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Introduction to The Modern Corporation and Private Property

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Introduction

Berle and Means' monumental work on the corporation has become one of those enduring classics that many cite but few read. As would be expected, a current rereading reveals that much of the book has become a period piece. In part, its success has been its undoing. The initial reaction to its publication led a generation of researchers to answer questions raised in the book. Consequently, much of the field of study focusing on the corporate system has moved beyond the point at which lawyer Adolf Berle and economist Gardner Means wrote about it.

Also, the economy has evolved. Who, writing in the depths of the Great Depression of the 1930s, would have anticipated the double-digit inflation of the late 1970s? Nevertheless, this classic raises many of the fundamental questions that still beset those concerned both with the role of business in society and the governing power of the large corporation. In fact, the book is so rich with insights and thought-provoking analysis that, in this introductory essay, we can do little more than whet the reader's appetite, while simultaneously warning about the host of legal and statistical detail which is now mainly of historical interest.

The Role of the Corporation

The most enduring theme of *The Modern Corporation and Private Property* is the divorce of ownership from the control of the modern corporation. It is the view of the authors that, as a practical matter, stockholders have traded their legal position of private ownership for the role of recipient of capital returns (Book I, Chapter I). In addition, a close parallel is drawn between workers who surrender the direction over their labor and shareholders who become merely recipients of "the wages of capital."

Without using the term, Berle and Means show a keen awareness of the concern of modern "agency" theory: the interests of the directors and managers can diverge from those of the owners of the firm, and they often do so. This separation between ownership and control of a corporation through expanded ownership of the company creates what Berle and Means call the quasi-public corporation. The characteristics found in a quasi-public corporation are its tremendous size and its reliance on the public market for capital.

In Book I, Chapter II, Berle and Means predict, on the basis of historical experience, that "practically all" economic activity will be carried on under this quasi-public corporate form. That forecast has suffered from the rapid rise of the service sector of the economy. There, individual proprietorships and partnerships remain widely used methods of organizing business activity, and dependence on organized capital markets is far less than in the case of the large corporation.

Nevertheless, Berle and Means are closer to the mark than the more recent and widely circulated projection in the late 1970s by Michael Jensen and William Meckling, that "The corporate form of organization is likely to disappear completely . . . the larger corporations as we know them are destined to be destroyed."[1]

Given the effective separation of ownership from management, Berle and Means noted the likely characteristic increase in the size of the modern corporation and the concentration of the economy. However, two more recent developments should be kept in mind. As the authors properly perceived in Book I, Chapter III, mergers and acquisitions are an important method of increasing corporate size. However, changes in corporate control can also lead to reducing the size of the company. An example during the 1980s was the split up of Beatrice Foods into a variety of smaller companies, which occurred in connection with that $12 billion giant corporation going "private."

A more basic criticism of the Berle and Means approach is that mergers among existing firms do not necessarily mean that the economy is becoming more "concentrated." In the dynamic industrial society that characterizes the United States, the rise of new companies overshadows the decline of the old. Thus, Berle and Means could accurately bemoan the demise of 49 of the largest 200 corporations within one decade. Yet we can celebrate the fortunes of many of today's giants that are not on their list -- IBM, Philip Morris, Boeing, United Technologies, Dow Chemical, Xerox, Pepsico, Digital Equipment, Hewlett Packard, Sara Lee, Conagra, Unisys, Lockheed, Motorola, Monsanto, TRW, and Textron. Even Berle and Means would have to admit that this is an impressive array of "newcomers."

Mergers and acquisitions continue to be an important force in maintaining a dynamic economy. In 1989 alone, 35 giant mergers occurred with an aggregate value of over $117 billion (see Table 1).

Table 1

Mergers and Acquisitions Over $1 Billion, 1982-1989

Year	Number of Deals	Value ($ millions)
1982	10	$19,440.3
1983	6	9,110.5
1984	19	55,178.5
1985	26	61,458.6
1986	31	67,932.4
1987	30	62,175.9
1988	42	96,399.4
1989	35	117,477.4

Source: Computed from *Mergers and Acquisitions*, various issues.

At times, changes in control, or even threats of hostile takeovers, may serve to increase the efficiency and profitability of individual firms.

The Management of the Corporation

Berle and Means made a fundamental contribution in their analysis of the extent to which management of the modern corporation has been separated from its ownership. But they may have gone overboard in stating that the power and control has shifted away from the common stockholders (Book I, Chapter IV). Berle and Means state that this separation has totally eliminated the checks and balances that owners once exercised over management. With this undaunted power, management supposedly pursues its own interest, oblivious to the welfare of the owners. A contrary view has been developed in more recent years. According to Harold Demsetz, "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 interest."[2]

As the reader might suspect, neither polar alternative accurately describes the complex reality of the world of corporate decision making. Top managements do possess significant discretion over the use of corporate resources. Merely consider the ability of the CEO of a major company to satisfy his whims in terms of the selection of charities and pet causes that the organization will support. However, shareholders are not left powerless. Ample evidence is furnished by the proxy fights and takeover battles between different groups of owners grappling for control that, on occasion, brighten the financial pages of the daily newspapers. Clearly, the power of management is far from the absolute position that Berle and Means forecast.

A fundamental development not foretold in *The Modern Corporation and Private Property* is the use by institutional investors of the latent powers they possess. Although Berle and Means were aware of the role of pension funds and insurance companies, they did not foresee either the growing importance of these investors or their desire to participate in corporate decision making.

According to a Columbia Law School Institutional Investor Project, the top 20 pension funds in 1989 owned 10.6 percent of General Motors common stock and 9.1 percent of IBM. In addition, institutions owned at least one-half of the stock of 27 of the top 50 U.S. corporations and at least one-third of 47 of the top 50.

Peter Drucker has referred to this phenomenon as "pension fund socialism." The term may have been more prescient than he anticipated.[3] The most activist role has been those of government pension funds. Thirteen of the top 20 pension funds are controlled by state or local governments. The top five state pension funds -- three from New York and two from California -- control $202 billion, or roughly 8 percent of total pension fund assets of $2.5 trillion.[4]

By forming a Council of Institutional Investors, a group of managers of large state pension funds have created a mechanism whereby a small number of large shareholders (or rather their agents) can work together. In a few recent cases, some of the largest institutional investors, notably state government employee pension funds, have entered into specific takeover battles. In the case of the attempt in 1990 to take over Lockheed, several large institutional investors supported the management slate after gaining assurance that in the future they could name three members of the board of directors.

In a broader sense, the increased activism of institutional investors is a response to the authors' concern about the euthanasia of the shareholder.

"The Control" of the Corporation

Berle and Means vaguely define the concept of "the control" of the corporation. They refer to a subgroup of the stockholders who have the actual power of selecting the board of directors through any of the following ways: (1) complete ownership of common stock, (2) majority control, (3) legal devices, (4) minority control, and (5) management control. The authors note in Book I, Chapters V and VI, that the interests of those in "control" differ from the profit-maximizing, risk-minimizing desires of the other owners and, as these interests move further apart, "the control" will ultimately lie in the hands of the management. Berle and Means provide an early and earthy statement of the agency problem: those who control the corporation, even if they own a large block of stock, "can serve their own pockets better by profiting at the expense of the company than by making profits for it."[5] This raises a serious question about the incentives for managers of the modern corporation to conduct business in accordance with the welfare of the owners.

Boards of directors have responded to these concerns in a variety of ways. Granting key executives options to purchase the stock at some fixed price above the current market value provides them with a powerful incentive to maximize share performance. Bonuses in the form of stock ensure that the recipients, at least to some degree, will start to think like shareholders. Predictably, however, corporate activists (corporate critics would be a more accurate phrase) oppose these methods of compensation whenever the issue is presented at a corporate annual meeting. Yet shareholder approval is overwhelming in virtually all cases.

Nevertheless, many serious analysts of the corporation contend that the normal incentives described above are not sufficient. They write favorably about "leveraged buyouts" and "going private," methods of increasing the ownership position of management by an order of magnitude. If these types of responses to the fundamental issues raised by Berle and Means became more widespread, they would make the corporation a less attractive place for many private investors who have no interest in "controlling" the affairs of the company whose stock -- or bonds -- they buy.

The Position of the Shareholder

Berle and Means bemoan the changed, more passive, role of the shareholder of the modern corporation. They note the extent to which the bondholder is superior, being guaranteed a fixed return on the funds invested in the corporation. In contrast, the stockholder is in a less desirable position, not knowing whether there will be any return at all on the investment (Book II, Chapters VI-VIII).

This portion of the book may have weathered least well. At the present time, we hear so often of the bondholders who have suffered an erosion of the market value of the principal because the managers have so highly leveraged the firm. Typically, this has been done by issuing high-yielding but very risky "junk bonds."

Even in more stable corporate relationships, stockholders can receive benefits not available to bondholders, notably participating in the growth of the firm. Writing in the Great Depression of the 1930s, Berle and Means could not envision the rapid inflation of the post-World War II period, when stocks became a major hedge against the erosion of real value. At the same time, bondholders often experienced serious declines in the market value of their portfolios, even when the nominal value of their assets and income streams remained unimpaired.

Stock Exchanges and Stock Markets

Berle and Means considered the listing of corporate shares on a stock exchange and the resultant open market for these securities as essential to, and as a product of, the rise of the modern corporation. In their view, dispersed shareholders have exchanged control for liquidity.

The authors discuss the many possible mechanisms that the directors possess in affecting the asset value of the stock or the distribution of company earnings (Book II, Chapters II and III). Based on the imperfections of normal judicial protection of shareholder rights, *The Modern Corporation and Private Property* presents the case for substantial regulation of security markets (Book II).

As we have seen in the more than half century since its publication, such protection can be exercised by both private-sector and public-sector institutions. Thus, the private New York Stock Exchange (NYSE) determines many "rules of the game," and, according to the authors, makes "slow but steady progress" in ensuring the availability of securities at their market value to all potential investors. Furthermore, it is the NYSE that requires all listed companies to set up audit committees staffed entirely by outside directors. Simultaneously, the U.S. Securities and Exchange Commission plays the role of "cop on the beat," to ensure an adequate flow of information to the prospective purchasers and current owners of corporate shares.

The prescience of the authors is especially evident in Book III, Chapter III, where they describe the problem of insider information. They state that the legal system can only choose randomly of the many unethical acts committed in securities markets and occasionally settle on one special case on which to act upon. However, Berle and Means reach a conclusion more optimistic than experience to date can justify: "As the standards of disclosure of corporate affairs become more exacting, the problem of the directors and managers in the market will become increasingly less important."[6]

Without defending the unethical practices of such slick operators as Ivan Boesky, the fact is that in 1990 no legal definition of insider trading exists to guide the honest market participant who wants to obey the law. Instead, legal advisers can only provide examples of the kinds of behavior that have resulted in government prosecution and those that have not.

Corporate Responsibility

For whose benefit does the corporation operate? Book IV, Chapter I, raises this fundamental issue. The traditional legal answer is that the corporation is conducted for the benefit of the owners. Berle and Means view corporate responsibility to shareholders in the sense of "equitable control" where managers, having obtained power from the dispersed group of stockholders, act in the best interest of the owners of the firm. The authors then question this by analyzing the profit incentive to the executives. According to the authors, executives have such an "insignificant" fraction of traditional property rights that the incentive of profits is not strong enough to insure that they will make effective use of corporate property.

The large degree of managerial discretion over corporate resources is borne out by a variety of case studies. Researchers at the Harvard Business School reported that none of the top executives of twelve successful American companies was very concerned about the market value of the company's stock. One chief executive stated this position very forcefully:

> The highest priority with me is perpetuation of the enterprise. I'd like to leave this joint in better shape than when someone passed me the baton. I have to take care of the shareholders in this, but I don't sweat the shareholders too much.[7]

Over the years, a far broader definition of the responsibility — some call it the social responsibility — of the corporation has developed. In an influential and widely cited report on the subject, the Committee for Economic Development (CED) describes the professional manager as a "trustee" balancing the interests of many diverse participants and constituents in the enterprise, including customers, employees, suppliers, and the community. Shareholders are listed only as one among those worthy groups -- and they are listed last.

It turns out that the CED statement is not too different from the description provided in *The Modern Corporation and Private Property*: "New responsibilities towards the owners, the workers, the consumers, and the State thus rests upon the shoulders of those in control."[8]

Berle and Means contended that the divorce of ownership from management destroyed the traditional belief that profit maximization will drive the corporation to most efficiently use its assets (Book IV, Chapter II). In good measure, the wave of hostile takeovers in the late 1980s was a response to managers who paid insufficient attention to the concerns of the shareholders. Too many chief executives focused on the theater and opera as the epitome of a corporation's responsibility to society. They seemed to forget that a business is an economic institution, designed to provide goods and services for consumers in order to benefit the stockholders.

Berle and Means forecast that, as the size of the corporation and the number of holders of its stock grew, a point would be reached where "the control" would be held by a self-perpetuating board of directors. Since the judicial process (along with the authors' understanding) is unable to deal with intricacies and vagaries of corporate "control," the authors saw no way that laws would be established to prevent such situations from occurring. Hence, the fiduciary role of the corporate board of directors (Book II, Chapter V) deserves continuous attention and needs to be updated from the rather simple view held by Berle and Means.

Both in legal theory and business practice, the board is the link between the shareholders who own the enterprise and the executives who manage it. Until the past decade or two, the senior executives of the enterprise often comprised the majority of the typical corporate board, with the firm's attorneys and bankers (commercial and investment) serving as outside directors, together with important customers and political figures in the locality in which the company maintained its headquarters.

In recent years, however, most of the boards of the larger companies consist primarily of outside (non-management) directors, most of whom at least nominally are independent of the management. However, the chief executive (CEO) usually serves as chairman of the board, setting the agenda for meetings and presiding over the deliberations.

Currently, the boards of directors of about 60 percent of the larger corporations have set up nominating committees to propose both candidates for the board and senior officers of the company. These committees usually have a strong majority of outside directors, typically four out of five. However, these statistics do little to illuminate the continuing powerful role of the chief executive in initiating or approving committee selections. In practice, approximately 80 percent of outside directors are chosen by the chairman/chief executive, who usually exercises an effective veto over the other selections.

Under the circumstances, many critics charge that the typical director acts as a rubber stamp, quickly approving the recommendations of the chairman/CEO. Although this charge does not lack substance, reality is far more complicated. Virtually all modern authorities on corporate governance agree that in times of crisis the board, led by the outside directors, exercises its powers, usually to the acclaim of impartial observers. However, short of emergencies, the board is reluctant -- and finds it difficult -- to override the recommendations of the management.

In their 1989 study of corporate boards, Jay W. Lorsch and Elizabeth MacIver report a widely held view of directors, " . . . to advise the management . . . he can't do much more than that."[9] There are many reasons for that situation, several altogether sensible. The management knows more about the details of the company's operations than the outside directors and there is a natural tendency to defer to the inside directors. More fundamentally, a committee can set policy but it cannot run an organization, only one leader can. Hence, a wise board does not attempt to compete with the chairman/CEO, but views its role as primarily providing advice and counsel.

All that is correct. Nevertheless, there are occasions when the board should turn down the proposals by the management because the interests of the shareholders dictate such action. Examples include a recommended acquisition which would unduly dilute the value of the stockholders' investment or a request by a strong division chief for a capital investment which would not likely yield a return adequate to cover the cost of capital.

Sad to report, it is the rare board that, under those circumstances, can say "no." On the positive side, wise CEOs informally review controversial proposals with key outside directors prior to formal presentation to the board. Thus, they avoid situations where they force their boards to turn them down on important matters. Too frequently, however, the CEO/chairman simply dominates the board's decision making, even though independent outside directors constitute a clear majority.

In Book IV, Chapter III, the authors return to analyzing the role of and the motivating influence on the professional manager. In more recent years, clear evidence has been developed on the motivations that comprise the driving force of modern corporations. Corporate managers are not fundamentally different from other individuals, nor do they differ from those of the past. Self-interest does and should be expected to dominate their decision making.

The same factors that encourage managers to be generous to themselves in allocating corporate resources can also be the driving force behind corporate acquisitions. After all, acquisitions do increase the amount of corporate resources in the winning management's span of control. Studies by the Conference Board confirm with telling statistics what most people instinctively know: top executives in larger companies are paid more than their counterparts in smaller firms. Size of firm is the most compelling factor.

To be sure, profitability and other factors help to determine management pay and fringe benefits. But, on average, the chief executive of a $10 billion company gets paid much more than the head of a firm whose yearly sales are only $5 billion.[10] In plain English, the bigger the company, the larger the rewards to top management. The intangible management benefits from controlling large enterprises also are substantial. Being on the cover of *Fortune* or *Business Week* is a heady experience.

The Future of the Corporation

Berle and Means wrote that the corporation as an institution may become not only an equal to the state, but even supersede it as the dominant social organization (Book IV, Chapter IV). From an economic viewpoint, they are correct. The privately owned corporation is the prevailing form of organizing the production and distribution of goods and services in the United States, and in other capitalist nations as well. The corporation is likely to continue playing this role for the indefinite future because, as the late Neil Jacoby stated, "There is simply no promising alternative way of organizing and carrying out most of the tasks of production." [11]

Moreover, the rise of political action committees with large budgets for political contributions has given many corporations direct access to powerful governmental decision makers. Also, the lack of geographic limits to the exercise of corporate power, a characteristic noted in passing by Berle and Means, has given rise to the multinational enterprise. Yet the contrast between government and business powers remains striking. The largest company cannot tax us; the smallest unit of government can. The most profitable corporation cannot throw us in jail; the smallest municipality can.

* * *

A half century later, what can we say about Berle and Means' *The Modern Corporation and Private Property*? Despite its many specific shortcomings, the book remains a useful introduction to the internal organization of the corporation in modern society. The analysis by this unique combination of lawyer and economist is still relevant to exploring the relationship between the owners of the firm and its managers.

To extend an old phrase, many of the answers provided by this book have been superseded by more recent events, but the questions raised continue to be worthy of the attention of scholar and practitioner alike.

NOTES

1. Michael C. Jensen and William H. Meckling, "Can the Corporation Be Saved?" *MBA*, March 1977, p. 16.

2. Harold Demsetz, "The Structure of Ownership and the Theory of the Firm," *Journal of Law & Economics*, June 1983, p. 380.

3. Peter Drucker, "Pension Fund 'Socialism'," *The Public Interest*, Winter 1976, pp. 3-46.

4. James A. White, "Giant Pension Funds' Explosive Growth Concentrates Economic Assets and Power," *Wall Street Journal*, December 28, 1990, p. C1.

5. Adolf D. Berle and Gardner C. Means, *The Modern Corporation and Private Property* (New York: MacMillian, 1962), p. 122.

6. Ibid., p.335.

7. Gordon Donaldson and Jay W. Lorsch, *Decision Making at the Top: The Shaping of Strategic Direction* (New York: Basic Books, 1983), p. 28.

8. *Social Responsibilities of Business Corporations* (New York: Committee for Economic Development, 1971), p. 22.

9. Jay W. Lorsch and Elizabeth MacIver, *Pawns or Potentates: The Reality of America's Corporate Boards* (Boston: Harvard Business School Press, 1989).

10. *Conference Board* (New York, 1986).

11. Neil H. Jacoby, *Corporate Power and Social Responsibility* (New York: MacMillian, 1973), p. 269.