Intercorporate Ownership: the 21st Century Revolution

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Introduction

The World entered the 1990s without the division of "East" and "West" which was based on difference of ideologies, political and economic systems. The values of democracy and the market economy principles have become more widely accepted and constitute the basis of social transformation in a large number of countries from different parts of the Globe. The most dramatic reforms are taking place in Central and Eastern Europe (CEE) and the CIS, where they amount to a radical change in the social systems. One of the most important aspects of transformation in this region is the transition from centrally-planned to market-driven economies. The reforming countries share the belief that the market, despite all its deficiencies and failures, is the best known mechanism for efficient resource allocation in the modern industrial economy.

A basic component of any economic system is ownership and the appropriate allocation of private property rights is considered to be one of the major prerequisites for economic efficiency in a market economy. Thus, when developing a market economy system, ownership relations can be regarded as its main building block.

This paper is devoted to one particular form of ownership, which is in congruence with the principles of the market economy, and which, albeit typical for the second largest market economy - Japan, has not been given due attention in discussions and practices of privatization in CEE. It is referred to as inter-market corporate alliance (ICA) in the text that follows.

In this period of rapid change in global socio-economic conditions, and particularly in the process of transformation of Central and Eastern European economies, it is difficult to overestimate the significance of a study considering alternative systems of business organization. The need for such a study stems also from the fact that the emphasis in discussions on privatization and economic restructuring in Central and Eastern Europe (CEE) has usually been put upon arm's length market transactions. The specific conditions in those countries, resulting from more than four decades of central planning, suggest that other, intermediate, forms could be more appropriate.

The exclusive attention given to the introduction of American-type corporate organization reflects the dominance in previous scholarly attempts of "[t]he "traditional" model of American corporate governance", which "presented the Berle-Means corporation-characterized by a separation of ownership and management resulting from the need of growing enterprises for capital and the specialization of management-as the pinnacle in the evolution of organizational forms. Given this model's dominance, the study of comparative corporate governance was peripheral; governance systems differing from the American paradigm were dismissed as mere intermediate steps on the path to perfection, or as evolutionary dead-ends, the neanderthals of corporate governance."[1]

More recent scholarship, as Gilson and Roe point out, challenges the "traditional" view, arguing that national systems of corporate organization are historically and politically contingent, and nothing in the evolutionary process of a particular system assures its productive superiority to systems that evolved under different conditions. This shift in the basic paradigm of American corporate governance theory, combined with "real world competition have obliged business scholarship to focus on comparative corporate governance".[2]

Not surprisingly, American scholars have devoted much attention to business organization in Japan. Different aspects of Japanese business alliances have been discussed in an extensive set of literature. This paper adds a new aspect to the analysis of that type of organization, although not referring directly to concrete Japanese groupings of firms. Based on the study of Japanese horizontal corporate groups, an abstract model of an Inter-market Corporate Alliance (ICA) is presented, which is defined as a new model of corporate ownership, named *inter-corporate*. In this new type of business organization, it is argued, the separation of ownership and control is overcome by merging, through cross share holding among affiliated companies, the positions of stockholder and manager in the form of a Council of ICA firm presidents. Ownership takes on the added features of mutual business interests and, by enhancing information sharing, the firms' abilities for mutual monitoring are improved.

The 20th Century Capitalist Revolution

In analyzing ownership economists have focused on the possession of residual decision rights and the allocation of residual returns.

Residual rights of control give power to make any decisions concerning an asset's use which are not explicitly controlled by law or assigned to someone else by contract. The importance of residual control derives from the impossibility to write and enforce complete contracts and, as a consequence, the cost advantages of leaving all the control rights, that are not otherwise assigned, to a single, distinguished individual.

Contractual incompleteness gives rise also to the notion of residual returns. The owner of an asset is considered to be the residual claimant entitled to all the net income that the asset can be made to produce.

[1] GILSON, Ronald J. and Mark J. ROE. "Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization", *The Yale Law Journal*, Vol. 102, No. 4, January 1993, p. 873.
[2] *Ibid.*, p. 873.

Fama and Jensen also define the ownership relations as including “the contracts that specify (1) the nature of residual claims and (2) the allocation of the steps of the decision process among agents”[3], and consider them central in any organization.

Adolf Berle also asserts that “property, theoretically considered, has two sets of attributes”[4]. In his words, residual control means using property as “a medium for creation and production and development”, and the right to residual returns “offers possibility for reception, enjoyment, and consumption”[5].

In the owner-managed firm the entirety of ownership rights is concentrated in one physical person. “An old fashioned farm or small business property held by a single owner or small group of owners combined both groups of attributes in the same hands. The owner used his property to create, to produce, to improve. In a word, he used it as a capital. He also used it to provide for his needs and for his enjoyment - in other words, for his consumption. Life was all in one piece, and the attributes were intertwined.”[6]

“The twentieth-century corporation has proved to be the great instrumentality by which these two groups of property attributes have been separated one from the other”. It led to a “split of property into its component attributes, assigning the receptive attributes to the group of shareholders, and gathering the creative attributes in a single command”[7]. Thus, in the joint-stock company the functional components of private property rights are allocated among different agents. In a classic book on what is known now as the separation of ownership and control, Berle and Means argued that the rise of the large, diffusely held, professionally managed corporation fundamentally altered the nature of firm ownership. "In terms of relationships, the present situation can be described as including:-(1) "passive property," consisting of a set of relationships between an individual and an enterprise, involving rights of the individual toward the enterprise but almost no effective powers over it; and (2) "active property," consisting of a set of relationships under which an individual or set of individuals hold powers over an enterprise but have almost no duties in respect to it which can be effectively enforced."[8]

Thus, while the “pre-corporate” firm consists of two main subsystems - owner-manager and internal organizational structure, the corporation comprises three: owners (shareholders), top management, and internal operating units. Shareholders and firm management are linked through capital market instruments and, in the traditional approaches to corporations, shareholders’ primary concern is considered to be the short-run profitability of the firm.

In short, the separation of ownership and control in the modern corporation has been regarded as altering the nature of private property, and in the 20th century the corporate form became so widely spread that it “revolutionize[d] national life”[9]. This process was labeled by A. Berle “the 20th century capitalist revolution”.

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[3] FAMA, Eugene F., and JENSEN, Michael C. "Separation of Ownership and Control", Journal of Law and Economics XXVI, June 1983, p. 302.
[4] BERLE, Adolf A. *The Twentieth-Century Capitalist Revolution*. London: Macmillan & Co Ltd, 1955, p. 18-21.
[5] *Ibid*.
[6] *Ibid*.
[7] *Ibid*.
[8] BERLE, Adolf A. and Gardiner C. MEANS. The Modern Corporation and Private Property. New York: The Macmillan Company, 1932, p. 347.
[9] BERLE, *Supra* 4.

Inter-market Corporate Alliances (ICA): A New Type of Ownership?

The twentieth-century corporation has proved to be the great instrumentality by which the rights of residual control and to residual claims have been separated one from the other. It is also among the corporations of the 20th century that a new organizational structure has emerged - the inter-market corporate alliance (ICA), which can be regarded as a "great instrumentality" for new interweaving of the different functional components of ownership.

The prototype of the theoretical model of ICA can be found among Japanese business groupings. Most industrial firms in Japan are affiliated with some enterprise grouping, which can be divided into two broad categories: horizontal and vertical. There are six big horizontal groupings, called *kigyoushuudan*, which play an important part in the Japanese economy - Mitsui, Mitsubishi, Sumitomo, Fuyo, Dai-ichi Kangin, and Sanwa. The first three groupings have direct roots in the pre-war financial empires - "zaibatsu" and they are the ones that can be described as ICA. This type of organization, as Gilson and Roe point out, "reflects not only the need for *corporate governance*, … , but also the need to support production and exchange - what we will call *contractual governance*."[10]

Structure of ICA

The study of Japanese horizontal inter-market enterprise groupings allows to derive the main characteristic features of an ICA.

The basic ***elements*** of ICA should include:

1) large *manufacturing firms* covering wide range of industries. The aim should be to encompass all major industries, but to include preferably no more than one firm of each industry. Such an organization will preclude internal competition, and will ensure conditions for more intensive intragroup transactions;

2) a large *trading company*, which should play a significant part in the organization of inter-firm relations on commodity markets. This will allow to take advantage of trading in large volume and price differentials in different markets. Such companies can invest in the accumulation of foreign market experience and in building their own business networks abroad. They could play the role of an information center by gathering global information, representing their client firms in multilateral negotiations, and by arranging formalities concerning joint projects of alliance companies;

3) financial institutions, with a centrally positioned commercial bank, which is the *"main" bank* for the affiliated companies in the sense that it procures a large portion of firm loans from private financial institutions, and, in most cases, is a major shareholder. The existence of an implicit long-term contract between the main bank and alliance firms is essential for creating greater credibility and readiness among other banks and financial institutions to extend credits to affiliated firms. This is facilitated by the main bank's role as delegated monitor for other banks-creditors of its main client firms;

4) a forum for co-ordination of firm activity within the ICA - *Council of Firm Presidents*. It has regular meetings and is very important for the strategic interaction of affiliated firms, since they can exchange information and views on matters of mutual interest, which is very important for problem solving and conflict resolution within the ICA.

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[10] GILSON and ROE, *Supra* 1 , p. 874.

The main forms of firm ***interconnections*** are:

a) *cross share holding*. A circular interdependence is ensured by each affiliated company holding shares of many of the other companies so that the controlling share of the stock of a separate firm is in the hands of other firms from the same ICA;

b) *intragroup transactions*. Large quantity of loans flows through the "main" bank, and large volume of trade is realized through the trading company. Preference is given to transactions with other affiliated companies;

c) *interpersonal network*. The contacts between employees of affiliated firms on different levels enhance the exchange of information among firms, and can serve as a means of external control. The exchange of personnel allows the transfer of necessary knowledge and skills when entering new spheres of activity. Regular meetings of directors, managers, heads of departments, technical staff are crucial for building such an interpersonal network within the ICA;

d) *joint projects*. Firms in ICA can invest jointly in new industries and production lines, as well as in common research and development facilities.

In this way, among enterprises in ICA multiple overlapping relationships exist: loans from the same bank, cross share holding, interlocking directorates, transacting through the same trading company, coordinated planning through the Council of Firm Presidents. When a company is a leading shareholder in a certain firm, the probability is very high that this company will also be an important trading partner, creditor, and will have representatives in the Board of Directors of the same firm.

Inter-corporate Ownership

In the ICA, and particularly in the cross holding of shares among affiliated companies, a new interweaving of the different functional components of ownership rights is achieved, which gives ground to regard this organizational form as a new "revolution" in ownership, giving rise to a new type of ownership. This new type can be called "inter-corporate model of share ownership", or "inter-corporate ownership".

The inter-corporate model is based on the corporate form. As no clear distinction can be drawn between private property and corporate ownership, so ownership in ICA retains the form of share ownership. The definition "inter-corporate" indicates that it is the corporations themselves that become the main subjects, as well as objects, of ownership.

What gives ground to consider ICA as being a new type of ownership?

First, ownership and control are realigned. *Second*, the objectives of firm ownership are changed. *Third*, the monitoring and control mechanisms are modified.

Realignment of Ownership and Control

Residual risk bearing and residual control are brought together again in one and the same subject, since the group of owners in ICA and the group of the managers of the affiliated firms overlap to a great extent. The principal shareholders in ICA companies are other firms from the same alliance. These firms-owners are represented by their managers, the latter combining the functions of managers of their own firms and owners of other affiliated companies. In this way, the Council of ICA Firm Presidents embodies both the management and ownership functions of the alliance as a whole.

If, as A. Berle asserts, the separation of ownership and control is a revolution in ownership and changes the character of private property, then the new merging of those two sets of ownership attributes should also lead to such a revolutionary change, and may be regarded as a new "revolution" (should we call it the 21st century revolution?). This merging, however, comes at a higher evolutionary level: not in the figure of a single owner-manager, but in a group of firm presidents who, as a result of cross share holding among their companies, combine the functions of ownership and management of the group of firms.

Thus, in terms of dialectics, if the owner-managed firm is the *thesis* and the corporation is the *antithesis*, then the new form is the *synthesis* combining elements of the two former types, but with modified qualitative characteristics. E.g., ICA retain the advantages of the corporate form of organization, as each of its firms operates as a legally independent entity. Outside capital can therefore be raised, a division of labor maintained, and risk diffused. However, since the main investors are other corporations, ownership becomes a means for structuring relationships among those corporations in ways that set markets for capital and control in the context of other business interests. The stock market continues to allocate capital and responds to conditions of supply and demand, but corporate ownership acquires the new characteristic to help protect and promote firms' strategic interests.

Change in the Objectives of Share Holding

Whereas in the traditional corporate governance models shareholders' primary concern is the short-run profitability of the firm, participation in ICA leads to a considerable diminishing of the importance for the firms-investors of their returns as shareholders. At the same time, much more essential for them becomes the stability of their partner firms as secure suppliers and clients. It is natural for such leading "shareholders" to consider the long-run development of the firm more important than the insignificant from their point of view returns on its stock. Indeed, by virtue of the cross holding of shares, paying dividends to affiliated firms-shareholders amounts to retaining the due sum within the firm. In this way, ICA firms have more discretion in the use of their profits, which also need not be maximized in the short-run. The main purpose of cross share holding in ICA is to support and encourage efficient production. It becomes a productive structure, a means for the integration of clients and suppliers, of different parts of the production process, whereby the investors are a mere constituent element

Control in the Inter-market Corporate Alliance

The traditional corporate governance relies heavily on the market for corporate control, which is external for the firm, to ensure compatibility of the objectives of managers and owners. On the other hand, the structure of interrelations in ICA is characterized by the merging of shareholder and management positions in a complex network of overlapping business and corporate interests, which internalizes the control mechanisms within the alliance. The mechanisms in the ICA for monitoring and control over the management of a separate firm include mutual monitoring, forming coalitions of shareholders, and the alliance bank's role as a monitoring and controlling agent.

The existence of alliances favors the formation of coalitions among the participating firms for exerting influence over the management of a separate firm. The considerable quantity of shares held by a limited number of affiliated firms brings the costs of building and maintaining the coalition to a low level.

The cross holding of shares and the exchange of personnel can be regarded as efficient monitoring mechanisms in view of the commitment of the affiliated firms to long-run relationships with each other. The monitoring activity is not the prerogative of a single member, since the characteristics of ICA lead to mutual monitoring among member firms.

The main bank in the alliance also plays important monitoring and control functions. In normal circumstances it does not exercise explicit control over firm policy or the choice of management, but it could intervene in different ways in management when the firm does not perform satisfactorily or is need of some kind of restructuring. This function of the main bank serves as a substitute for the external market for corporate control by replacing inefficient managers and reorganizing firm assets to improve performance.

Revolutions in Ownership and Privatization in Bulgaria

The study of the ICA type of business organization might give useful insights for the process of privatization in post-socialist Bulgaria. A new type of privatization through the exchange of stock among enterprises can be resorted to, the aim of which should be the formation of inter-market corporate alliances. Two points can be made to illustrate some relevance of the introduction of the inter-corporate model into economies in transition from socialist to capitalist-market system.

1) The ICA model of organization could be a good way to solve problems pertaining to the structural reform of the economy. The creation of a couple of competing with each other “mini-economies” will channel capital in the ICA to such enterprises, which will guarantee the highest return on investment, because, as a result, all the firms will be better off. By thus extending the activity of some firms, at the same time inefficient production sites can be divested of, directing the released workforce to the growing enterprises.

2) In the transition from central planning to a market-oriented system firm managers are not prepared to act in a free-market environment and that is a major problem. To overcome this, it is essential for firm managers, besides acquiring solid theoretical background, to obtain more complete information about the concrete market circumstances and to build in a short period of time the necessary practical managerial skills. An important element in this process is learning by doing. The Council of ICA Firm Presidents serves to co-ordinate affiliated firms’ activities, but it could also become a forum for enhancing managerial skills by sharing information about encountered problems and the solutions found.

By introducing the ICA in some transition economies, the efficiency of this organizational form will be put to the test in a different environment from the one, in which its prototype has emerged, and, maybe, will be given a chance to become spread in other countries as well, thus reaching a scale that can revolutionize the socio-economic systems where introduced. After this happens, the 21st century corporate revolution, as defined in this paper, will have taken place.