko (1990) measures ownership as a percentage of the value of the firm; as previously noted, however, numerous researchers have countered that ownership is more appropriately measured in absolute dollar terms. Chacko (1990) further failed to differentiate between market and accounting measures of firm performance. Finally, the analysis employed the relatively unsophisticated method of scattergraph plots to test for simple correlations. In spite of such shortcomings Chacko takes great liberties with his conclusions:
The theory that managers’ performance is dependent on stock ownership in the companies they manage, once proposed, should have received a prompt burial. All that the theory had going for it was a certain populist charm...

There were gaping holes in the theory from the beginning. Normally, theories based on anecdotal experiences or pure conjecture should, sooner or later, withstand a systematic empirical test or be relegated to the status of unsubstantiated speculation...As the empirical test we have performed and reported here shows, the data have been readily available and the test itself quite simple—so much so that the continued failure by the supporters of the theory to back up their claims with needed evidence should long ago have alerted business leaders and the media to look askance at the theory’s soundness.

1990: 77, 78

No theoretical explanation is offered for such ‘findings.’ Of greater concern is Chacko’s (1990) apparent ignorance of the empirical literature herein cited—virtually all of it more powerful than his own—supporting the relationship between managerial equity holdings and firm performance.

Benston (1985) offers one of the few studies specifically addressing the issue of managerial stock holdings. Evidence is presented demonstrating that managers of conglomerates are able to command handsome salaries in spite of the poor performance of the business portfolios which they manage—seeming support for the separation thesis. However, Benston notes that the earnings (or losses) associated with changes in the value of personal stock holdings (and options) accruing to managers of conglomerates in any given year far outstripped their stated compensation (1985: 77).45 On this basis it would seem reasonable to hypothesize that conglomerates—which on the basis of traditional ownership criteria would be classified as manager-controlled—nonetheless do not fall prey to the agency problem. Benston’s work lends empirical, as well as logical, support to the hypothesis—and further argues in favor of revising the owner-control operationalization to include CEO income derived from corporate equity:

These shares in the companies they manage provide the executives with the same sort of gains and losses that are experienced by their shareholders. They are a means by which the executives bond themselves to the companies. Furthermore, it would be misleading to identify a company as ‘manager controlled’ only when the managers control at least ten percent of the company’s

45 This finding is consistent with Lewellen’s (1971) finding that stock-related compensation of executives runs anywhere from three to five times the value of fixed-dollar rewards.
shares…This metric is misleading since a very small percentage of a large publicly-traded company is a lot of money…For executives…the determining variable is the amount of the executive’s total wealth invested in the companies they manage.

While his findings were not specifically related to corporate effectiveness, Benston’s (1985) examination of conglomerates is consistent with the suggestion that the performance of manager-controlled firms comes to mirror that of owner-controlled firms as rewards for managerial performance are more closely tied to shareholder expectations.

Gomez-Mejia et al. (1987) more directly explore the parity between executive pay and firm performance. Their study demonstrates a differential effect between CEO pay and corporate performance depending upon whether the firm is owner- or manager-controlled: if the firm is owner-controlled, top executive compensation and firm performance are more closely coupled (Gomez-Mejia et al., 1987: 51). This finding suggests dominant stockholders have the power to align managerial incentives with the interests of shareholders, and thereby overcome the agency problem—a discovery having profound organizational implications. It is assumed owner and manager interests differ as well as that managers lack equity interest in the firms which they manage (Gomez-Mejia et al., 1987: 53-4). Of further interest is the lack of support for the hypotheses that “[b]onuses and long-term income will be greater proportions of total CEO compensation in owner-controlled firms than in management-controlled firms” and “[b]onuses and long-term income as proportions of total CEO compensation will be more highly related to performance in owner-controlled firms than in management-controlled firms” (Gomez-Mejia et al., 1987: 56, 62). In their discussion section Gomez-Mejia et al. summarize their findings as follows:46

A firm’s type of ownership significantly affects its CEO’s pay…Compensation mix does not differ for the two types of firms, and long-term income, as a proportion of total compensation, appears to be closely associated with performance in both owner- and management-controlled firms…this study also showed that

46 It has been previously argued the latter hypothesis lacks consistency with the logical structure of agency theory.
performance does have a significant effect on executive’s compensation in both owner- and management-controlled firms; however, it is a much weaker predictor of executives’ compensation in the second.  

While Gomez-Mejia et al. tested the relationship between all components of executive pay, firm performance, and firm size for both owner- and manager-controlled firms, the authors readily admit “other, excluded factors may have strong effects on the observed relationships” (1987: 67). It is here suggested executive ownership may well be one such significant factor. The authors’ rationale for not including CEO income derived from corporate equity as an independent variable is attributable to their reliance upon Rich and Larson’s finding that “companies with long-term incentives for chief executives were giving ‘stockholders an annual return no better than the return in companies without such incentives’” (1984: 20; as referenced in Gomez-Mejia et al., 1987: 53). Interestingly, as with Berle and Means Gomez-Mejia et al. offer public policy recommendations on the basis of their findings, including their counsel that “regulation may shift the balance of power toward equity holders and help resolve these [goal] conflicts” (1987: 66).

While each of these studies relates to the theory-based hypotheses herein proposed, neither individually nor collectively does such scholarship provide a definitive resolution of the research question under consideration. By uniting a rich theory base, existing empirical research, and the specific hypotheses to be empirically tested, this dissertation is designed to move beyond earlier work in both theory and testing. The threads of several disparate theoretic traditions having been interwoven into a single strand, attention will now turn to the empirical test suspended thereon.

**Construct Definition: Operational**

“Though indispensable, operational definitions yield only limited meanings of constructs. No operational definition can ever express all of a variable” (Kerlinger, 1973: 32). While the only relationship which can be observed is the association between the measures of the independent
and dependent variables within a sample, the researcher hopes to infer relationship between the ‘true’ underlying constructs in order to generalize findings to the broader population. The current section derives operational definitions for both independent and dependent variables from the conceptual definitions previously presented.

**Independent Variables**

Compensation “has three distinct components: salary, bonuses, and long-term income” (Gomez-Mejia et al., 1987: 60; see also Crystal, 1989: 91). As each of these elements is of importance to the current study, all will be included in the analysis; however, it should be reemphasized the focus of this work will be upon long-term income and, more specifically, CEO income from equity holdings as it relates to firm performance. Lewellen and Huntsman issue a caveat worth here repeating:

“A second unexpected feature of the test results was the lack of improvement in fit upon substitution of total executive compensation [including long-term effects such as profit-sharing and equity income] for salary plus bonus as the dependent variable…A sizeable proportion of [the total compensation variable], especially in the later years tested, is attributable to compensation arrangements whose values depend importantly on short-term fluctuations in employer-company share prices—stock options, for example. Because these short-term fluctuations reflect a host of random influences, the total compensation figures embody a considerable ‘noise’ element.”

(1970: 717-18)

This issue will be a matter of concern as valuation of CEO equity interests is considered.

Salary and bonus data are essential to the testing of $H_{2a-d}$ in that the ratio of CEO income derived from corporate equity to direct current corporate compensation needs to be calculated. For the purposes of the present analysis CEO income derived from corporate equity will be defined as gains (or losses) on current CEO equity holdings, inclusive of dividends; both salary

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47 It will be remembered that pension contributions, stock option awards and exercises, and all deferred pay items are therefore to be excluded from consideration (Lewellen et al., 1985: 215).
and bonuses will similarly be considered current sources. Salary is measured as gross cash earnings of the CEO; bonuses are similarly represented as a continuous variable expressed as gross cash income for the year of disbursement.

Lewellen et al. suggest three ways to measure the relative importance of senior management’s stockholdings: “by the percentage of the firm’s common stock held by senior management, by the ratio of the dollar value of those holdings to the dollar amount of senior management’s total direct current remuneration, and by the ratio of the expected annual income from the stockholdings to current remuneration” (1985: 230). The current approach is most consistent with the last of these. It has been argued previously the percentage of firm stock owned by management reveals virtually nothing; there is no theoretic basis for suggesting an arbitrary threshold level of stock ownership establishes control on behalf of any individual or group. Nor does the literature herein reviewed suggest a clear relationship between managerial corporate share value and current compensation. However, the ratio of CEO income derived from corporate equity to direct current corporate compensation—as well as the gross amount of such holdings—are presumed to have an effect upon firm performance; as Benston has discovered, “[t]hough individually [managers who also were directors] did not own more than small percentages of the total shares outstanding, the amounts they owned yielded annual gains and losses that swamped their remuneration…the amounts derived from owning their companies’ shares are large, particularly compared to their remuneration” (1985: 81).

While it could be argued certain bonuses are more appropriately long-term income, it will be remembered variables are to be defined with respect to the research question under consideration (Kerlinger, 1979: 29). As the hypotheses focus upon the effect of managerial equity holdings (i.e., current sources) on firm performance, bonuses are best represented as current revenue as well. Analysis is simplified commensurate with this formulation, for one need not be concerned with amortizing the effect of long-term bonuses over the term of the performance period as, among others, Antle and Smith have suggested (1985: 302; see also Crystal, 1989: 91).

A brief note contrasting proportions and ratios is in order. While the conceptual literature has consistently spoken of the proportion of total compensation attributable to corporate equity income as having an impact on firm performance, virtually no researchers have tested this hypothesis: data on total CEO compensation is simply not available. As Lewellen and Huntsman have discovered, however, direct current compensation is a useful surrogate for total income (1970: 717-18). In following this convention it is essential to substitute the term ratio for proportion: equity revenue is measured as a ratio to current compensation rather than as a proportion of total income.

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All proposed hypotheses require measurement of either the value of managerial stock holdings or equity income. For the purpose of testing H\textsubscript{1a-d} and H\textsubscript{3a-b} value of stock holdings will be computed as the multiple of number of shares held by the CEO and per-share value of such stock on the day said holdings are reported. Analysis of H\textsubscript{2a-d} requires an assessment of the income derived from CEO corporate shareholdings. On Benston’s formulation change in value of shareholdings may be measured as the average number of shares held–adjusted for stock splits–valued at the average price per share, plus dividends (1985: 74). This formulation will be followed in the present analysis.\textsuperscript{50} Unlike base salary and bonus payments which typically pay off every year, earnings from equity sources may tend to be sporadic. While some researchers have therefore suggested smoothing out the effects of shareholding income (see, e.g., Crystal, 1989: 91), in the context of the current study such equalizing would have the undesirable consequence of ‘diluting’ the very effects under empirical scrutiny. Consistent with the models of classical economics, managerialism, neo-classical economics, and agency theory, it is herein assumed the market is highly responsive and therefore quick to reflect changes in investor confidence. Given that the wealth effects of principals’ perceptions are critical to the current analysis, it would be ill-advised to restrict variance by controlling for such effects.

The final matter to be here addressed is the manner in which owner-controlled firms are to be distinguished from manager-controlled firms for the purpose of analyzing H\textsubscript{3a-b}. Kahl (1957) has noted the difficulty with deriving observational consequences from the ‘control’ construct: “power, ‘because it is potential, is usually impossible to see’” (as cited in Zeitlin, 1974: 1085). Researchers have most often defined firms as owner- or manager-controlled on the basis of the percentage of corporate ownership held by the majority shareholder. Per Berle and Means (1968), the threshold has routinely been set at five percent:

\textsuperscript{50} Some researchers argue CEO compensation necessarily includes the annualized value of stock option gains (Crystal, 1989: 91). While such gains may appropriately count as income, in their strictest sense stock options do not represent an ownership interest in the firm—the topic of the research herein proposed. For this reason stock option gains will not be included in the present analysis.
Using this 5% ownership convention, researchers have demonstrated significant differences between owner- and management-controlled firms on a variety of measures, including rates of return on investment (Boudreaux, 1973), risk aversion (Palmer, 1973), performance (Glassman/Rhoades, 1980; McEachern, 1975; Sorenson, 1971, 1974), executive transitions (Salancik/Pfeffer, 1980), and antitrust activities (Blair/Kaserman, 1983; Chevalier, 1969).

Gomez-Mejia et al., 1987: 57

In a sample of 456 of the Fortune 500 firms, 354 have at least one shareholder owning at least 5 percent of the firm...the average holdings of the largest shareholder among the 456 firms is 15.4 percent...a large number of (these majority shareholders) are families represented on the boards of directors (149 cases)...pension and profit-sharing plans (90 cases)...financial firms...(117 cases)...The final category consists of firms and family holding companies with large stakes who do not have board seats (100 cases).

Shleifer & Vishny, 1986: 462

Not a few theorists consider dichotomization of the control construct to be at best arbitrary and at worst conceptually bankrupt. Such researchers argue for measuring degree of control as a continuous variable: “Although most other studies examining corporate control issues employ the arbitrary dichotomy of ‘owner controlled’ versus ‘manager controlled’ firms, characterizing the degree of corporate control as a continuum appears to be more appropriate in the agency context” (Dyl, 1988: 22-3; see also Cubbin & Leach, 1983: 354-55). In light of both the dominant research tradition supporting utilization of Berle and Means’ (1968) five percent criteria as well as Dyl’s (1988) recommendation that control be operationalized as a continuous variable, the current research will adopt aggregate percent of outstanding stock held by major shareholders—i.e.,

51 While Berle and Means did characterize firms lacking a majority stockholder holding a minimum five percent ownership position as manager-controlled, a careful review of their criteria indicates these writers did not suggest the converse to be true:

1) Owner-controlled, characterized by a single-largest stock position of greater than 20 percent;
2) Neither owner-controlled nor manager-controlled, characterized by a single-largest stock position of less than 20 percent but greater than 5 percent;
3) Manager-controlled, characterized by a single-largest stock position of less than 5 percent.

52 Few, if any, researchers have taken account of the ‘excluded middle’ obvious in the above typology.

The reader will recall certain authors have argued control is established by ownership positions far less than five percent (See, e.g., Cubbin & Leach, 1983: 364-65; Dye, 1985: 9-10; Pitelis, 1986: 84).
owners of record holding a five percent or greater ownership position in the firm—as a measure of being closely held.

**Dependent Variables**

Thompson has aptly noted “[u]nder norms of rationality, complex organizations are most alert to and emphasize scoring well on those criteria which are most visible to important task-environment elements [which may well include managers]” (1967: 90). As the literature on separation of control from ownership is principally concerned with the erosion of shareholder wealth which, the theory posits, occurs as a result of managers operating the firm for their own benefit, for the purpose of the current study the most important constituency is the firm’s shareholders. Consequently, the appropriate performance dependent variable is return to shareholders—among the easier of the constructs under consideration to operationalize.

Market measures of firm performance fall into the two general categories of *growth in share value* and *dividends paid*: “[r]aw returns [to shareholders] are calculated...[as]...the annual dividend and capital gain yields for each firm’s stock” (Krause, 1988: 33; see also Crystal, 1989: 91; Gomez-Mejia et al., 1987: 58-9). Capital yield of corporate stock is calculated as annual gain (or loss) in stock price for the calendar year, divided by beginning-of-year share price. As financial theory suggests that firm earnings can be expected to have an impact upon share value, earnings per share—calculated as annual corporate earnings divided by number of shares

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53 Clark notes “[w]hile tying the executives’ compensation to the fate of the company stock has advantages, it also has weaknesses...[t]he stock market often moves in mysterious ways, not always governed by the company’s current financial results” (1990: A14). For the purpose of the present analysis, however, general environmental conditions can be presumed to affect corporations in an unprejudiced manner; performance variance is therefore best understood as attributable to unique corporate characteristics, including extent of managerial stock ownership.

54 While dividends paid will therefore be included as an independent variable for the purpose of valuing CEO income from firm-related equity sources, there is no precedent in the agency literature for including dividend analysis as a dependent variable; in fact, to the extent dividends are stable over time increases in share value have the effect of deflating dividend yield.
outstanding—are included as a performance measure within the present analysis.\textsuperscript{55} Final consideration is now given to the method by which data so derived is to be analyzed.

**Methods and Analysis**

The particular method of investigation under consideration has been selected in response to the substantial body of literature herein reviewed. While it is not expected that the proposed research will produce the definitive treatise on the theme of separation of ownership and control, it is hoped that conceptual as well as methodological inaccuracies in extant literature will be remedied. This final section of Chapter 3 will cover the topics of data sources, collection, and analysis. While the proposed analytic techniques are at times complex, as with construct operationalization the design of the study will give preference to considerations of parsimony. What is sought is the most refined treatment to acceptably resolve the issue of whether there exists a positive relationship between CEO equity interest in the firm and firm performance.

**Sources and Collection of Data**

\textsuperscript{55} There has been much debate in the literature concerning the appropriateness of accounting-based vs. market-based measures of firm performance. Child has found:

the type of strategic objectives selected for business organizations may have some influence upon performance...a greater concentration of ownership with control predicted that chief executives would attach greater importance to maximizing profits and growth...This tendency for the owner-controlled company to attach greater weight to expressly financial objectives [measured through surveying values of top management] leads one to expect an equivalent link with the financial performance actually achieved.

Child, 1974: 184-5

While Baran and Sweezy (1966) argue firms seek to maximize profits at least partly because they seek maximum growth and/or survival (as referenced in Pitelis, 1986: 84), and therefore accounting and market measures are compatible, Lewellen and Huntsman suggest “[o]ther possible viewpoints include the propositions that executives are rewarded according to both profit and sales performance, or, at the opposite extreme, that neither item is relevant” (1970: 712). Contrary to the sales maximization version of the self-serving management hypothesis, researchers investigating the pay-performance relationship have generally found managers’ total compensation to be more highly related to stock price and earning performance than to sales (see, e.g., Benston, 1985; Bilimoria, 1988; Krause, 1988; Lewellen & Huntsman, 1970; Masson, 1971).
The target population for the proposed research consists of those business enterprises Berle and Means’ (1968) have christened ‘the modern corporation.’ “The very large firm is obviously the one in which the phenomenon of the separation of ownership from control—and its possible consequences in terms of managerial behavior—is likely to be most severe” (Lewellen & Huntsman, 1970: 711; see also Demsetz & Lehn, 1985: 1174 [footnote 11]). For this reason the sample examined consists of two hundred firms drawn randomly from among America’s one thousand largest public corporations as ranked by market value.56 The organizational level of analysis makes the use of archival data particularly attractive; in fact, Podsakoff and Dalton have found “the majority of archival research is conducted at the organizational level” (1987: 424).

Data on CEO salary, bonuses, and number of corporate shares owned is gleaned from Business Week’s annual Corporate Elite issue for the years 1987, 1988, 1989, and 1990.57 In order to compute the value of CEO shareholdings as well as capital and dividend yield of the firm’s stock, historical stock price data from Lotus Development Corporation’s on-line ‘One Source’ (CD/Corporate version) has been utilized. In those few instances in which such data is not reported, The Wall Street Journal’s daily report of New York Stock Exchange composite transactions or Moody’s Industrial Manual served as a contingency source. Lastly, major ownership data was found on Lotus Development Corporation’s ‘One Source’ (CD/Corporate version). Standard procedures were used for coding data.

Analysis of Data

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56 The sample will therefore exclude privately owned or closely held companies, although it seems reasonable to assume a score of such private companies have sufficient market value to otherwise qualify for the list. This fact is of no concern, however, in that only public corporations are presumed to suffer from the agency problem.

57 McEachern (1975) argues “[a] four-year period is long enough to limit the influence of short-term irregularities, but short enough that management’s philosophy and structure can be thought of as continuous” (as referenced in Gomez-Mejia et al., 1987: 56).
Per H$_{1a-b}$ and H$_{2a-b}$, one of the central research questions is whether there is a correlation between firm performance and the value of corporate stock held by the CEO. The appropriate test is a Pearson correlation. However, given the fact that data has been collected at four points in time and there is some question as to the direction of causality, the more sophisticated technique of structural equation modeling (LISREL) is employed as a test of H$_{1c-d}$ and H$_{2c-d}$. Finally, H$_{3a-b}$ are analyzed using hierarchical multiple stepwise regression. Elaboration of both rationale for and design of the analysis follow.

H$_{1a-b}$ and H$_{2a-b}$ each involve analysis of an interval-level independent variable having to do with CEO equity interests and an interval-level dependent variable measuring firm performance (See Tables 1 & 2). Given the described variable characteristics as well as the additional fact that neither outliers nor intervening variables are anticipated, a Pearson correlation can be employed to test each of the four hypotheses. Pearson correlations were run for each path represented in the general LISREL model (see Figure 1). As noted previously, however,

The fact that the level of performance is found to relate to a feature of organization does not of itself tell us how much performance is the consequence or the cause of that feature…cross-sectional data…cannot of themselves demonstrate the direction or the process of causality between variables known to be interrelated.

Child, 1974: 176
### Table 1
Summary of Hypothesis 1 and Associated Analysis

<table>
<thead>
<tr>
<th>Hypotheses</th>
<th>Independent Variables</th>
<th>Dependent Variables</th>
<th>Analyses</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>H1a</strong>: There is a positive correlation between market value of the CEO's equity interest in the firm and capital yield of the firm's stock</td>
<td>Managerial Ownership (Interval)</td>
<td>Stock Performance (Interval)</td>
<td>Pearson Correlation</td>
</tr>
<tr>
<td><strong>H1b</strong>: There is a positive correlation between market value of the CEO's equity interest in the firm and earnings per share of the firm's stock</td>
<td>Managerial Ownership (Interval)</td>
<td>Earnings per Share Performance (Interval)</td>
<td>Pearson Correlation</td>
</tr>
<tr>
<td><strong>H1c</strong>: Capital yield of the firm's stock is in part a function of market value of the CEO's equity interest in the firm</td>
<td>Managerial Ownership (Interval)</td>
<td>Stock Performance (Interval)</td>
<td>LISREL</td>
</tr>
<tr>
<td><strong>H1d</strong>: Earnings per share of the firm's stock is in part a function of market value of the CEO's equity interest in the firm</td>
<td>Managerial Ownership (Interval)</td>
<td>Earnings per Share Performance (Interval)</td>
<td>LISREL</td>
</tr>
</tbody>
</table>

### Table 2
Summary of Hypothesis 2 and Associated Analysis

<table>
<thead>
<tr>
<th>Hypotheses</th>
<th>Independent Variables</th>
<th>Dependent Variables</th>
<th>Analyses</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>H2a</strong>: The higher the ratio of CEO income derived from corporate equity to CEO direct current corporate remuneration the greater the capital yield of the firm's stock.</td>
<td>Ratio of CEO equity income to CEO current income (Interval)</td>
<td>Stock Performance (Interval)</td>
<td>Pearson Correlation</td>
</tr>
<tr>
<td><strong>H2b</strong>: The higher the ratio of CEO income derived from corporate equity to CEO direct current corporate remuneration the greater the earnings per share of the firm's stock</td>
<td>Ratio of CEO equity income to CEO current income (Interval)</td>
<td>Earnings per Share Performance (Interval)</td>
<td>Pearson Correlation</td>
</tr>
<tr>
<td><strong>H2c</strong>: Capital yield of the firm's stock is in part a function of higher ratios of CEO income derived from corporate equity to CEO direct current corporate remuneration.</td>
<td>Ratio of CEO equity income to CEO current income (Interval)</td>
<td>Stock Performance (Interval)</td>
<td>LISREL</td>
</tr>
<tr>
<td><strong>H2d</strong>: Earnings per share of the firm's stock is in part a function of higher ratios of CEO income derived from corporate equity to CEO direct current corporate remuneration.</td>
<td>Ratio of CEO equity income to CEO current income (Interval)</td>
<td>Earnings per Share Performance (Interval)</td>
<td>LISREL</td>
</tr>
</tbody>
</table>
In that $H_{1c-d}$ and $H_{2c-d}$ explicitly argue for causality, analysis of these hypotheses requires a degree of sophistication not accessible with a simple correlation (See Tables 1 & 2). It must be re-emphasized causality has no meaning apart from specification within a theoretic framework; inferences cannot, therefore, be drawn from isolated tests of causality:

What must be recognized is that in and of themselves cross-lagged correlations, beta weights, factor loadings, and partial correlations are not measures of causal effects. Only within the context of a model specified by the researcher does any statistic bear on a causal inference...Each statistic is valid, but only in the context of a reality presumed by a given model [emphasis added].

Kenny & Harackiewicz, 1979: 377

Even the above qualification is not sufficient to resolve the issue of designing an appropriate test for $H_{1c-d}$ and $H_{2c-d}$, however. It might be reasoned that not only do managerial equity holdings lead to favorable firm performance, but additionally healthy firm performance might induce managers to increase their equity positions in the firms they manage—or stock might be offered as a reward for good corporate performance. Once the possibility of reciprocal causality is introduced, analytic options are restricted (Williams & Podsakoff, 1989). Additionally, time-series data is necessary for such an analysis; it is for this reason that data for all hypotheses has been collected and coded for 1987, 1988, 1989, and 1990 (Child, 1974: 176).58

Cross-lagged correlation analysis has frequently been used as a test of reciprocal causality. However, several criticisms of this approach have been raised (Feldman, 1975; Heise, 1970; Locascio, 1982; Randolph, 1981; Rogosa, 1980; Snyder, 1980; as referenced in Williams & Podsakoff, 1989: 265). Rogosa has shown "the difference between cross-lagged correlations does not have a direct correspondence to measures of causal effects" as a result of lack of stability within the parameters themselves over time (1980: 251; as cited in Williams & Podsakoff, 1989: 265; see also Kenny & Harackiewicz, 1979: 377-78). Furthermore, "extension of [cross-lagged correlation] analysis to data from more than two waves or time periods is problematic" (Williams & Podsakoff, 1989: 267) in that "many patterns of causal inference cannot

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58 Multi-year data has the auxiliary benefit of allowing for the testing of lag effects (Billimoria, 1988: 19).
be detected from a series of two-wave snapshots” (Rogosa, 1980; as cited in Williams & Podsakoff, 1989: 267). Dynamic correlation analysis suffers from this same methodological shortcoming (Williams & Podsakoff, 1989: 267), while the frequency-of-change-in-product-moment technique “does not rest on an adequate formulation of causal logic” (Howard & Krause, 1970: 219; as cited in Williams & Podsakoff, 1989: 269). Finally, path analysis—while having the advantage of accounting for the causal influence of a variable on itself over time—is unacceptable in that “with only one fallible measure [containing random measurement error] of each variable at each time point, it is not possible in general to obtain acceptable estimates of the parameters of a regression model for panel data” (Rogosa, 1980: 254; as cited in Williams & Podsakoff, 1989: 269).

Latent variable causal models, which can be evaluated using the computer program LISREL (Joreskog & Sorbom, 1985), provide solutions to these problems. Among their other attributes, latent variable models allow for simultaneous examination of reciprocal relationships among several variables (Williams & Podsakoff, 1989: 273): 59

Another use of latent variable models is to analyze data obtained at more than two points in time. This type of application may be used to pursue two objectives, the first being to estimate simultaneously all of the causal relationships based on multiple time lags and the second being to serve as an aid in identifying the appropriate time lag.

Williams & Podsakoff, 1989: 281

Latent variable modeling permits complex causal relationships to be examined. LISREL is therefore the most powerful tool for testing $H_{1c-d}$ and $H_{2c-d}$. LISREL utilizes a maximum-likelihood algorithm to compute parameter estimates. Assessment of overall fit is not the only attribute of LISREL; imposition of a variety of constraints upon various parameters of the hypothesized models allows for examination of competing models. 60 Competing models can be

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59 “[W]hen only one indicator for each construct is available, identification problems make necessary assumptions about the values of these parameters…[a]s described by Kenny (1979), in such instances information from the reliabilities can be used for the purpose of estimating the effect of the construct and random error on the indicator” (Williams & Podsakoff, 1989: 275).

60 LISREL permits parameter estimates to be set to particular values, fixed to zero, or set equal to another designated parameter the value of which is to be estimated.
constructed by setting parameters of critical interest\textsuperscript{61} equal to zero—allowing for tests of reciprocal causality as well as the appropriateness of various time lags, with chi-square differences between competing models serving to indicate the best-fitting model.

For the purposes of such analyses the causal model is represented per Figure 1.

\textsuperscript{61} Prior to estimating parameters model identification—the process of determining that no two sets of distinct parameter values could produce the same covariance matrix—must be established. The proposed model meets the generally-accepted condition that the number of parameters to be estimated does not exceed the number of elements in the covariance matrix (Joreskog & Sorbom, 1985).
The final pair of hypotheses (H\textsubscript{3a-b}) require examination of the collective impact of CEO equity holdings and ownership diffusion upon firm performance (See Table 3). It is argued that the relationship between managerial ownership and corporate performance is moderated by the diffusion variable; an interactive effect is therefore hypothesized between the two interval independent variables. In such circumstances the appropriate analytic test is the moderated hierarchical multiple stepwise regression.

<table>
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<td>H\textsubscript{3a}: The effect of market value of the CEO’s equity interest in the firm upon capital yield of the firm’s stock is greater in firm’s characterized by high levels of ownership diffusion than in firms characterized by low levels of ownership diffusion.</td>
<td>Managerial Ownership (Interval) and Ownership Diffusion (Interval)</td>
<td>Stock Performance (Interval)</td>
<td>Moderated Hierarchical Multiple Regression</td>
</tr>
<tr>
<td>H\textsubscript{3b}: The effect of market value of the CEO’s equity interest in the firm upon earnings per share of the firm’s stock is greater in firm’s characterized by high levels of ownership diffusion than in firms characterized by low levels of ownership diffusion.</td>
<td>Managerial Ownership (Interval) and Ownership Diffusion (Interval)</td>
<td>Earnings per Share Performance (Interval)</td>
<td>Moderated Hierarchical Multiple Regression</td>
</tr>
</tbody>
</table>
CHAPTER 4: ANALYSIS AND RESULTS

Introduction

In the tradition of ‘good science,’ the detailed review of literature and formulation of hypotheses upon which this study is based must now give way to empirical examination. Each hypothesis has been logically deduced from the prior literatures’ theorizations and carefully formulated so as to be able to be checked against an observable ‘reality.’ The power of probabilistic statistics will now be brought to bear on the data, and the findings of such inquiry presented. No attempt will here be made to interpret these findings; such further conjecture is most appropriately the subject of the final chapter of this dissertation.

Final Sample

The initial random sample of 250 companies was drawn from the Business Week 1000 for the year 1987. These companies were tracked within this publication over the next three years. Of the beginning sample, 182 firms remained within the Business Week 1000 for all four years. For three of these 182 firms shareholding data were not available. The final sample of 179 firms is cataloged in Appendix A. The reader interested in descriptive statistics relating to the average value of CEO shareholdings, CEO salary and bonuses, CEO equity income, annual stock yield, and earnings per share are referred to Appendix B.
Model Evaluation

In their conjectural forms the three sets of hypotheses have to do with the firm performance effects of CEO equity holdings, CEO equity income, and CEO equity income as moderated by ownership diffusion. The tests of correlation and regression analysis are designed to inform the researcher of the existence of simple bivariate or multivariate relationships, while the more powerful technique of structural equation modeling enables one to infer causality. The general LISREL model as presented in Figure 1 provides the basis for all subsequent testing. Pearson product moment correlation analysis is employed to ascertain the existence of relationships between variables along each bivariate path in the general model, while moderated hierarchical multiple regression analysis indicates the presence—or absence—of an interactive effect between the model’s independent variable(s) and ownership diffusion, a separate exogenous variable hypothesized to have an indirect effect upon firm performance.

While the techniques of correlation and regression analysis are rather straightforward and well-defined, such is not the case with structural equation modeling. Specification of an appropriate baseline model against which other hypothetical models are to be compared is the first stage in the process. Although the baseline model ideally incorporates all available theoretical and empirical information concerning relationships among examined variables, pragmatism dictates that simplifying assumptions concerning the stability of relationships among variables be built into this model. Relative to the baseline model, those models providing a better ‘fit’ with the data are presumed to represent an improvement in our understanding. Given the central role of the baseline model in subsequent model evaluation, appropriate specification is critical.

Several constants can be recognized within the general LISREL model under consideration. The first deduction to be made is that there is no measurement error in this model. Each of the independent and dependent variables are by definition accurately measured. For the purposes of
the current analysis, therefore, each $\delta$ and $\varepsilon$ can be held to zero. By extension, each $\lambda$ can be held to one, for the absence of measurement error guarantees that the construct and its measure are identical. It is further expected that disturbance terms will be highly positively correlated, for any unmeasured factors exerting an influence on endogenous variables in the first time period of a longitudinal panel design can reasonably be expected to be equally in evidence during all subsequent time periods. Thus correlations among the $\zeta$s are restricted to be equal. However, no other assumptions can safely be built into the baseline model; there is little reason to argue for the existence of stable synchronous, auto-, or cross-lag correlations.\textsuperscript{62} Consistent with the logic of structural equation modeling, following specification and estimation of the baseline model restrictions were systematically relaxed until incremental improvements in the chi-square ‘goodness of fit’ index became non-significant.\textsuperscript{63} The findings of both correlational and causal analysis for $H_{1a-d}$ and $H_{2a-d}$ are now presented, followed by the outcome of the moderated multiple regression for $H_{3a-b}$.

**$H_{1a-d}$: CEO Equity Holdings and Firm Performance**

This set of hypotheses has to do with the general thesis that there exists a relationship between managerial equity ownership and performance of the firm. It is notable that these hypotheses state ownership value in absolute dollar terms rather than as a percentage of firm value. Firm performance is alternatively measured as capital yield of the firm’s stock or earnings per share of the firm’s stock. $H_{1a-b}$ imply simple correlations between independent and dependent measures, while $H_{1c-d}$ argue the stronger condition that CEO equity interests are at least in part causes of

\textsuperscript{62} It might be argued that the stability paths ought to be set to one in the baseline model to reflect the conviction that if there were no exogenous factors exerting influence on the measured variables such variables would be stable over time (Sobel & Bohrnstedt, 1985). However, not only are there a multitude of determinants of firm performance (see, e.g., Lenz [1981]); it is further the case that in the present model many of the independent measures are partially functions of firm performance. Finally, correlation analysis demonstrates that CEO equity holdings is the only variable in the model which exhibits empirical stability over time—calling into question the wisdom of imposing restrictions on the ‘stability’ paths within the baseline model.

\textsuperscript{63} …or the number of parameters to be estimated exceeded the available degrees of freedom.
favorable firm performance. The statistical results associated with analysis of each of these hypotheses will now be examined, moving from the simple to the more complex.

**Correlational Analysis**

Within a longitudinal panel study, prior to testing for the effects of independent variables upon dependent variables one should determine the stability of the measures themselves over time. This can rather easily be accomplished by calculating autocorrelations for all variables. One might well expect the value of *managerial equity holdings* to hold fairly constant over time; as can be seen from paths X5, Y5, and Z3 of Figure 2, this is in fact the case. However, autocorrelations represented by paths X6, Y6, and Z4 of the same figure reveal that the first measure of performance—*capital yield of the firm’s stock*—shows no consistency over time.

**Figure 2**

*Hypothesis 1a Synchronous Correlations and Autocorrelations*

![Diagram showing synchronous correlations and autocorrelations with correlation values and significance levels indicated.](attachment:image.png)

Correlation significant * ¥ .05 ** ¥ .01
Correlation non-significant
Figure 2 also reports the synchronous correlations, or correlations between independent and dependent variables within the same time period. No consistent intra-time period pattern of relationships among variables is demonstrated; the only statistically significant correlation occurs in time period three, where significance is demonstrated at the .05 level.

The hypotheses under consideration are little concerned with auto- and synchronous correlations; rather, the effect of managerial equity ownership is argued to have a lagged effect on capital yield of the firm’s stock. The current research has suggested this lag might occur over a one or two year time period. Paths X4, X3, Y4, Y3, and Z2 of Figure 3 report the lag correlations for H1a. Given that only two of the five lag correlations are even marginally significant, no consistent lagged relationship between the independent and dependent variables can be concluded.

![Figure 3: Hypothesis 1a Cross-lag Correlations]

- Correlation significant * .05 ** .01
- Correlation non-significant
One concern throughout this research project has been to address the issue of reverse or reciprocal causality. With respect to $H_{1a}$ reverse causality is depicted by paths $X_1, X_2, Y_1, Y_2,$ and $Z_1$ of Figure 3. Of the five correlations represented by these paths, only three achieve any level of statistical significance—and these three do not support a specific time lag, but rather are split between one and two year lags. The use of cross-lag correlation comparisons has been suggested as one means of determining causal priority, although problems with this approach have been previously noted (see, e.g., Williams & Podsakoff, 1989: 265). Findings associated with $H_{1a}$ reveal only one set of statistically significant reciprocally causal relationships, depicted by paths $X_1$ and $X_2$ of Figure 3. The correlations for these paths are virtually identical, revealing nothing about causal priority. In short, the findings herein outlined do not support the conjecture of $H_{1a}$ that managerial equity ownership is positively associated with yield of the firm's stock, and it is therefore rejected.

The reasoning for $H_{1b}$ follows that of $H_{1a}$; the only difference between these two hypotheses is the way in which firm performance is operationalized. The autocorrelations between discrete measures of managerial equity holdings over time—paths $X_5, Y_5,$ and $Z_3$ of Figure 4—are identical to these same paths for $H_{1a}$, indicating stability in this variable. However, autocorrelations represented by paths $X_6, Y_6,$ and $Z_4$ of Figure 4 demonstrate that the second measure of performance—earnings per share of the firm's stock—generally shows considerable consistency over time. This makes some intuitive sense as one considers that the difference between the way performance is measured for $H_{1a}$ and $H_{1b}$ turns on the distinction between market and accounting measures of firm performance; stock yield is subject to the vagaries of capital markets, while earnings per share are exempt from these same idiosyncratic forces. The synchronous correlations for $H_{1b}$ are in all cases statistically non-significant, indicating the absence of intra-time period relationships between managerial equity holdings and earnings per share.
Figure 4
Hypothesis 1b Synchronous Correlations and Autocorrelations

Managerial Equity Ownership → Earnings Per Share
X5: 0.77**
Managerial Equity Ownership → Earnings Per Share
Y5: 0.99**
Managerial Equity Ownership → Earnings Per Share
Z3: 0.91**
Managerial Equity Ownership → Earnings Per Share
-0.06
Managerial Equity Ownership → Earnings Per Share
-0.08
Managerial Equity Ownership → Earnings Per Share
-0.02
Managerial Equity Ownership → Earnings Per Share
-0.01

Correlation significant * 0.05 ** 0.01
Correlation non-significant

Figure 5
Hypothesis 1b Cross-lag Correlations

Managerial Equity Ownership → Earnings Per Share
X3: -0.05
Managerial Equity Ownership → Earnings Per Share
Y3: -0.01
Managerial Equity Ownership → Earnings Per Share
Z2: 0.00
Managerial Equity Ownership → Earnings Per Share
X4: -0.12
Managerial Equity Ownership → Earnings Per Share
Y4: -0.03
Managerial Equity Ownership → Earnings Per Share
X1: -0.04
Managerial Equity Ownership → Earnings Per Share
X2: -0.05
Managerial Equity Ownership → Earnings Per Share
Y1: -0.09
Managerial Equity Ownership → Earnings Per Share
Y2: -0.08
Managerial Equity Ownership → Earnings Per Share
Z1: -0.03

Correlation significant * 0.05 ** 0.01
Correlation non-significant
In Figure 5 are presented the lag correlations for H_{1b}. The findings are consistent throughout the time periods analyzed: in no instance is a statistically significant relationship between managerial equity holdings and earning per share demonstrated, leading to rejection of H_{1b}.

Causal Analysis

H_{1c-d} speculate that CEO equity interest in the firm is in some sense a cause of firm performance. The recommended analytic technique for evaluating this pair of hypotheses is latent variable causal modeling, using the LISREL statistical package.\(^{64}\) Such structural equation modeling is characterized by both its power as well as its complexity. This statistical method allows for the simultaneous evaluation of interrelationships among multiple independent and dependent variables, as well as for assessment of causal priority. However, it is unrealistic—indeed, inappropriate—to expect a program such as LISREL to discover relationships between uncorrelated variables. This makes eminent sense as one considers the conceptual equivalent: while it is relatively easy to envision two variables which are correlated yet not causally related, it is impossible to imagine two variables which are causally linked, yet lack any correlation with one another. For these reasons prudence would dictate not proceeding with a LISREL analysis if the correlations among variables within a given model have previously been established to be statistically non-significant. The current analysis is therefore offered only as confirmatory evidence for the lack of association between managerial ownership and firm performance.

H_{1c} argues for a causal relationship between managerial equity value and stock yield. Table 4 presents the findings of this analysis. The first step is to estimate the null model, or the case in which all parameters of interest are fixed to be zero. For the case under consideration the

\(^{64}\) While there are no latent variables in the model under consideration, as has been previously argued one of the ancillary uses of LISREL is simultaneous assessment of multiple interrelationships among variables—including those variables which might theoretically be reciprocally interdependent.
‘goodness of fit’ index is a modest 0.459. Subsequent steps involve systematically relaxing the parameter specifications and reevaluating each new model in turn. Given that $H_{1c}$ proposes stock yield is at least in part a function of managerial equity holdings, the first constraint to be relaxed is this causal relationship (represented by paths $X_4$, $X_3$, $Y_4$, $Y_3$, and $Z_2$ of Figure 1). While the $X^2$ drops from 1384.10 to 706.25 with this change, the fit index improves to 0.630. The next step is to free those paths representing reverse causality (see paths $X_1$, $X_2$, $Y_1$, $Y_2$, and $Z_1$ of Figure 1). This move changes the fit index by only 0.031. The final step involves allowing the LISREL program to estimate the paths representing synchronous relationships between independent and dependent variables, thereby improving the ‘goodness of fit’ index to a respectable 0.913.

<table>
<thead>
<tr>
<th>Model Specification</th>
<th>Chi-Square/ Degrees of Freedom</th>
<th>Fit Index</th>
<th>$\Delta$ Chi-Square/ Degrees of Freedom</th>
<th>$\Delta$ Fit Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full Null Model (all parameters fixed)</td>
<td>1384.10**/27</td>
<td>0.459</td>
<td>----/--</td>
<td>----</td>
</tr>
<tr>
<td>Free Equity Value $\rightarrow$ Stock Yield</td>
<td>706.25**/20</td>
<td>0.630</td>
<td>677.85/7</td>
<td>0.171</td>
</tr>
<tr>
<td>Free Stock Yield $\rightarrow$ Equity Value</td>
<td>641.60**/14</td>
<td>0.661</td>
<td>64.65/6</td>
<td>0.031</td>
</tr>
<tr>
<td>Free Synchronous Correlations</td>
<td>73.78**/8</td>
<td>0.913</td>
<td>567.82/6</td>
<td>0.252</td>
</tr>
</tbody>
</table>

Chi-Square significant * $\leq$ .05 ** $\leq$ .01
Chi-Square non-significant ns

---

65 Fit indices below 0.90 are generally considered to be unacceptable; in such cases the data do not support the proposed model.
66 The LISREL 'goodness of fit' index is generally regarded as a better measure of overall model specification than is the Chi-square ($X^2$) value.
67 The fully unconstrained model would only be realized by further freeing the stability paths (see paths $X_5$, $Y_5$, $Z_3$, $X_6$, $Y_6$, and $Z_4$ of Figure 1). However, were these additional paths estimated by LISREL the total number of parameters to be estimated would exceed the degrees of freedom, and the model would not be identified (i.e., no unique parameter specification would be possible).
The foregoing analysis has accomplished little more than to demonstrate that improvement in model ‘fit’ is the natural result of reducing the number of constrained parameters. One might be tempted to additionally conclude that causality runs from equity holdings to firm performance, rather than from firm performance to equity holdings, given that the fit index experiences only a modest (0.031) rise when the prior analysis is expanded to include the reverse causality case. However, the appropriate test for reciprocal causality involves comparing the ‘fit’ of two models which differ only with respect to the parameter under consideration—in this case a comparison of the model with paths X4, X3, Y4, Y3, and Z2 of Figure 1 free with the same model with paths X1, X2, Y1, Y2, and Z1 free. The findings of this analysis are presented in Table 5.68

<table>
<thead>
<tr>
<th>Model Specification (Equity Value/Stock Yield)</th>
<th>Chi-Square/ Degrees of Freedom</th>
<th>Fit Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Free Equity Value – &gt; Stock Yield</td>
<td>41.47**/6</td>
<td>0.933</td>
</tr>
<tr>
<td>Free Stock Yield – &gt; Equity Value</td>
<td>9.40*/3</td>
<td>0.983</td>
</tr>
</tbody>
</table>

Chi-Square significant * \( \leq .05 \) ** \( \leq .01 \)
Chi-Square non-significant ns

Both models have significant \( X^2 \) values, while the ‘goodness of fit’ indices are in the same range. No conclusions can be drawn about causal priority based upon this analysis; however, the LISREL analyses presented to this point indicate support for \( H_{1c} \). On this point the correlation analysis is actually more revealing. While LISREL aggregates the impact of managerial stock ownership on stock yield into a single value, and is sensitive enough to detect a moderate effect, the correlation analysis has previously revealed that no consistent pattern of causal relationships

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68 For this and all subsequent LISREL analyses \( \Psi \) matrix parameters were freed as indicated by the ‘maximum modification index’ estimates, accounting for the difference in degrees of freedom between paired causal models.
in fact exists. Absent such statistically significant correlations the structural equation modeling findings here reported must be viewed as tentative.

Analysis of H$_{1d}$ follows that of H$_{1c}$; the only difference between the two hypotheses is that for H$_{1d}$ firm performance is operationalized as earnings per share rather than stock yield. Table 6 reveals that per expectations model fit improves as parameter constraints are relaxed, with the exception that as the possibility of reverse causality is introduced the ‘goodness of fit’ statistic exhibits no change.

<table>
<thead>
<tr>
<th>Model Specification</th>
<th>Chi-Square/ Degrees of Freedom</th>
<th>Fit Index</th>
<th>Δ Chi-Square/ Degrees of Freedom</th>
<th>Δ Fit Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full Null Model (all parameters fixed)</td>
<td>1495.35**/27</td>
<td>0.426</td>
<td>----/--</td>
<td>----</td>
</tr>
<tr>
<td>Free Equity Value $\rightarrow$ EPS</td>
<td>796.10**/20</td>
<td>0.571</td>
<td>699.25/7</td>
<td>0.145</td>
</tr>
<tr>
<td>Free EPS $\rightarrow$ Equity Value</td>
<td>793.27**/14</td>
<td>0.571</td>
<td>2.83/6</td>
<td>0.000</td>
</tr>
<tr>
<td>Free Synchronous Correlations</td>
<td>73.78**/8</td>
<td>0.913</td>
<td>719.49/6</td>
<td>0.342</td>
</tr>
</tbody>
</table>

Chi-Square significant * $\leq$ .05 ** $\leq$ .01
Chi-Square non-significant ns

Once again, however, the test for causal priority demands assessment of the two competing causal models against one other. The results of this analysis can be found in Table 7. Although the data support model fit, in neither case is the $X^2$ statistically significant. This finding is consistent with the cross-lag correlations reported in Figure 5, in which no instances were found in which managerial equity ownership and earnings per share covaried. There need be no equivocation on this point; H$_{1d}$ is rejected.
Table 7
Hypothesis 1d LISREL Causal Priority Results

<table>
<thead>
<tr>
<th>Model Specification</th>
<th>Chi-Square/ Degrees of Freedom</th>
<th>Fit Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Free Equity Value – &gt; EPS</td>
<td>3.82 ns/3</td>
<td>0.993</td>
</tr>
<tr>
<td>Free EPS – &gt; Equity Value</td>
<td>6.26 ns/3</td>
<td>0.989</td>
</tr>
</tbody>
</table>

Chi-Square significant * £ .05 ** £ .01
Chi-Square non-significant ns

H_{2a-d}: CEO Equity Income and Firm Performance

This set of hypotheses has to do with the general thesis that there exists a relationship between the ratio of CEO income derived from corporate equity sources to CEO direct current corporate remuneration and performance of the firm. It is notable that these hypotheses reflect the value of CEO equity holdings relative to CEO salary and bonus structure. Firm performance is alternatively measured as capital yield of the firm’s stock or earnings per share of the firm’s stock. H_{2a-b} imply simple correlations between independent and dependent measures, while H_{2c-d} argue the stronger condition that the ratio of CEO equity income to current compensation is at least in part a cause of favorable firm performance. The statistical results associated with analysis of each of these hypotheses are now presented.

Correlational Analysis

As with the previous set of hypotheses, the first concern is to assess the stability of measures over time. The independent variable within H_{2a-b} is the quotient of equity-derived income and salary plus bonuses. Equity income is comprised of a fairly volatile component—capital appreciation of stock holdings—and a very stable factor—dividends paid. Since the effect of
dividends on total equity-related income is routinely overshadowed by the market effects of share price, one could well expect equity income to be a fairly unstable measure over time. A similar argument could be made for current compensation: bonuses—typically the ‘lion’s share’ of total compensation—tend to be fairly volatile, while salary is subject to little variation, suggesting the measure as a whole is somewhat unstable. When these two unstable measures are conjoined into a single ratio, there is little reason to expect the ratio of CEO income derived from corporate equity sources to CEO direct current corporate remuneration to hold constant over time. Paths $X_5$, $Y_5$, and $Z_3$ of Figure 6 confirm this suspicion, with only the autocorrelation between the last two time periods suggesting stability in the CEO income ratio. As argued with reference to $H_{1a}$, correlations represented by paths $X_6$, $Y_6$, and $Z_4$ reveal instability in capital yield of the firm’s stock.

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69 While the autocorrelation along path $X_6$ is statistically significant, it is also a negative correlation, suggesting a high level of instability in this measure.
Figure 6 also reports the synchronous correlations between measures, giving the suggestion of a strong relationship between independent and dependent variables in three of the four time periods. However, one must recall that the independent variable (ratio of equity income to salary) is in part a function of the dependent variable (stock yield): the equity-related income component (numerator) of the revenue ratio is the product of CEO shares held and the difference between beginning and ending stock price for the year holdings are reported, plus dividends paid. The apparent intra-time period association of these factors is therefore likely to be a statistical artifact rather than a reflection of an underlying structural relationship between the two variables.

Figure 7
Hypothesis 2a Cross-lag Correlations

Paths X4, X3, Y4, Y3, and Z2 of Figure 7 depict the lag correlations for H2a, while reverse lagged relationships are indicated by paths X1, X2, Y1, Y2, and Z1. Given that only two of the ten lag
correlations are statistically significant, no consistent lagged relationship between the independent and dependent variables can be concluded. It is on this basis that H$_{2a}$ is rejected.

H$_{2b}$ and H$_{2a}$ are distinct only in the way in which firm performance is operationalized. As reported in Figure 8, the autocorrelations for H$_{2b}$ provide us with no new information: the instability of the income ratio has previously been reported with respect to analysis of H$_{2a}$, while consideration of H$_{1b}$ revealed temporal consistency in the accounting measure of earnings per share. Synchronous correlations in all time periods approach zero, and are statistically non-significant. Figure 9 reveals absolutely no statistically significant lagged correlations between the CEO equity income ratio and earnings per share, leading to the rejection of H$_{2b}$.

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**Figure 8**

*Hypothesis 2b Synchronous Correlations and Autocorrelations*

<table>
<thead>
<tr>
<th>Correlation</th>
<th>Significance</th>
</tr>
</thead>
<tbody>
<tr>
<td>X5: -.16*</td>
<td>* .05</td>
</tr>
<tr>
<td>Y5: .14</td>
<td>.00</td>
</tr>
<tr>
<td>Z3: .91**</td>
<td>** .01</td>
</tr>
<tr>
<td>X6: .13</td>
<td>* .05</td>
</tr>
<tr>
<td>Y6: .44**</td>
<td>** .01</td>
</tr>
<tr>
<td>Z4: .51**</td>
<td>** .01</td>
</tr>
</tbody>
</table>

---

*Correlation significant * .05 ** .01
*Correlation non-significant*
Causal Analysis

It is worth here repeating the caveat that LISREL analysis can not appropriately be employed to test for causal relationships in cases where simple correlations have not been discovered. The only justification for proceeding with latent variable modeling is to undertake validation of earlier findings.

H₂c argues for a causal relationship between the ratio of CEO income derived from corporate equity sources to CEO direct current corporate remuneration and stock yield. Table 8 presents the findings of this analysis. Consideration of the null model reveals a ‘goodness of fit’ of only 0.573. Iteratively easing parameter constraints results in ultimate improvement of model fit to an acceptable 0.988.
### Table 8
**Hypothesis 2c LISREL Results**

<table>
<thead>
<tr>
<th>Model Specification</th>
<th>Chi-Square/ Degrees of Freedom</th>
<th>Fit Index</th>
<th>Δ Chi-Square/ Degrees of Freedom</th>
<th>Δ Fit Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full Null Model (all parameters fixed)</td>
<td>1243.00**/27</td>
<td>0.573</td>
<td>----/--</td>
<td>----</td>
</tr>
<tr>
<td>Free Equity Ratio → Stock Yield</td>
<td>919.04**/20</td>
<td>0.692</td>
<td>323.96/7</td>
<td>0.119</td>
</tr>
<tr>
<td>Free Stock Yield → Equity Ratio</td>
<td>884.75**/14</td>
<td>0.700</td>
<td>34.29/6</td>
<td>0.008</td>
</tr>
<tr>
<td>Free Synchronous Correlations</td>
<td>48.69**/8</td>
<td>0.938</td>
<td>836.06/6</td>
<td>0.238</td>
</tr>
</tbody>
</table>

Chi-Square significant * Ł .05 ** Ł .01
Chi-Square non-significant ns

Once again it is necessary to test for causal priority by comparing two models which differ only with respect to those paths representing opposing causal directionality. As Table 9 reveals, the $\chi^2$ for each of the two models is statistically significant, with the fit indices substantially the same—indicating support for both causal models. While it would be fair to accept $H_{2c}$ on the basis of the LISREL analysis, it will be recalled that only two of the cross-lag correlations—one representing an effect from equity ratio to stock yield, and one an effect from stock yield to equity ratio—were statistically significant, indicating no evidence of a consistent longitudinal causal effect.

### Table 9
**Hypothesis 2c LISREL Causal Priority Results**

<table>
<thead>
<tr>
<th>Model Specification</th>
<th>Chi-Square/ Degrees of Freedom</th>
<th>Fit Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Free Equity Ratio → Stock Yield</td>
<td>30.75**/6</td>
<td>0.948</td>
</tr>
<tr>
<td>Free Stock Yield → Equity Ratio</td>
<td>24.11**/4</td>
<td>0.955</td>
</tr>
</tbody>
</table>

Chi-Square significant * Ł .05 ** Ł .01
Chi-Square non-significant ns
In Tables 10 and 11 the findings relating to H2d are reported. These findings are entirely consistent with the cross-lag correlations reported in Figure 9, in which no statistically significant relationship between equity income ratio and earnings per share was discovered. Although the data fit the hypothesized causal model, the lack of \( \chi^2 \) statistical significance allows for no other conclusion than rejection of H2d.

### Table 10

**Hypothesis 2d LISREL Results**

<table>
<thead>
<tr>
<th>Model Specification (Equity Income Ratio/EPS)</th>
<th>Chi-Square/ Degrees of Freedom</th>
<th>Fit Index</th>
<th>( \Delta ) Chi-Square/ Degrees of Freedom</th>
<th>( \Delta ) Fit Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full Null Model (all parameters fixed)</td>
<td>1419.69**/27</td>
<td>0.508</td>
<td>--/-/--</td>
<td>---</td>
</tr>
<tr>
<td>Free Equity Ratio -&gt; EPS</td>
<td>1094.88**/20</td>
<td>0.595</td>
<td>324.81/7</td>
<td>0.087</td>
</tr>
<tr>
<td>Free EPS -&gt; Equity Ratio</td>
<td>1091.17**/14</td>
<td>0.596</td>
<td>3.71/6</td>
<td>0.001</td>
</tr>
<tr>
<td>Free Synchronous Correlations</td>
<td>8.94 ns/8</td>
<td>0.988</td>
<td>1082.23/6</td>
<td>0.392</td>
</tr>
</tbody>
</table>

Chi-Square significant * \( \leq .05 \) ** \( \leq .01 \)
Chi-Square non-significant ns

### Table 11

**Hypothesis 2d LISREL Causal Priority Results**

<table>
<thead>
<tr>
<th>Model Specification (Equity Income Ratio/EPS)</th>
<th>Chi-Square/ Degrees of Freedom</th>
<th>Fit Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Free Equity Ratio -&gt; EPS</td>
<td>2.35 ns/3</td>
<td>0.996</td>
</tr>
<tr>
<td>Free EPS -&gt; Equity Ratio</td>
<td>8.55 ns/4</td>
<td>0.984</td>
</tr>
</tbody>
</table>

Chi-Square significant * \( \leq .05 \) ** \( \leq .01 \)
Chi-Square non-significant ns
H₃ₐ-b: CEO Equity Holdings, Ownership Diffusion and Firm Performance

The final set of hypotheses argue that the relationship between *managerial ownership* and *firm performance* is moderated by the extent of *ownership diffusion*. The expectation is that managerial equity ownership will have a stronger effect in those corporations characterized by more diffuse ownership. The closing pair of hypotheses ensue from application of this contingency argument.

**Regression Analysis**

H₃ₐ and H₃ₐ differ only in the way in which firm performance is operationalized. Table 12 presents the analytic findings for H₃ₐ, with stock yield serving as the dependent variable. The first stage of this analysis involved entering *market value of the CEO’s equity interest in the firm* and the measure of *ownership diffusion* within the regression model, using *capital yield of the firm’s stock* as the dependent variable. While the $R^2$ is significant at the .05 level, the coefficient of determination is a modest .045. The *interaction term* was introduced into the regression equation as the second stage of this analysis, with such modification changing the $R^2$ from .045 to .047. While this interactive effect was found to be statistically significant, it can hardly be considered *theoretically* significant: this interaction explains less than one percent of the variation in stock yield. Nonetheless, the findings lend *support* to H₃ₐ—indicating the relationship between managerial equity holdings and stock yield is stronger in those firms characterized by higher levels of ownership diffusion.

---

70 As 5% ownership information was available only for the 1990 time period, analysis of H₃ₐ-b relied upon this year’s data.
In Table 13 are reported the findings of a similar analysis in which *earnings per share* are substituted for stock yield as the dependent variable. Once again *market value of the CEO’s equity interest in the firm and ownership diffusion* were entered in the first stage of the analysis, followed by the *interaction term* on stage two. In all cases effects were statistically non-significant, leading to rejection of H3b.
CHAPTER 5: DISCUSSION AND CONCLUSIONS

Discussion of Findings

The current analysis has uncovered only a modest relationship between managerial equity holdings and firm performance, with no consistency in the lagged effect. The explained variance in the performance measures, even where statistically significant, has proven to be so negligible as to be theoretically trivial. Yet each of the foundational theories explicated in the introduction to this research project offered support for the hypotheses which followed. It is worth exploring what retrospective rationalizations might be offered for the weak association between the confluence of ownership and control and firm performance on the basis of managerialism, neo-classical economics, and agency theory.  

The basic trusteeship model, when conjoined with the classical economic assumption that managers plainly represent the interests of the firm’s owners, affords the most austere view of the corporation. The managerial framework modifies this simplistic characterization by acknowledging the existence of seductive incentives impelling managers to breach their trusteeship obligations. Managers face a moral dilemma to the extent that their role as trustees for the interests of enterprise shareholders stands in conflict with their role as beneficiaries of their own trusteeship dispositions. The incentive for managers to breach their fiduciary responsibility to the firm’s owners is presumably diminished to the extent that managers

71 There are no findings within the current analysis which would permit one to conclude which of these ‘stories’—or any others which might be offered—capture the ‘right’ reasons for the lack of model support. The best that can be hoped for is to design further studies which explicitly test the variety of assumptions underlying these models—an issue to be addressed as ‘Future Research Directions’ are considered.
themselves hold an equity stake in this same firm; in such cases simple pragmatism dictates that managers strive to enhance corporate value. And yet the present empirical exploration has found managerial ownership has little effect upon firm performance. How can this be so? The inferential structure of the theoretic argument is flawless; if there is some inconsistency it must therefore have to do with the assumptions inherent within the paradigm. These assumptions each take the form of necessary conditions, the failure of any one of which is sufficient to defeat the logic of the argument.

Perhaps the most basic assumption of managerialism is that fiduciary responsibility is rather easily overridden by managerial self-interest. In its ‘pure’–or normative–form, trusteeship theory holds that managers ought to faithfully discharge their institutional obligations irrespective of the lure of personal material gain. 72 Under such ‘ideal’ conditions managerial equity ownership would be of no consequence, for managerial action would be informed by a moral imperative–and therefore not subject to compromise. Suppose this is descriptively as well as prescriptively true: to the extent that managers take seriously their trusteeship obligations, managerial equity ownership is of little effect–offering one explanation for the weak empirical support of the hypotheses under review.

A second assumption of managerial theory is that absent managerial equity holdings the interests of shareholders/trustors and managers/trustees diverge–a supposition once again premised on the belief that individuals are irretreiveably self-interested. On this view shareholder self-interest

72 A ‘broad’ reading of trusteeship theory would conclude that managers are accountable to the full range of organizational constituencies, not solely to shareholders. Berle and Means (1968) certainly were of this opinion; however, as Stigler and Friedland note,

Berle’s suggestion that the time was ripe to view corporate directors as trustees, not only for stockholders but also for other interested groups such as consumers and laborers, seemed unrealistic.

1983: 242

Current changes in both management theory as well as law would seem to indicate that Berle’s trusteeship claims were not ill-founded; rather, they were merely fifty years ahead of their time.
is manifest in their preference for return on investment, while managers prefer on-the-job consumption. Although theoretically managerial equity holdings would serve to unite the (self-) interests of owners and executives, so too would superordinate goals. It is not at all unreasonable to assume that both shareholders and managers have an interest in the survival of the firm, for if the firm ceases to be a viable organizational entity all stakeholder groups stand to suffer loss.\footnote{Unless, of course, the organization is so undervalued by the market that its asset value is greater than its market value, in which case the shareholders might be better off were the corporation liquidated…} This mutual support for a preeminent goal might well serve to unite the interests of shareholders and managers, obviating the further effect of tying managerial incentives to firm performance—and offering an explanation for the lack of empirical support of the hypotheses herein considered.

Yet another assumption unique to the managerial model is that stock performance is subject to managerial control. It is here worth drawing a distinction between intentions and outcomes. Granting for the moment that managers are willing to suspend their loyalty to shareholders in order to pursue their self-interest and that managerial preferences differ from those of shareholders, one might reasonably conclude that executives holding equity positions in the firms they manage have a strong incentive to seek shareholder wealth maximization. Managerial intentions can be presumed to mirror these incentives. However, one may reasonably lack confidence that such intentions will have any discernible performance effect if the desired outcome is perceived as beyond managerial control. Executives holding substantial ownership positions in the corporations they manage may fully intend to enhance the marketplace value of the firm, but this outcome may be well beyond their control—once again offering a rationalization for the weak explanatory power of this dissertation’s hypotheses.

The neo-classical economic model gives explicit attention to the role of the marketplace in establishing firm value. Rather than assuming that owners and managers are equally competent to achieve favorable organizational performance, neo-classical economists argue that
professional executives bring a level of proficiency to corporate problem-solving which more than offsets the variety of costs associated with acquisition of their expertise. In spite of managerial ‘shirking,’ therefore, “the separation of the ownership and control of a firm may be a good thing for the owners, because non-profit-maximising managers may earn higher profits than would profit-maximisers” (Vickers, 1983: 139).

The hypotheses under review have presumed that managerial equity ownership serves to reduce the incentive for shirking, thereby improving firm performance. However, the neo-classical model further suggests there exists a market for managerial expertise, and that this market operates in accordance with traditional capitalist principles. This free-market perspective implies a pay-for-performance paradigm, with managers who are successful at creating firm value being more highly prized in the labor market than those who fail to enhance organizational performance. Within this schema managers are incentivized to foster value-enhancing projects even absent an ownership position in the firm, offering an alternative explanation for the lack of observed relationship between managerial equity holdings and stock appreciation within the current study.

It has been assumed throughout this analysis that managerial shirking is a highly elastic factor, and one subject to manipulation on a case-by-case basis. Once again neo-classical economics proves instructive on this point. Given the existence of a market for managerial expertise, it is entirely possible that some minimal level of shirking is engaged in by all participants within the labor pool. Such a ‘shirking threshold’ would have no effect on shareholder preferences for managerial competence, as owners would only be able to differentiate among executives on the basis of variance in excess of this base level. Similarly, it is not unreasonable to presume that a ‘shirking ceiling’ exists; beyond this maximally-acceptable level of idling are those executives who have in effect priced themselves out of the market for managerial expertise. To the extent that managerial shirking is relatively inelastic and restricted in range across the executive population, the effectiveness of managerial ownership in reducing shirking—and thereby
Increasing firm performance is diminished. And under such conditions one would expect to find little support for the hypotheses under review.

Williamson extends this line of reasoning to intra-firm considerations by accenting the problem of moral hazard. Executives are presumed to suffer from a bent toward opportunism, with this tendency driving them to give preference to personal rather than corporate gain. Managerial equity holdings serve as both part of the compliance machinery of the firm as well as the policing machinery of the market, restricting the occasion for managerial opportunism—and thus substituting for workplace trust.

The constructs of trust and shirking are inversely related: the more ‘trustworthy’ the manager, the less shirking occurs. The arguments offered with respect to neo-classical economics therefore apply to agency theory as well: not only does the market penalize breaches of trust, but this very act of tacit regulation restricts opportunism—and ensures a minimum level of ‘trustworthiness’ among managers. Under such conditions managerial equity holdings would be—contrary to the prediction of the hypotheses under review—of little effect.

The foregoing retrospective reason-giving has accomplished little more than to demonstrate the resilience of managerialism, neo-classical economics, and agency theory. Modification of the basic assumptions undergirding each model allows one to give a reasoned account of this dissertation’s findings, while concurrently preserving the underlying logic of each theoretic system. But what does this exercise allow us to conclude about the predictive merit of these competing paradigms? After all, Popper has already demonstrated that ‘good’ theory is characterized by the possibility of falsification, which presupposes that such theories “can be submitted to severe critical tests” (1965: 115). The severity of critical tests is premised upon the hypothetico-deductive conviction that observation is the final arbitrator among rival explanations.
The inescapable conclusion is that *to the extent any given theory is able to rationalize contradictory findings it fails to qualify as ‘good’ theory.*

The attempt to reinterpret the logic of this investigation’s hypotheses in light of both the data as well as the speculations of managerialism, neo-classical economics, and agency theory reveals that each of these theory bases fails to advance a complete account of managerial action. Each model’s simplifying assumptions allow for a great degree of latitude in the evaluation of findings.74 A review of the rationalizations employed to ‘make sense’ of the reported results indicates all have to do with the issue of human nature in general, and managerial motivation in particular. Appropriating the reasoning of classical economics, managerialism, neo-classical economics, and agency theory presuppose that managers are solely motivated by self-interest.75 More particularly, these models hold to the radical-behaviorist tenet that human conduct is strictly a function of behavioral consequences. Yet the behaviorist proposition does not support the deduction that economic outcomes are the only rewards which serve to motivate managers:

What kinds of environmental events count as rewards and punishments? Here is a major parallel between behavior theory and economics. Economics makes no distinction between needs and wants; it has no theory of value. Individual desires will be particular and idiosyncratic, and all one can say is that people will always want something and will act in such a way as to maximize want satisfaction. So it is with rewards and punishments. Behavior theorists spent many years trying to identify some property that all rewards had in common—trying to develop a theory of value based on the biological needs of an organism. All such attempts failed.

Schwartz, 1986: 128

The findings of the current inquiry provide some evidence that managerial equity holdings motivate managers to act in sympathy with the goal of the firm’s owners.76 The work of those in

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74 One might even question whether or not firm performance is at issue. The ‘efficient market’ assumption relied on by each of these theories requires the presupposition that the most efficacious structural arrangements have quite naturally emerged; therefore, all that such theories actually offer is a rationale for the diversity of organizational forms observed in the real world.

75 This premise has increasingly fallen into disfavor; consider, for example, the host of facts and observations contradicting the assumption that individuals are exclusively self-interested offered by Mansbridge (1990), a political scientist and sociologist, and Thaler (1991), an economist.

76 It would be a mistake to presume that stockholders share a singular goal. While the majority of shareholders are presumed to view their shareholdings purely in investment terms, any individual
the field of organizational behavior is of much help in developing a more comprehensive explication of managerial motivation. One particular model, expectancy theory, reduces the complexity of managerial motivation to three factors: expectancy, instrumentality, and valence (see, e.g., Campbell et al., 1970; Galbraith & Cummings, 1967; Graen, 1969; Porter & Lawler, 1968; and Vroom, 1964).\(^77\) Definitionally, expectancy is the expectation that effort will lead to performance, instrumentality is the belief that performance will lead to rewards, while valence refers to the value the individual places upon the available rewards. Steers notes that "these three variables are believed to influence…motivational level in a multiplicative fashion...[h]ence, for [a manager] to be highly motivated, all three factors must be high" (1984, 178).

Projections regarding the firm performance effects of managerial equity holdings become imminently more intelligible in light of expectancy theory. Rather than assuming that managerial equity holdings will spontaneously spur managers to increase share value, expectancy theory allows for independent examination of the elements of the managerial motivational “blueprint.” By definition manager-owners experience high instrumentality, for success in elevating share price has a direct and personal benefit. Valence is presumed to be high due to individual manager-owner’s preference for wealth; however, it should be recognized that preference structures can vary dramatically across organizational participants:

There is still room for doubt about the relevance of behavior theory principles, even in the face of successful applications [to economics]. The ubiquitous feature of human life is choice. The issue for people is not whether to engage in some operant for reinforcement. The issue is which operant, for which reinforcement. When the economist discusses “rational economic man,” he is discussing how people choose to allocate limited resources [including their effort and expertise] among available alternatives. He is discussing how people choose among different bundles of commodities so as to maximize preference. Choice is what economic behavior is about.

Schwartz, 1986: 133

\(^{77}\) Steers further notes that “in addition to motivation, at least three ingredients are involved [in influencing performance]: 1) abilities and traits; 2) role clarity and acceptance; and 3) opportunity to perform (Porter and Lawler, 1968; Campbell and Pritchard, 1976)” (1984: 179).
But what of *expectancy*? To the extent that managers view manipulation of share price as being beyond their personal control, expectancy necessarily approaches zero. And given that motivation is a multiplicative function of, among other factors, expectancy, the syllogistic conclusion is that managerial motivation to enhance share price approaches zero as well—even if instrumentality and valence take their highest values.

While Williamson (1964) was instrumental in extending the reasoning of neo-classical economics to the *firm* level, managerial models fail to give an adequate account of the relationship between *individual* motivation and firm performance. The simple yet profound recognition that managers’ preferences might differ from those of shareholders has done much to advance our understanding of *organizational theory* in general and *corporate governance* in particular. Yet attempting to develop a *full* account of firm behavior by merely conjoining this revelation with the assumptions of classical economics is wrongheaded. Managerial motivation is not only complex, it is subject to empirical examination. Simplifying assumptions concerning the motivational nature of persons allows managerialism, neo-classical economics, and agency theory to be *parsimonious* in every sense of that word—78—but only at the expense of *relevance*.

This conclusion is consistent with the more general observation that neo-classical models of the firm presume corporate activity can be explained solely on the basis of exogenous market forces. In the field of law this has generally meant managers are ‘held harmless’ for actions taken on behalf of the firm.79 Not a few corporate social responsibility theorists argue for firm accountability on the basis of the public complexion of the business enterprise, while ignoring personal ethics altogether. The notion that *individuals* provide the impetus for *corporate* action is banished from all such perspectives. Yet differences in individual managerial characteristics—

78 “…sparing or frugal, esp. to excess [emphasis added]” (The Random House College Dictionary [*Revised edition*]).

79 Unless, of course, such managers have exceeded their agency capacity or have performed acts for which they can be held personally criminally liable.
whether they be personal abilities and traits, or personal motivation, or personal moral constitution—might well explain much of the variance in firm performance.

Organizational rationality therefore is some result of (1) constraints which the organization must face, (2) contingencies which the organization must meet, and (3) variables which the organization can control...

Our basic formulation is that human action emerges from the interaction of (1) the individual, who brings aspirations, standards, and knowledge or beliefs about causation; and (2) the situation, which presents opportunities and constraints. Thompson, 1967: 24, 101-2

This line of thought will be explored in greater depth as consideration turns to the place of moral deliberation in organizational life in the final section of this dissertation.

**Future Research Directions**

The proposals for future research which follow take three conformations. The first charge is to consider the variety of ways in which the present analysis might be strengthened operationally. Emphasis is here given to the objective of improving construct measurement. The second charter involves cultivating a more refined theory of the firm. To this end explicit tests of the assumptions pertaining to the current inquiry are incorporated within the neo-classical perspective. The third commission spotlights the role of the corporation as social institution, employing the stakeholder model to qualitatively elucidate a spectrum of non-economic ‘measures’ of firm performance.

**Construct Measurement**

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80 While this might seem an ill-advised undertaking in light of the theoretic shortcomings outlined above, recommendations will be applicable to a variety of conjectural frameworks.
Construct operationalization is one arena in which a great deal of controversy has surfaced. Leech (1987a), Fombrun (1984), and Shleifer et al. (1986) have addressed the challenge of measuring *ownership*, while Dye (1985), French (1987), Hall (1985), and Easterbrook et al. (1983) have considered the issue of *control*. Lewellen and Huntsman (1970) and Gottlieb (1989) contrast the variety of ways in which the relative effect of managerial salary and equity *compensation* can be determined. Krause’s (1988) discussion of the divergent results one might achieve if using accounting-determined rather than market-determined *performance* measures is instructive. It is possible that reexamination of the share-price effects of managerial equity holdings employing construct operationalizations of greater empirical relevance would help reconcile the contradictory findings reported within these studies.

Ownership

Societal currents today are resulting in the amalgamation of firm ownership in fewer and fewer hands—quite the opposite of the forces evident in the 1930s as Berle and Means were drafting their original edition of *The Modern Corporation and Private Property*. Given such recent widespread changes favoring more *concentrated* ownership, empirical research opportunities into the managerial thesis exist on a scale unimaginable to Berle and Means (1968). The direction for further investigation into the proposition that consolidated ownership leads to increased firm *performance* is clear: studies designed to test for performance differences between that set of firms distinguished by the fact that their stock is relatively closely held and those firms characterized by ownership diffusion are replete with promise. One might well wonder if the ‘agency problem’—if it indeed exists—will resolve itself as systemic changes promote an increase in focused, rather than diffused, ownership.

The arena of *institutional investment* is one such area offering fertile ground for further testing of the separation hypothesis. Recent estimates place the value of institutional investment at
approximately sixty per cent of the worth of all outstanding stock. A mature argument could be made that such investment represents not only highly concentrated corporate ownership but a tremendous pool of latent organizational control as well. Pass and Witt are among those suggesting institutional ownership results in the convergence of ownership and control—an imminently testable hypothesis—although these same authors caution that “financial institutions themselves are largely management-controlled,” and therefore subject to the same breaches of managerial trust as the companies in which ownership positions are held (1985: 67).

One particular type of institutional investor, the employee stock ownership plan (ESOP), has captured the imagination of organizational theorists and neo-classical economists alike. There could hardly be conceived a more effective means of uniting ownership and control than through worker equity holdings. While seductive in theory,

> [t]he assumption underlying such a view is that employee-owners control the ESOP. This is not, however, the norm. As a company perk, in some instances ESOPs fall under the direct purview of management—although more often employee ESOP shares are held in trust for employees until programmed dispersal dates (with trustees frequently appointed by management). Even under the most common scenario, in which banks fulfill the trusteeship function, corporate executives may have ‘real’ control “[b]ecause banks are dependent on management in all aspects of such plans, the ES[O]P strengthens management control” (Dye 1985). Finally, standstill agreements in which large block stockholders agree to vote with management for some period of time may have been put in place at the occasion of ESOP inception—again effectually transferring ownership control of the corporation to management.

Dunn, 1989: 32

The managerial argument that companies having a significant share of their outstanding stock held by employees should outperform corporations operating under conditions of ownership diffusion needs to be tempered by the awareness that executives may exercise effective control of ESOP share-voting rights. Additionally, it must be remembered that even if employees are found to be in control of the ESOP they might prefer on-the-job consumption to return-on-equity, perhaps in part accounting for Conte and Svejnar’s (1988) finding that moderate amounts of indirect worker ownership have a positive effect upon productivity, while direct worker ownership
has a *negative* effect. Russell is unwilling to concede that worker equity has any outcome beyond generating higher levels of organizational commitment: “…the chief contribution of employee ownership is that it makes employees less likely to depart from the firm, and encourages them instead to spend their entire careers in the same organization” (1985: 231).

*Management buy-outs* have been suggested as yet another means whereby corporate ownership and control coalesce—in this case in the hands of management (Green, 1988). In such situations executive ownership is hypothesized to lead to organizational effectiveness due to, among other things, the operation of managerial self-interest. If the separation thesis is valid, this line of reasoning would suggest that corporations with diffuse ownership which undergo management buy-outs can be expected to become better performers over time. This proposition, very much in the spirit of Berle and Means’ (1968) writings, begs for empirical evaluation. Kim et al.’s (1988) preliminary work suggests that insider ownership *is* a statistically significant variable related to abnormal returns.81

**Control**

The issue of *corporate control* has perhaps been subject to the most restrictive assumptions of any variable within the managerial model. Berle and Means (1968) are unrelenting in their argument that under conditions of ownership diffusion managers exercise practical control of the business enterprise. On the ontological plane, however, Stigler and Friedland point out that “[t]he majority of the voting stock is the ultimate control over a corporation even if that stock is diffused among many owners…so in an ultimate sense ownership and control cannot be separated [emphasis added]” (1983: 248). Dye (1985) similarly makes reference to voting rights as a measure of control. DeAngelo and DeAngelo (1985) suggest generic ownership may not adequately capture the locus of organizational control, noting dual classes of common stock—one

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81 Other writers, rather than focusing on the *performance* effects of management buy-outs, have concerned themselves with *ethical* evaluation of transfers of firm ownership (see, e.g., di Norcia, 1988).
class imbued with voting rights, and the other stripped of these same rights—are not at all uncommon. But even the claim that voting stock represents control, while operationally appealing, does not seem to offer an adequate representation of corporate control.

In recognition of the shortcomings of their previous claims, Stigler and Friedland offer a test of de facto corporate control:

...if the membership of the board of directors changes substantially, normal retirement aside, but the senior officers remain in office, again normal retirement aside, then management is in control. With the reverse pattern, the stock ownership is in control. This test...is probably applicable only in times of serious crisis, but it is usually only in such periods that a major change in policy or personnel is called for.

1983: 248

While this line of reasoning might seem to establish an empirical referent for the control variable, the occasion for observing gross changes in corporate governance is indeed rare—too uncommon to be empirically useful.

The above approaches seek to operationalize the control variable through reference to archival data, emphasizing expediency at the expense of theoretic relevance. An ‘ideal’ research methodology would measure control in a more direct manner. Rather than expressing control as a minimum level of ownership—thereby confusing the control and ownership variables—or making assumptions about who controls the firm under conditions of ownership diffusion, Pitelis suggests control be defined as “the ability to determine broad corporate objectives despite resistance from others” (1986: 72). Application of this rendering within the current research context would likely engage the researcher in an ambitious sociological expedition into the actual power dynamics of the organizations under study. Dye (1985) carries this approach yet one step further through his suggestion that kinship ties, or other ownership networks, need to be identified and evaluated. Such counsel favors qualitative methodologies, a process whose merits will be explored in greater detail in the closing paragraphs of this chapter subdivision.
Compensation

The current research might come under some criticism for not factoring the value of noncash benefits into executive remuneration. In their research Lewellen and Huntsman appraised the worth of the noncash components of managerial earnings, including various deferred and contingent pay schemes—a value they termed “current income equivalent” (1970: 714). Gottlieb anticipates stock options to be a non-trivial portion of executive compensation:

A study by Towers Perrin, a major compensation consulting firm, found that options exercised by CEOs from 40 of America’s largest corporations last year were almost as lucrative as salaries and bonuses combined. The average gain on exercised stock options among these chiefs was $916,936, compared with average salary and bonus totaling $1.2 million. Both forms of compensation increased substantially over 1987: Stock option gains rose 40%, while salaries and bonuses went up 14%...The increase in option gains may just reflect CEOs’ views that the stock market’s strong rise since 1982 hasn’t long to run, so it’s time to exercise options. Or it may embody a healthy trend toward making managers more like owners.

Gottlieb, 1989: 109

While Gottlieb’s characterization of managerial stock option gains as a “healthy trend toward making managers more like owners” is discredited by the findings of the current research project, granting attention to the compensatory nature of stock options is instructive. Future research into the firm performance effects of managerial equity holdings might give explicit consideration to the stock option component of managerial salary. It could be argued that stock options—whether exercised or not—serve to incentive managers to attend to the interests of shareholders, thereby minimizing the effects of the separation of ownership and control.\(^{82}\)

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\(^{82}\) In defense of the current dissertation it should be noted the focus on \textit{actual} ownership, rather than \textit{latent} ownership, is more in keeping with the spirit of Berle and Means’ (1968) original thesis.
The final operationalization challenge has to do with improving the measures of firm performance. While the current inquiry has relied upon both market measures (stock yield) and accounting measures (earnings per share) of firm performance, the managerial thesis is principally concerned with the share price implications of the separation of ownership and control. It is well known, however, that stock value is affected by numerous exogenous forces—not the least of which is the relative riskiness of alternative investments. Krause (1988) has found that computation of a risk-adjusted rate of return improves the predictive merit of those hypotheses designed to test the separation postulate. In summarizing his findings, Krause concludes “the results of the market-determined performance measures provide empirical support for the managerial hypothesis that OC [owner-controlled] firms outperform MC [manager-controlled] firms and that the former are riskier than the latter” (1988: 37). Adjusting performance data for the effects of systematic risk is a recommended approach.

There exists a foundational performance issue, however, which is of paramount importance—a controversy which trivializes the concern over whether accounting or market measures of firm performance bear greater empirical merit. Perrow correctly asserts that “[i]f we define organizations…as intentional human constructions wherein people and groups within and without the organization compete for outputs of interest to them under conditions of unequal power, we have posed the issue of effectiveness quite differently than in the other perspectives [emphasis added]” (1977: 101; as cited in Gaertner & Ramnarayan, 1983: 102). Traditional performance criteria, whether they be market-based or accounting-based, implicitly favor the interests of shareholders relative to all other stakeholder groups. This orthodox view not only fails to

83 Consistent with Berle and Means’ (1968) categorization, Krause split his sample into owner-controlled and manager-controlled firms in a dichotomous manner: “OC [owner-controlled] status was assigned to a firm if the largest shareholder owned 20 percent or more of the voting common stock…[c]onversely, MC [manager-controlled] status was assigned to a firm if no single holding of stock was greater than 5 percent of the outstanding common stock” (1988: 31). The disadvantages of this operationalization have been previously noted. Nonetheless, Krause’s findings that “statistically significant differences between the market-determined returns…of OC [owner-controlled] and MC [manager-controlled] firms…offers support for the [separation] hypothesis…[while] [t]he accounting measures of…return…produced conflicting and inconclusive results [emphasis added]” (1988: 31) are supported by the results of the current inquiry.
adequately account for the differences in outcome preferences across stakeholder groups, but additionally ignores the interdependencies among organizational constituencies. Alternatively, Gaertner and Ramnarayan construct “effectiveness as the ability of an organization to account for its outputs and operations to its various internal and external constituencies,” additionally arguing that “effectiveness in organizations is not a thing, or a goal, or a characteristic of organizational outputs or behaviors, but rather a state of relations within and among relevant constituencies of the organization [emphasis added]” (1983: 97). On this view “effectiveness is not a state but rather a process; it is a characteristic of relations and not outputs; it is negotiated rather than produced [emphasis added]” (Gaertner & Ramnarayan, 1983: 97). This progressive view is mirrored in the writings of Kanter and Brinkerhoff:

...the most interesting sociological problems no longer involve finding universal dimensions for organizational comparison. Rather, the new focus is on (a) how particular measurement systems arise, (b) whose interests they serve, and (c) how (or whether) they function to guide or shape an organization’s activities.

1981: 344

This final point—that measurement standards may lead to changes in organizational practice—relates very specifically to the managerial thesis. The modest contention of the separation literature is that to the extent the preference schedules of owners and managers differ firm performance is eroded. All that is ‘revolutionary’ about the stakeholder model is that it extends this same reasoning to the full spectrum of organizational constituencies. It is therefore suggested future research be committed to assessing the impact of stakeholder preference diversity on firm effectiveness. Such studies would necessarily evaluate performance relative to the preferred organizational outcomes of all relevant stakeholder groups; qualitative research approaches are again recommended as ideal methodological companions to such inquiry.

Tests of Assumptions
Refinement of construct operationalization can be expected to offer only the most marginal of contributions to our understanding of the firm performance effects of ownership diffusion. Substantive concerns focus upon the suppositions underlying the managerial dogma, indicating future research premised upon the mere sharpening of construct measurement is the proverbial ‘straining at the gnat while swallowing the camel.’ Finessing construct measures must give way to explicit tests of these foundational assumptions if our knowledge of the relationship between ownership and control is to be advanced.

One of the premises concealed within the research design itself holds that the relationship between ownership and control is linear. It has been previously noted that Conte and Svejnar’s (1988) findings might be interpreted as approbation of a curvilinear relationship between extent of worker ownership and productivity. Lecraw (1984) offers research of a decidedly different—and refreshing—character. Lecraw's research is based on the experiences of transnational companies operating new business ventures within the ASEAN region. Specifically, he is concerned with the corporation’s ownership interest relative to that of the host government. Most significant is Lecraw's finding that both high and low levels of equity ownership on the part of transnational corporations are associated with high levels of success—suggesting a curvilinear relationship between ownership and performance. Lecraw concludes that a transnational’s control of critical operational variables is directly related to venture survival. Argumentation explicitly hypothesizing curvilinearity between the extent of managerial equity holdings and firm performance would enhance prospective research into the separation thesis.

One recurring theme of the current research has to do with the extent of managerial opportunism. Philosophers and social theorists alike have debated the issue of the nature of persons for literally millennia. Maitland et al. are very much to the point in their contention that “[w]hether

84 ASEAN is an acronym for Association of Southeast Asian Nations, a transnational alliance formed in August of 1967 for the promotion of the mutual interests of the sovereign republics of Brunei, Indonesia, Malaysia, Philippines, Thailand, and Singapore.
Williamson or Ouchi is right or wrong about the extent of opportunism and its obverse, reciprocity, obviously is an empirical question, not one to be settled a priori [emphasis added]” (1985: 64). In many cases the discussion of this dissertation’s findings has turned on the issue of managerial self-interest. Rather than assuming managers are exclusively self-interested, future research would do well to explore this premise in some depth. It is not difficult to conceive of survey research constructed around managerial responses to ‘trusteeship scenarios.’ Were appropriate attention accorded both the content of decisions as well as the processes by which these judgments are formulated, such an approach would bear the potential of providing abundant insight into the seriousness with which executives regard their trusteeship obligations.85

A related theme of such central importance to the managerial thesis that exclusive research attention is deserved is the assumption that manager and owner interests necessarily diverge. Bilimoria notes “[s]everal issues are important in the application of compensation systems to resolve the conflicts of interest between owners and managers,” concluding that “to the extent the board of directors can ensure executives are compensated for performance, non-risk averse behavior, and long term decision making, the compensation package may be considered to be in the best interests of the owners” (1988: 5-6). Yet no indication is given by either Bilimoria or any other researcher that the issue of interest divergence has been the object of empirical inquiry. Recommendations that managerial compensation packages be wholly redesigned to align managerial incentives with owners’ objectives are routine, but even if such ill-founded counsel suffers implementation the expected return to owners is diminished to the extent owner and manager interests are already harmonious.86 There exists a well-developed body of literature surrounding the issue of organizational preferences; it is suggested further research into the separation thesis incorporate exploration into the extent of owner and manager value similarity.

85 While social desirability concerns always accompany research into ‘moral’ phenomenon, this would only be an issue to the extent the objectives of the research were transparent to corporate respondents.
86 There may be any number of reasons for modifying executive compensation packages. All that is here suggested is that if the rationale for such changes includes as a central aim the uniting of owner and manager interests, and thereby the optimization of equity return, empirical evidence justifying such action is lacking.
Even if it is found that manager and owner interests diverge, and that managers are hopelessly self-serving, *corporate governance* oversight might effectively suppress managerial greed. Several writers have offered reasoned empirical extentions to the separation thesis. Fama et al. (1983) attribute the continued existence of those corporations characterized by the separation of ownership from control to the apparatus of the board of directors, suggesting capable board monitoring adequately mediates the conflict between managerial and stockholder interests—thereby engendering success for even those corporations suffering from the ‘agency problem.’ Such an approach would seem consistent with the work of Williamson (1983). However, Williamson—while concuring with Fama et al.’s argument that specialized governance structures arise in response to the efficiency needs of individual organizations—is concerned with their contention that governance structures have reached a high degree of efficaciousness. Klein (1983) offers an even stronger rejoinder to the work of Fama et al. Klein takes the position that agent-managers can be relied upon to shirk their organizational responsibilities, for complete, fully contingent, costlessly enforceable contracts exist only in the economists’ ideal world. Klein lacks any confidence that boards of directors will be able to enforce managerial agency obligations. Klein’s admonition that “…future research should entail a more detailed examination of the particular shirking possibilities and incentives within particular organizations” should not go unheeded (1983: 374). Subsequent hypotheses must capture the differences among existing corporate governance systems, arguing the separation thesis has greater ‘merit’ within those organizations devoid of clear and direct board oversight.

**Qualitative Research**

Quantitatively assessing the degree of watchful care provided by a board of directors is a research challenge likely to prove daunting even for the most radical of empiricists. One alternative is to engage in *qualitative research*. Consideration will now be given to a variety of
variables which may affect the interplay between managerial ownership and firm performance, yet which also seem to defy reasonable quantification.

Aldrich (1979) has applied the evolutionary paradigm to organizational inquiry, suggesting management plays little role in assuring firm survival. While Aldrich’s view is extreme, neoclassical economists have noted that environment may play a role in the altering of agency cost characteristics. Demsetz and Lehn propose “[f]irms that transact in markets characterized by stable prices, stable technology, stable market shares, and so forth are firms in which managerial performance can be monitored at relatively low cost…[i]n less predictable environments, however, managerial behavior simultaneously figures more prominently in a firm’s fortunes and becomes more difficult [and thereby more expensive] to monitor [emphasis added]” (1985: 1159). Empirically evaluating the stability or turbulence of environmental forces is challenging, yet the agency theory arguments are so theoretically compelling on this point that to ignore such background conditions would be irrational. Qualitative appraisal is an option having both theoretic as well as pragmatic appeal. Prospective hypothesization ought to incorporate the moderating effect of environmental stability/turbulence on the expectation of managerial shirking, with research design and methods reflecting qualitative enlightenment.

Qualitative research further allows for exploration of outcomes which, while only obliquely related to corporate performance, hold intrigue for organizational theorists:

For instance, although Snow and Hrebiniak (1980) did not find differences in strategic approaches as a function of environmental uncertainty, it is quite possible that strategic approaches differ by type of control. For example, management-controlled firms may tend toward defensive and reactive strategies, and owner-controlled firms may be analytical and entrepreneurial. Although these points are conjectural, the evidence that type of control has important effects seems very clear…

Gomez-Mejia et al., 1987: 51-70

Ownership design needs to be distinguished as a strategic decision variable in its own rite. While offering forceful economic and social arguments in favor of diffused ownership, Chappell (1986)
notes there is increasing evidence that companies will derive benefits from a positive planning approach to ownership. It may be that a contingency approach to ownership design is called for. In general, focused ownership may lead to increases in firm value—although the evidence on this point is decidedly less than compelling. However, under conditions of ownership/managerial goal congruity, or a high degree of managerial expertise, or to the extent other organizational outcomes are in demand, diffuse ownership may represent the best strategic equity option. Harrigan (1985) offers a first step in this direction: in her work on integration strategies, Harrigan has found that high levels of ownership were associated with competitive strategies based on achieving high market share. While existing strategy typologies hold great intuitive appeal, reliable empirical verification of discrete strategic categories is lacking. Until construct operationalization is refined, qualitative research methodology is the preferred inquiry paradigm for exploration of strategic ownership propositions.

The dominant theme of this discussion of future research directions has been that organizations cannot be well understood in isolation from their social context. Neo-classical economics affords only a limited concept of organizational reality, for “[a]gency theory presents a partial view of the world that, although it is valid, also ignores a good bit of the complexity of organizations… [a]dditional perspectives can help to capture the greater complexity” (Eisenhardt, 1989: 71-2). Most fortuitously we have at our disposal a management framework which adequately captures such organizational intricacy. It is discussion of this stakeholder model which will occupy the remainder of this discussion of future research directions.

The work of Berle and Means called for a radical reevaluation of the role of the corporation in modern society, including assessment of corporations as social institutions:

The organizations which [managers] control have passed far beyond the realm of private enterprise—they have become more nearly social institutions…

It is conceivable,—indeed it seems almost essential if the corporate system is to survive,—that the “control” of the great corporations should develop into a purely
neutral technocracy, balancing a variety of claims by various groups in the
community and assigning to each a portion of the income stream on the basis of
public policy rather than private cupidit.y.

1968: 46, 312

What is unclear is how Berle and Means’ recommendation that the corporation be subject to
political processes serving to determine the distribution of organizational outcomes is to be
evaluated. The theory of stakeholder management would seem to offer a specific forum for
investigating such issues. The challenge facing the creative investigator is to design a research
agenda addressing the role of the modern corporation within its broader societal framework—while
simultaneously not ignoring intra-firm considerations. Although this is an ambitious charge, it
seems the only way to consider what are likely to prove the most meaningful of research
questions. Unfortunately, research questions demanding a ‘macro’ perspective do not lend
themselves well to appraisal within what has proven to be the dominant research paradigm of the
last century.

Deeply held philosophical differences often surface when the suggestion is made that the
corporation is a social as well as an economic institution. Some argumentation, such as that of
Child, has the ring of ‘good’ scientific inquiry: “Where chief executives attach more importance to
external points of reference, namely serving the community…financial performance tends to
suffer [emphasis added]” (1974: 184). Other dialogue, such as that of Johnson, is supported by
the weight of church doctrine: “For those perennially impoverished because of their dispossessed
status (orphans, widow, sojourners), the law demands a sharing in the produce of the land
[emphasis added]” (1981: 92). While it is difficult to reconcile such opposing views, Jones et al.
have outlined a reconceptualization of agency responsibility which is brilliant in both its
comprehensiveness as well as its simplicity:

Stakeholder agency theory can now be simply stated in terms of two rules—a
“boundaries rule” and a “decision rule.”

1. Contracts [both implicit as well as explicit] between managers and various
stakeholder groups result in boundaries to managerial decision making authority; and
2. In decision-making areas where managerial behavior is *not* so circumscribed, *managers will act in their self interest*...

This discussion of the contracting process has highlighted the important differences between the assumptions of agency theory as seen by Financial Economists, and stakeholder agency theory. Because *stakeholder agency theory makes limited assumptions about equilibrium and efficiency in contracting*, contracting processes can be seen as dynamic and subject to power imbalances. These power imbalances result from information asymmetries and differing degrees of diffusion among contracting parties. *This latter set of assumptions better represents the economic realities of modern capitalism and lends richness to the examination of the corporate system* [emphasis added].

While Jones et al. (1989) have been concerned with providing a model possessing *descriptive* merit—something classical economists have failed to do—, their framework is imminently *testable*. The two conditions outlined above give explicit recognition to the fact that even if managers *are* predisposed to act self-interestedly there exist *non-ownership constraints* upon such behavior. And although Jones et al. do not discuss this option, it is nonetheless the case that *managerial values* may themselves result in *implicit contracting obligations*, thereby serving to restrict the exercise of executive self-interest. The stakeholder agency model focuses on both *rights* and *power*, uniting *prescription* and *description* within a single framework. In short, many of the current dissertation’s recommendations for definitive testing of agency model assumptions have been incorporated within this singular model. The stakeholder agency model is recommended as a platform upon which to erect further research projects designed to extend our understanding of the firm performance effects of the separation of ownership and control.

**Conclusion**

And so we reach the end of this journey. It is clear there is much work left to be done if we are to adequately comprehend both the *actual* as well as the *appropriate* role of managerial activity within the modern corporation. The closing to this dissertation will not offer anything by way of summary; all that has gone before can be readily accessed by those interested in specific topical
areas. Preference will here be given to a final discussion of the rightful role of the individual within social systems. The general argument develops along the following lines:

Neither the "legal fiction" view that corporations are amoral, nor the "personhood" view that corporations are moral, offers a sensible account of corporate responsibility. A third alternative supposes that "the rights of organizations such as corporations are derived from, dependent upon, and secondary to, individual rights" (Werhane 1985). The reasoning is straightforward. Because they are rational moral agents, all persons possess a set of primary rights. Because corporations are not moral agents, such rights do not directly apply to them. Even though corporations are not capable of primary (or volitional) action, they nonetheless engage in secondary "actions" when they are moved to perform such "deeds" by corporate decision makers. Attached to the corporation's potential for "action" are derivative rights: "rights that they derive from their capacity to 'perform' secondary actions" (Werhane 1985). One fundamental characteristic of derivative rights is that such rights may not take precedence over individual rights. Corporations are therefore subject to the duty to respect the equal rights of individuals as well as other corporations; this responsibility, however, is in no way premised upon holding the corporation to be a moral entity.

Dunn, 1991: 6

The Enterprise Strategy Perspective

Previous discussion has illuminated the variety of rights conflicts which might exist within the organizational context. Freeman and Gilbert's reconceptualization of the corporation is consistent with the view that individual rights take priority over corporate rights:

...the best possible conception of corporate strategy is one that is based on the rights of individuals...[c]orporations are, in our view, to be seen as mere means toward the accomplishment of human goals. This contrasts sharply with the common view that corporations are ends in themselves, and that individual goals, wants, desires, values and personal projects must be subordinated to those of the corporation.

1988: 8

Under this concept of the corporation the primary rights of individuals are appropriately afforded special status when they conflict with the secondary rights of the corporation. Conflict of a more pragmatic sort has also been examined: the clash of self-interest between shareholders and managers which is hypothesized to occur when corporate ownership is diffuse. Given the prior discussion of rights, this particular conflict can now be recast from the perspective of moral
theory. Shareholders are the bearers of a specific set of property rights, entailing both privileges and responsibilities. Managers are commissioned to represent shareholder interests as they conduct the day-to-day business of operating the corporate enterprise, with the following stipulation: the exercise of shareholder entitlements shall not encroach upon the legitimate claim(s) of other stakeholders. This proviso requires that managers reflect upon the consequences of corporate activity for a variety of organizational constituencies, including a corporation’s employees, customers, suppliers, communities, and governments.

Neo-classical economists have suggested the trusteeship view of moral obligation fails due to breaches of managerial fiduciary responsibility. Extending executive accountability to the full spectrum of stakeholder interests is only likely to amplify the potential for conflicts of interests. The hope has been that resolution of the agency problem might be found with managerial equity ownership—though empirical support for this premise has been less than convincing. Even were executive shareholding to incentive managers to faithfully discharge their fiduciary responsibilities to the firm’s owners, there is no theoretic rationale for anticipating such shareholdings to mitigate the tension between managerial self-interest and non-shareholder interests, including the stakes of employees, customers, suppliers, communities, and governments. Unfortunately, breach of trust lies at the heart of the agency problem— and systemic solutions can hardly be expected to reverse the effects of personal moral failure.

The Role of Moral Reflection in Managerial Life

Those who prefer to conduct inquiry in the relationships among classes, states, and other organizations as such, and without attempts to reduce analysis to the individuals who participate, do not, in my view, pass muster as social scientists in any useful sense of the term [emphasis added].

Buchanan, 1985; as cited in Hirsch et al., 1987: 317
By precluding attention to *non-rational* elements of human behavior, economists leave themselves no mechanism for learning about the crude and messy empirical world that so defies their models...

What is interesting...is the various levels at which economic rationality is purported to show up and what room is left (or not left) for *values* depending on where rationality is placed [emphasis added].

Hirsch et al., 1987: 320, 327

The recommendation has been made that research into the agency problem give explicit consideration to the role of managerial moral predispositions. This is not to suggest, however, that the most fundamental *reason* for focusing on executive values has anything at all to do with the instrumental end of striving to maximize shareholder fortunes. Executive values do play a central role in establishing not only corporate direction but the *means* taken to achieve enterprise *ends*. Although the legal system *may* restrict the legal liability of managers for actions taken on behalf of the corporation,

[...] it would be a gross *error* for manager-agents to presume the corporate institution holds them *morally* as well as *legally harmless* for actions taken on its behalf. And if the corporation is not able to accomplish this stronger commission of moral protection, what rationale might be offered for suggesting that managers neglect their personal ethical ideal in favor of simply seeking to maximize shareholder wealth [emphasis added]?  

Dunn, 1991: 8

By its very form the corporation provides a safeguard for committed executive action. This buffer is, however, curiously flawed. While the corporate shell is generally impervious to *legal* attack, it is not at all successful as a defense against claims for release from personal *moral* culpability. To the extent managers are responsible for corporate action they therefore have an introspective interest in enterprise conduct.

In recognition of the central organizational role played by managerial values, Williamson notes “...modes of organization or practices which would have superior productivity consequences if implemented within, and thus would be adopted by, a group of expected pecuniary gain maximizers, may be *modified* or *rejected* by groups with *different values* [emphasis added]” (1975: 39). Clark gives attention to the role of moral rhetoric in achieving organizational
compliance, suggesting “moral opprobrium seems to attach to misdeeds for which the usual market and legal controls will not provide adequate deterrence” (1985:78). The value of trust may be evidenced within the workplace; one outcome may be that “trust increases economic efficiency, that is the transaction costs associated with an exchange will be much less if the parties trust each other...[t]hus a high-trust culture may ceteris paribus be more efficient in economic terms” (Maitland et al., 1985: 63). The observation that executive values play a central role in managerial decision-making allows for no prescriptive conclusions; it is a well-known tenet of moral philosophy that one cannot derive an ought from an is.

“Utopian thought almost always represents a return to the primitive” (Johnson, 1981: 120). Rather than attempting to derive some notion of managerial rectitude from the claim that ethical behavior leads to preferred organizational outcomes, it is worth simply returning to the fountain of moral philosophy and exploring the appropriate role of reflection in the virtuous life. Williams (1985) is one who supports a non-traditional view of the place and function of moral reflection. Williams’ premise is that philosophy is not distinguished from other human activities due to, as Socrates and Plato would have us believe, its reflective quality. Foundational to his arguments is Williams’ concern “not just to describe how we think about the ethical but to tell us how we should think about it” (1985: 17). Williams’ concern is that the mere act of a moral agent’s thinking about moral dispositions themselves and relating them to a life of well-being necessarily engenders egoism: “[t]he I that stands back in rational reflection from my desires is still the I that has those desires and will, empirically and concretely, act; and it is not, simply by standing back in reflection, converted into a being whose fundamental interest lies in the harmony of all interests” (1985: 69).

This focus on what may be termed the macro-ethical (as opposed to the personal, or micro-ethical) captures much of what Williams (1985) would consider the appropriate role of reflection in the ethical life. Williams notes “difficulties arise from any attempt to see philosophical reflection in ethics as a jump to the universalistic standpoint in search of a justification, which is then brought
back to everyday practice” (1985: 110). But if cognitive rationality fails to provide direction for embracing the moral life, so too does reliance upon mere intuition:

…intuition in ethics, as a faculty, is no more. But intuitions—the beliefs which, when there was supposed to be a faculty, were supposedly given by it—are very much part of the subject. These are spontaneous convictions, moderately reflective but not yet theorized, about the answer to some ethical question…

Williams, 1985: 94

The role of reflection in the formation of ethical theory—“critical reflection that…seeks justificatory reasons”—is critical to Williams’ arguments:

Much explanatory reflection is itself critical, simply in revealing that certain practices or sentiments are not what they are taken to be. This is one of the most effective kinds of critical reflection.

1985: 112

It is clear that Williams’ focus is on identification of collective understanding of morality rather than identification of universal objective ‘truth’:

[R]eflective criticism should basically go in a direction opposite to that encouraged by ethical theory. Theory looks characteristically for considerations that are very general…because it is trying to systemize…But critical reflection should seek for as much shared understanding as it can find on any issue…

Reflection on the excellence of a life does not itself establish the truth of judgments using those concepts or of the agent’s other ethical judgments. Instead it shows that there is good reason…to live a life that involves those concepts and those beliefs [emphasis added].

1985: 116-17, 154

It is here suggested the social-contract theory of organizations be fortified with Williams’ (1985) perspective on moral meditation. Under the conditions of such a reinforcement the appropriate moral role of managers involves promoting reflective equilibrium among the full range of legitimate stakeholder groups. Managerial moral responsibility extends beyond the single-minded pursuit of some personal ethical ideal; as laudable as such an avocation may be, as Williams

87 What is excluded from the purview of ethics on Williams’ view is “reflection that asks for understanding of our motives, psychological or social insight into our ethical practices…” (1985: 112). Williams correctly notes that such a focus upon critical reflection may lead the personal moral agent into a life characterized by ethical indecision—and guilt. The emphasis upon shared ethical theoretic construction, however, may likewise leave such agents with a lingering sense of ill-being.
(1985) has indicated this endeavor is necessarily fraught with self-regard. The manager is called to live a life which is both selfless and reflective.

But not too reflective. While “[p]art of God’s call to us is for us to pay attention to our lives” (Johnson, 1981: 108), Williams maintains that “[a]n effective way for [wrong] actions to be ruled out is that they never come into thought at all, and this is often the best way” (1985: 185). Voltaire (1984) would seem to concur. In closing his most celebrated work, Voltaire pens the following:

“I also know,” said Candide, “that we must cultivate our garden.”
“You’re right,” said Pangloss, “because when man was put in the Garden of Eden, he was put there ‘to dress it and to keep it,’ that is, to work; which proves that man was not born to be idle.”
“Let’s work without theorizing,” said Martin; “it’s the only way to make life bearable” [emphasis added].

1984: 120

Williams “conclusion is that the demands of the modern world on ethical thought are unprecedented, and the ideas of rationality embodied in most contemporary moral philosophy cannot meet them; but some extension of ancient thought, greatly modified, might be able to do so” (1985: vii). But the time has now come for each of us to tend our own garden...

Far beyond this summary, the real revolution of our time is yet faintly perceived...Philosophical preoccupation will become more important than economic. What is this personal life, this individuality, this search for personal development and fulfillment intended to achieve? Mere wallowing in consumption would leave great numbers of people unsatisfied...Is it possible, as Walt Rostow maintains, that the population will merely become bored? Perhaps; but if so, it will be because esthetics, the arts, the endeavor to understand, use and enjoy the meaning, will have tragically lagged far behind economic advance. Not impossibly, the teacher, the artist, the poet and philosopher will set the pace for the next era.

Berle & Means, 1968: xxvii
### APPENDIX A: FINAL SAMPLE

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# APPENDIX B: DESCRIPTIVE STATISTICS

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<td>14,865,670</td>
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<td>Stock yield–Std. deviation</td>
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REFERENCES


NAME: Craig Patrick Dunn

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Society for Business Ethics
The Council on Employee Responsibilities and Rights
World Future Society