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Successfully reshaping the ownership relationship by reducing ‘moral debt’ and justly distributing residual claims: The cases from Scott Bader Commonwealth and the John Lewis Partnership

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ABSTRACT

This paper examines the issues relating to the most appropriate form of corporation ownership including organizational and cultural systems that will maximize the firm’s value to society whilst maintaining a more sustainable market value. The paper argues that the maximization of firm value to society may be more readily achieved through a closed corporation type formation with better rights protection for all internal stakeholders, such as an employee-owned corporation or a limited liability partnership similar to Scott Bader Commonwealth and John Lewis Partnership, rather than a publicly-owned open corporation with large ‘moral debt’ claims, conflicts of interest, and agency costs. The four main perceived theoretical arguments against a closed corporation are: The horizon problem; the common-property problem; the non-transferability problem; and the control problem. Our analysis demonstrates how the Scott Bader Commonwealth and the John Lewis Partnership with support from the capital markets evolved successful solutions to the above theoretical issues. In other words, closed corporations such as Scott Bader Commonwealth and John Lewis Partnership with their better organizational and cultural systems can be considered to be more just at distributing residual and ‘moral debt’ claims than open corporations and thus are better at maximizing their value to society.

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1. Introduction

The nature of the firm can be generally defined as a publicly-owned open corporation with separate residual risk-bearing and decision making rights (Fama and Jensen, FJ, 1983a,b). In other words, outside shareholders of the firm do not need to play an ‘active’[1] role in the organization and their residual rights are alienable without restriction (FJ, 1985). In contrast, a closed corporation can be defined as having residual claims that are largely restricted to important internal decision agents (FJ, 1985, 1983a,b). That is, there is no separation of residual risk-bearing (ownership) rights and decision-making (control) rights. Furthermore, Jensen and Meckling (JM, 1979) argue that there are four main determinants, i.e. the horizon problem, the common-property problem, the non-transferability problem, and the control problem, that makes a closed corporation less efficient than an open corporation. In this paper we demonstrate that with capital market support with new innovations

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[1] Jensen (1989b) defines an active investor as one that actually monitors management, sits on boards, is sometimes involved in dismissing management, is often intimately involved in the strategic direction of the company, and on occasion even manages.

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the closed corporation may be more efficient than the open corporation and through more ethical organizational structure[2] and culture[3] can more easily satisfy residual and 'moral debt'[4] claims.

In more recent times, it is argued that increasing equity ownership for executives with appropriate incentives and corporate governance schemes ultimately increases shareholders' wealth and the firm's performance through what represents a new organizational form (Jensen and Warner, 1988; Jensen, 1986). However, the separation of ownership and control in open corporations also requires senior management to delegate decision rights to employees but "employees, however, are not owners: they cannot sell company property and keep the proceeds. Therefore, employees have fewer incentives to worry about the efficient use of company resources than do owners" (Brickley et al., 2002, p. 1825).

Thus, there is an argument to allow all inside stakeholders to have equity ownership, which will help to justly distribute residual (financial) claims by reducing 'moral debt' and conflicts of interest, i.e. agency costs[5], due to the common sharing of risk-bearing and decision-making rights. For instance, Core and Larcker (2002) find evidence that an increase in equity ownership for executives in conjunction with appropriate incentives and corporate governance schemes ultimately increases a firm's performance. Furthermore, Chaplinsky et al. (1998) U.S. evidence for the 1980's on LBO's (leveraged buy-outs) showed that there was no statistical difference in post buyout performance, i.e. long-term outcomes and employment growth, between MBO's (management buy-outs) and EBO (employee buy-outs).

Employee ownership is a growing phenomenon in business, however, it is not yet well known or understood by the public, business communities, or the academic community (typically, textbooks either do not refer to such entities or provide a sentence or two). In the UK alone wholly employee-owned closed corporations[6] account for around £20bn worth of turnover and one of the largest is John Lewis Partnership (JLP, employing around 65,000 people with a turnover of £5.1bn in 2006). The ultimate purpose of the John Lewis Partnership is defined in its constitution—"the happiness of all its members through their worthwhile and satisfying employment in a successful business" (John Lewis Partnership, 2006). In the US there is around 11,000 firms that have ESOPs and around "23 million Americans own stock in their employer, and perhaps 10 million own options" (Rosen et al., 2005, p. 9). Furthermore, from the late 1910s onwards Americans such as Kelso, Adler, Eliot (Harvard President), Brookings (Brooking Institute), John D. Rockefeller Jr., and Stanford (Stanford University) supported and advocated employee ownership (Rosen et al., 2005; Blair et al., 2000). Rowlinson et al. (2006, p. 682) cite that Adam Smith and John Stuart Mill "opposed the separation of ownership from control and were highly critical of joint stock companies" (see also Arnold and De Lange, 2004; Reiter, 1997).

The remainder of this paper is organized as follows. In Section 2, we discuss the various issues facing both open and closed corporations in relation to residual (risk-bearing) and 'moral debt' claims. In Section 3, we discuss the main theoretical determinants against closed corporations as argued by JM (1979) and the real practical solutions that evolved to overcome these determinants against closed corporations. Section 4, concludes.

2. Open versus closed corporation: residual and 'moral debt' claims

> "We are fully conscious that we must make wealth before it can be distributed. . ." The Scott Bader Commonwealth (Bader, 1986, p. 73).

Jensen (1986, 1988) and FJ (1983a) argue that an open corporation survives because it delivers product and services demanded by consumers at the lowest price. There is a caveat, in that an open corporation has major organizational problems associated with the failure of internal control systems (Jensen and Chew, 2003; Jensen, 1994, 1989b). To compensate for the less efficient open corporation the capital markets have promoted takeover activity that has transferred control of corporate resources "to smaller, more focused – and in many cases private – corporations and individuals, who returned huge amounts of equity capital to shareholders" (Jensen and Chew, 2003, p. 1). However, open corporations have outlived their usefulness in many sectors of the USA economy (Jensen, 2001, 1989a,b). Furthermore, Arnott and Stiglitz (1991) argue that when significant market failure occurs there is a strong incentive for non market institutions to develop towards remedying the deficiency. There now seems a thriving market for (non-tradable) closed corporations such as private Leveraged Buy Outs

[2] Chaplinsky et al. (1998, p. 317) observe that because of long-term performance and survivorship rates employee buy outs "are a viable organizational structure for certain firms."

[3] Brickley et al. (2002, p. 1822) observe that "business ethics and the internal structure of the organization", what they call organizational architecture that includes the culture of the firm, "are inextricably linked." Furthermore, Charny (1999, p. 92) refers to culture as "the influence of shared beliefs and of social norms on the conduct of the firm's participants." Culture also encompasses governance which can be referred "to the variety of ways in which parties control or influence the decisions reached in an enterprise" (Rock and Wachter, 1999, p. 147).

[4] Guidi et al. (2008, p. 603) argue that if we consider a corporation as an entity within a universe of other entities then 'moral debt' exists "when the firm takes rights from other stakeholders as their own. In other words, 'moral debt' originates when the firm takes a benefit from others through not fulfilling just business decisions (where just means protecting both alienable and inalienable rights)." Furthermore, 'moral debt' claims follow Kant's 'perfect' and 'imperfect' obligations as argued by Sen (2004).

[5] Agency costs arise because the nexus of contracts that define a firm are not costlessly written and enforced (Jensen and Meckling, 1976; FJ, 1983b; Fama, 1990; Brickley et al., 2002).

[6] For example, the paper uses terms 'closed corporation' and 'employee-owned closed corporation' in respect to the closed class of beneficiaries. There are, however, various forms of closed corporations with their different organizational structures and cultures. Thus, the paper will use specific wording for clarification purposes on the type of closed corporation being referred to e.g. 'closed employee-owned corporations' or 'private equity firm'.

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