Ownership Structure Follows Managerial Strategy: Management Control Revisited

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Abstract: Economics of corporate governance treats the ownership structure of shares as an independent variable. This follows the scheme by Berle and Means (1932) that asserts the fact that the broad dispersion of stock ownership promotes “management control” by managers. However, Chandler’s (1977) review of the cases of the telephone and railways at the time indicate that the arrow of cause and effect for the telephone is pointed in reverse, and the pursuit of a larger scale of capital by outstanding managers leads to a dispersion of stock ownership. In railways, management work was extremely complex, and management was left to managers since specialized skills and training were required. In other words, ownership structure was not an independent variable for the separation of ownership and control. In actuality, salaried managers acquired power in Japan’s zaibatsu, which had no dispersion of ownership, at the time.

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Introduction

Economists conceive corporate governance as questioning the method of setting up a system that guarantees funders enough profits for their funding in terms of the conflict of interest between funders and managers (Hanazaki & Teranishi, 2003, Preface). This can be stated differently as “disciplining managers to ensure that shareholder profit is an important objective” (Osano, 2001, p. 11). Immense literature in economics has focused on the impact of ownership structure of corporate shares on management behavior and corporate performance. For example, among major companies in Japan’s manufacturing industry, some studies have noted the positive influence that insider ownership has on corporate performance (Lichtenberg & Pushner, 1994). Further, the negative influence on performance, when the shareholding ratio of financial institutions is low, shifts to a positive influence when the shareholding ratio is high (Morck, Nakamura, & Shivdasani, 2000).

However, is ownership structure such a decisive independent variable? Research on ownership structure and disciplining managers directs us to the studies of legal scholar Adolf A. Berle, Jr. and economist Gardiner C. Means, with Berle and Means (1932) using US data from the end of the 1920s to note the separation of ownership and control in major corporations. The reason for this separation was explained as the broad dispersion of stock ownership. This idea is handed down as it is to the current economics research, but is it true?
Separation of Ownership and Control

Institutionally, managerial decision-making is influenced by the demands, opinions, advice, and objections of powerful owners, or rather, major shareholders. However, Berle and Means (1932, pp. 69–90) thought that different circumstances manifest themselves when companies grow in scale and capital and progress through the following stages.

Stage 1 (private ownership and control): companies begin on a small scale and have individual shareholders who are able to provide all or most of the required capital. These are categorized under “private ownership and control” if the ownership ratio is 80% or more.

Stage 2 (majority control): as capital grows progressively larger, it becomes difficult for individuals to provide all the necessary capital, and thus, owners turn to others as shareholders that provide capital. The company then procures capital as required. If there is a large shareholder with more than half of the shares, that majority shareholder acquires control.

Stage 3 (minority control): when the capital requirements of a company become greater, there are more shares, as well as a greater dispersion of stock ownership. Thus, even the largest shareholders are relegated to minority shareholder status with ownership of less than 50% of the company shares. Minority parties that have gained sufficient power of proxy from other shareholders are able to control the company. In this category, the largest shareholders may have more than 20% of the company shares.

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1 This paper references “Book 1” of Berle and Means (1932). They follow Means (1931a) and Means (1931b) in “Book 1,” and more precisely, this paper references the study provided by Means (Takahashi, 2016b).
Stage 4 (management control): as the shareholder ratio of the largest shareholders becomes extremely small, the shareholders cannot dismiss managers unless the company falls into a crisis state, and the managers then become self-perpetuating.

Berle and Means (1932) noted that, as the dispersion of stock ownership in major US companies progresses, a new situation is created wherein “there are no dominant owners, and control is maintained in large measure apart from ownership” (Berle & Means, 1932, p. 117). This situation is termed as the “separation of ownership and control”.

Berle and Means (1932, Book 1, chap. 5), an expanded edition of Means (1931b), analyzed this state of separation of ownership and control in 1930 through the following steps (a) and (b).

(a) The largest 200 non-financial companies in the US (as of January 1, 1930) were categorized and summarized in 11 tables (Berle & Means, 1932, pp. 95–114) as Table 12 (A)–(K).
(b) Based on Table 12 (A)–(K), the type of immediate control of each company was surveyed. Each company in Table 12 (I), (E), and (F) had controlling companies above it, the company in question was equally divided by the control types of the controlling companies, included in the type of ultimate control in each category, and totaled.

When categorizing 200 companies into Table 12 (A)–(K) in step (a), it must be noted that in Table 12 (G) “management control” was not a category defined by the shareholder ratio of the largest shareholder but was originally a qualitative classification. This exhibits a striking contrast to the categorization by shareholder ratio of the largest shareholders for (A) “private ownership and control,” (B) “control by majority ownership,” and (D) “minority control through ownership of an important minority block of stock.” After the qualitative
classification of Table 12 (G) into “management control,” Berle and Means (1932) stated that “it is notable that in none of the companies classed under management control was the dominant stock interest known to be greater than 5 per cent of the voting stock” (Berle & Means, 1932, p. 93). As a result, when the shareholder ratio of the largest shareholder is between 5% and 20%, the company is categorized as “joint minority–management control by the minority owners and managers” in Table 12 (F).

Apart from these, (C) “control by a legal device” would be, for example, pyramiding, whereby Company X has control of another Company Y (subsidiary) by owning majority shares and Company Y is made to own majority shares of another Company Z (the subsidiary’s subsidiary), resulting in Company X then having control of Company Z, and so forth. At the time, the Van Sweringen brothers (Oris Paxton and Mantis James Van Sweringen) used pyramiding to successfully and practically control a major railroad network across the entire American continent with an asset value of more than two billion dollars, using an investment of less than 20 million dollars in shares of a company at the top of the controlling pyramid.

Two hundred companies were categorized through these categorization procedures. The companies whose type of ultimate control of the controlling company was classified into “management control” rose to 44.25% of all companies, with assets of 58.11% (Berle & Means, 1932, p. 115, Table 13). Berle and Means (1932) termed management control and control by a legal device as “separation of ownership and control” and subsequently combined the percentage of companies totaling 64.75% and the accumulated assets totaling 79.78%.

The Visible Hand

With these figures, Berle and Means (1932) emphasized that, by
the end of the 1920s, separation of ownership and control in the US had progressed such that the phenomenon of management control had also advanced. As if in response to Berle and Means (1932), business historian Alfred D. Chandler, Jr. provided case studies focusing on the period of time from the 1840s to the 1920s. The picture portrayed by Chandler (1977) was evidently different than that outlined by Berle and Means (1932).

**Telephone**

The case of AT&T (American Telephone and Telegraph) is particularly impressive (Chandler, 1977, pp. 200–203). Alexander Graham Bell invented the telephone in 1876, and Theodore N. Vail joined the Bell Company in 1878 as a manager. Vail began as a telegraph operator in the Mail Service in 1868, though he was successful in improving mail operations and delivery plans; these accomplishments provided him with a bright career, ensuring that he became the General Superintendent of the United States Rail Mail Service at the age of thirty. Vail emphasized the construction of direct long-distance lines between local telephone companies, the maintenance of holding shares of the main operating companies lending telephones and exchange equipment, and the increasing investment into providing regional telephone services faster than anyone else at the time. However, capitalists satisfied with profits at the time opposed Vail’s ideas, arguing that the costs would decrease dividends and endanger their own control of the company. Vail was disheartened and he submitted his letter of resignation in 1885. But company directors retained him as the president of AT&T, which was created as a new company with the purpose of constructing long-distance lines. However, Vail did resign when, in another two years, the first long-distance lines were completed.

After all, Vail’s assertions were correct. In the 1890s, when basic Bell patents expired, the number of independent short-distance lines
companies began to increase. However, American Bell had control of direct long-distance lines; this allowed them to suppress the growth of new companies.

In 1902, Vail returned to the company as a director, and in that same year, directors allowed the increase of 50,000 shares and 7.7 million dollars of capital. In 1906, at Vail’s suggestion, the company decided to issue 100 million dollars’ worth of convertible bonds, and Vail again became president in 1907. The number of AT&T shareholders grew dramatically from only 10,000 in 1901. Berle and Means (1932, p. 108) categorized AT&T as “management control”, with total assets of 4.284 billion dollars, 469,801 shareholders, and the largest shareholders being corporate, with a shareholder ratio of only 0.6%. This is exactly what they term as a broad dispersion of stock ownership. In actuality, Berle and Means (1932) gave AT&T as a typical example of dispersion of stock ownership in Chart 1 (Berle & Means, p. 54) and Table 7 (Berle & Means, p. 55).

However, in case of Vail, managers did not appear in a company with greater dispersion of stock ownership, but rather, the arrow of cause and effect was most certainly in reverse. Vail, a manager who was once dismissed by capitalists opposed to greater capital and dispersion of stock ownership, returned to the company in 1902, and thereafter drove for greater capital, which resulted in a dispersion of stock ownership. In other words, managers such as Vail pursued a larger company size and greater capital as a managerial strategy, and this resulted in greater dispersion of stock ownership in companies where managers are successful. As demonstrated in Figure 1, the dispersion of stock ownership does not ensure that managers appear on the scene, but rather the arrow of cause and effect is in reverse. This implies that “ownership structure follows managerial strategy.”

Where there are unused start-up expert managerial services because of excess capacity in outstanding managers, the economies of growth are noted by Penrose (1959) (Takahashi, 2015).
managerial strategy,” to apply Chandler’s (1962) famous proposition “structure follows strategy” to the separation of ownership and control.

**Railroads**

Railroad companies were first noted by Chandler (1977) and described in detail in about 20% of the pages of his study (Chandler, 1977, pp. 81–187). Between the latter half of the 1840s to the 1850s, the US saw its first nationwide railroad boom, which allowed, for example, people to travel by railway from New York to Chicago in only two days by 1857. However, the greatest strength of the railroads was not the speed, but rather the high reliability that guaranteed shippers that their deliveries would arrive according to a carefully laid out schedule without being impacted by the weather.

These railroad companies were the first modern enterprise in the US. Managing the railroads to maintain a high level of reliability was an extremely complex task requiring special skills and training, and therefore, shareholders and their representatives were unable to provide such management. These companies were the first to manage numerous personnel and offices spread out over a vast territory. The managers with these specialized skills and training

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**Figure 1.** True causal relationship between the dispersion of stock ownership and management control
created a hierarchical organization for operating railroads and created an organization structure clearly delineating responsibilities, rights, and communication among central/regional headquarters and operating divisions. Roles were outlined in organizational manuals and organization charts.

Forty-two of the 200 companies covered by Berle and Means (1932) were actually railroad companies. Among these were the Alleghany Corporation, created by the Van Sweringen brothers, that stood at the top of the pyramid. Combined with five other railroad companies in that group, six of the 42 companies were controlled by the Van Sweringen brothers, and Berle and Means (1932, pp. 73–75) described Alleghany Corporation in detail as a typical example of pyramiding.

Considering the railroad companies that were under the Alleghany Corporation umbrella, Erie Railway\(^3\) categorized under “minority control” was actually used by Chandler (1977) as an example where managers appeared on the scene, and the company was very frequently referred to.

In particular, Daniel C. McCallum of the Erie Railway was a central figure described by Chandler (1977) as a pioneer of modern management. From the 1850s to the 1860s he was a manager at the Erie Railway, serving as a superintendent and then as a general superintendent of the railroads. He proposed the six basic principles of general administration, cost accounting, and cost management, and garnered a broad interest in these organizational

\(^3\) Chandler (1977) described the company as “the Erie”. Between 1861 and 1878, the company was known as Erie Railway, though from 1878 to 1895, it was known by the name New York, Lake Erie, and Western Railroad, and from 1895 to 1960, it was known as Erie Railroad. In 1960, it merged with another company to become the Erie Lackawanna Railroad; further, that company, which went bankrupt in 1972, was bought by the federal government in 1976, and its railroads were incorporated into Conrail (Consolidated Rail Corporation).
innovations. These principles of general administration were particularly famous. The “Superintendent’s Report” written by McCallum in 1856 is listed in some readings (e.g., Shafritz, Ott, & Jang, 2005) of organizational theory to this day.

At the time, the American Railroad Journal published many articles on McCallum’s organizational innovations, and the journal chief editor even printed McCallum’s organization chart and sold copies for a dollar apiece. It was the chief editor, Henry Varnum Poor, who created the credit rating agency Standard & Poor’s (S&P) and who was also Chandler’s grandfather.

The Erie Railway was subsidized by a Van Sweringen brothers company in the mid-1920s, though the Van Sweringen brothers went bankrupt after the great depression of 1929. The brothers died in 1934 and 1936, several years after the publication of Berle and Means (1932), and their remaining assets at the time were known to be only a few thousand dollars. During that time, management of the railroads was complex enough, despite any major changes in ownership structure to require managers with the necessary specialized skills and training. In fact, strategy and structure follow technology (Takahashi, 2016a). Ownership structure has almost no explanatory power.

**Concluding Remarks**

Berle and Means (1932) asserted that the dispersion of stock ownership was the reason for the appearance of managers on the scene, though counterexamples can be found in Japan’s wealthy cliques known as *zaibatsu* (Takahashi, 2016b). Prior to World War II, Japan’s zaibatsu employed a system termed *soyusei*, wherein one capitalist family provided all the assets. For example, zaibatsu families such as the Mitsui family owned all assets, and though they were able to obtain all the profits, they could not sell off their
Ownership structure follows managerial strategy

assets. Thus, when the future of their companies was in doubt, they were unable to find a means of escape.

Thus, zaibatsu had no dispersion of ownership. Despite this, zaibatsu companies had salaried managers who played very important roles. In the latter part of the Meiji era, it became common to use individuals with professional management skills to manage companies. For example, the Mitsubishi Zaibatsu had Heigoro Shoda (general manager, Mitsubishi Goshi Kaisha) and Taijiro Yoshikawa (president, Nippon Yusen Kabushiki Kaisha) from the Keio Gijuku School; Michinari Suenobu (chairman, Tokio Marine Insurance) and Hakaru Isono (founder, Meidi-Ya Store) of the Imperial University; the Mitsui Zaibatsu had Raita Fujiyama (senior executive director, Oji Paper), Sanji Muto (president, Kanebo), and Osuke Hibi (chairman, Mitsukoshi) of the Keio Gijuku School; and Takuma Dan (office manager, Mitsui Coal Mine) of MIT serving as salaried managers.\(^4\) These managers appeared among zaibatsu using the soyusei in the latter part of the Meiji era despite there being no dispersion of ownership. The assertion of Berle and Means (1932) completely missed the mark for major Japanese companies at that time. Simply put, ownership structure is not an independent variable for separation of ownership and control.

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\(^4\) It should also be noted that these professional managers did not quickly move from one company to another as today’s MBA holders often do. This perhaps had something to do with the competitiveness of Japanese firms (Wada, 2016).
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