CHAPTER 6

# *The Modern Corporation's* Final Chapter

**Abstract** The final section concludes by drawing together the various ideas about corporate governance and incentives that have been identified earlier in the book, and shows how these ideas are consistent with proposals for a possible future for the public corporation set out in the last chapter of *The Modern Corporation and Private Property*, by Berle and Means, published in 1932.

**Keywords** The modern corporation • Rethinking capitalism

## Introduction

At the end of *The Modern Corporation and Private Property*, Adolf Berle and Gardiner Means describe three possible futures for the public corporation. First, they propose that the traditional logic of property rights, whereby corporations "belong" to their shareholders, might be substantially reinforced, such that managers controlling corporations are placed explicitly in the position of trustees who are required to operate the corporation for the sole benefit of shareholders. This would require corporate law and securities regulation to be tightened considerably to enshrine in law a doctrine which Berle and Means refer to as "corporate powers as powers in trust":



A. Pepper, *Agency Theory and Executive Pay*,
https://doi.org/10.1007/978-3-319-99969-2_6

> By application of this doctrine, the group in control of a corporation would be placed in a position of trusteeship in which it would be called on to operate or arrange for the operation of the corporation for the sole benefit of the security owners despite the fact that the latter have ceased to power over or to accept responsibility for the active property in which they have an interest. Were this course followed, the bulk of American industry might soon be operated by trustees for the sole benefit of inactive and irresponsible security owners.[1]

It is clear from the way that this paragraph concludes (the reference to "inactive and irresponsible security owners") that Berle and Means do not favour this first option. "Inactive and irresponsible" shareholders do not deserve the benefit of full fiduciary oversight.

Berle and Means like the second option even less.[2] They describe how the inexorable logic of laissez-faire economics and pursuit of the profit motive might lead to "drastic conclusions":

> If, by reason of these new relationships, the men in control of a corporation can operate it in their own interests, and can divert a portion of the asset fund or 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.[3]

To put this in another way, if shareholders' reasonable expectations are satisfied by receiving regular dividends and having the ability to sell securities at any time on the stock market, then the rent-seeking activities of managers should be regarded as an inevitable and acceptable cost of investing in company shares. Under this scenario, investors would simply have to live with "rentier capitalism".

To many people, this second possible future, characterised as it is by powerful rent-seeking managers, describes rather well the current state of Western capitalism. It is not, to the liberal-minded and socially conscious,

[1] Berle, A., & Means, G. (1932) *The Modern Corporation and Private Property*. New York: Macmillan. p. 354.

[2] As they say, "if these were the only alternatives, the former would appear to be the lesser of two evils". Berle, A., & Means, G. (1932) p. 355.

[3] Berle, A., & Means, G. (1932) p. 354.

an attractive option. While many would regard capitalism as having been the most successful wealth-creating system that the world has ever seen, its current version appears to have a number of undesirable features. There are also signs of stress. In June 2018 the Bagehot column in the Economist newspaper put it like this: "wage growth is sluggish; economic insecurity is rife; a well-connected oligarchy is sucking up a disproportionate share of the proceeds of growth".[4] Bagehot goes on to describe how, in *The Wealth of Nations,* Adam Smith, the father of modern economics, worried that markets were (in Bagehot's words) "prone to being hijacked by rent-seekers". These potential rent-seekers, according to Smith, may include senior executives of companies with dispersed shareholdings, where "negligence and profusion"[5] prevails. Some would argue that this is indeed what has happened at the start of the 21st century.

An extensive literature on the present state of capitalism has grown since the financial crisis of 2008–2009. Certain commentators, including Guy Standing, Wolfgang Streeck, and Paul Mason, have predicted the end of capitalism as we know it.[6] Others, including Martin Wolf, Michael Jacobs, and Mariana Mazzucato, have provided a more nuanced analysis—they argue that predictions of capitalism's imminent demise are greatly exaggerated, while at the same time acknowledging that some fundamental changes are required to the current economic system in the West.[7] The economist and social commentator John Kay has been saying much the same thing for some time.[8] In a similar spirit, Jesse Norman argues that Adam Smith was not the market fundamentalist and apologist for inequality and human selfishness that some neoliberal economists claim that he

[4] The Economist. Good capitalism v bad capitalism (June 9, 2018) p. 30.

[5] Adam Smith (1776) *An Inquiry into the Nature and Causes of the Wealth of Nations.* Book V, Chapter 1, Part III.

[6] Standing, G. (2016). *The Corruption of Capitalism: Why Rentiers Thrive and Work Does Not Pay.* London: Biteback Publishing Limited., Streeck, W. (2016). *How Will Capitalism End? Essays on a Failing System.* London: Verso., Mason, P. (2015). *Post Capitalism: A Guide to our Future.* London: Allen Lane.

[7] Wolf, M. (2014). *The Shifts and the Shocks: What We've Learned – And Have Still To Learn – From the Financial Crisis.* London: Allen Lane. Jacobs, M., & Mazzucato, M. (2016). *Rethinking Capitalism.* Chichester: Wiley Blackwell. Mazzucato, M. (2018). *The Value of Everything: Making and Taking in the Global Economy.* London: Allen Lane.

[8] See, for example, Kay, J. (2003). *The Truth About Markets: Their Genius, Their Limits, Their Follies.* London: Allen Lane.

is.[9] Smith's second great work, *The Theory of Moral Sentiments*, anticipates a number of ideas subsequently found in modern behavioural economics.[10] Far from being a doctrinaire libertarian, Smith would, according to Norman, have supported many of the proposals for repairing capitalism advanced by Wolf, Jacobs, Mazzucato, and Kay.

Karl Marx famously predicted the end of capitalism in the nineteenth century. He was wrong of course. The weight of evidence does not support communism, the alternative to capitalism that was proposed by Marx: the collapse of the Soviet Union in 1990 brought to an end its communist command economy, sometimes described as the greatest (failed) field experiment of twentieth-century economics. Central planning on such a grand scale does not work. Capitalism is fixable but changes are required. The thesis of this book is that one of the areas where change is necessary is in corporate governance and executive compensation.

### *The Aspirin Trap*

By proposing ever-larger awards to incentivise senior executives, especially under long-term incentive plans, agency theorists have fallen into the "aspirin trap". Let me explain what I mean by this. One 300 mg aspirin tablet will cure your headache. Two or three will do so more quickly. Taking 20 tablets at one time will make you ill. A single dose of 50 tablets might kill you. This phenomenon, involving a favourable response to a low level of exposure of a potentially toxic substance but negative responses to much larger exposures, is called "hormesis" by biologists. It exemplifies how relationships in nature are rarely defined by linear functions.

The human motivation curve is not a linear function, as I have explained in Chap. 5. When it comes to pay, relatively small (proportionately speaking) extrinsic incentives can help to enhance agent motivation because they signal what is most valued by principals. Larger incentives may increase this motivational effect by increasing the strength of the signal and providing a tangible reward. However, at some point, extrinsic incentives start to undermine intrinsic motivation, and eventually intrinsic motivation may be crowded out altogether. Very large incentive payments can have undesirable

[9] Norman, J. (2018). *Adam Smith: What He Thought and Why it Matters.* London: Allen Lane.

[10] Ashraf, N., Camerer, C., & Loewenstein, G. (2005). Adam Smith, Behavioral Economist. *Journal of Economic Perspectives, 19*(3), 131–145.

consequences. The size and nature of awards recommended by agency theorists in order to encourage high performance and align the interests of shareholders and managers under the standard principal-agent model are based on a flawed understanding of human behaviour. Standard agency theory must be repaired. Behavioural agency theory, as described in Chap. 5, provides a much better framework for designing rewards and incentives than the standard model.

## A Third Possible Future for the Public Corporation

In *The Modern Corporation* Berle and Means describe a third possible future for the public corporation. It is often overlooked.[11] They suggest the possibility of retaining the benefits of public corporations, while at the same time ridding society of the corporation's attendant evils.[12]

> When a convincing system of community obligations is worked out and is generally accepted, in that moment the passive property right of today must yield before the larger interests of society. Should the corporate leaders, for example, set forth a program comprising fair wages, security to employees, reasonable service to their public, and stabilization of business, all of which would divert a portion of profits from the owners of passive property, and should the community generally accept such a scheme as a logical and human solution of industrial difficulties, the interests of passive property owners would have to give way. Courts would almost of necessity be forced to recognize the result, justifying it by whatever of the many legal theories they might choose. 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.[13]

[11] See Bratton, W., & Wachter, M. (2010). Tracking Berle's footsteps: the trail of the Modern Corporation's last chapter. *Seattle University Law Review, 33*(4), pp. 849–875.

[12] For the evils that attend public corporations see, for example, the (somewhat polemical) book *The Corporation – The Pathological Pursuit of Profit and Power* by Joel Bakan (2004). For a philosophical argument that corporations are in effect private governments or dictatorships, see Anderson (2017).

[13] Berle, A., & Means, G. (1932) p. 355.

This third option is curiously prescient, anticipating many of the ideas about the repaired theory of executive agency which have been explained in the preceding chapters. These various ideas are summarised in the ten propositions set out below which are put forward in the spirit of Berle and Mean's third potential future for the public corporation.

*Proposition 1*

The standard model of executive agency, which has had a major impact on management theory and practice in the last 30 years, is flawed and in urgent need of repair.

*Proposition 2*

The doctrine of (short-term) shareholder value maximisation, advocated by Milton Friedman and others, is misconceived—it does not serve the best long-term interests of companies, shareholders, employees, or society. It should be replaced by a new doctrine of long-term total firm value maximisation. Directors, investors, employees, and any other important stakeholders should be encouraged to unite around this new doctrine. Long-term total firm value maximisation should become the primary objective of all public corporations. If necessary this principle should be enshrined in company law and financial regulations.[14]

*Proposition 3*

Public corporations have too much ontological substance to be dismissed as mere legal fictions. Corporations are real entities with identities, temporal existence, corporate cultures, and physical presence. They have legal and ethical responsibilities commensurate with their positions in society.

*Proposition 4*

Corporate managers have fiduciary responsibilities of a higher legal and ethical standard than those implied by an agency relationship. All senior exec-

[14] In the UK this would mean amending section 172 (1) of the Companies Act 2006 to make it clear that directors have a duty to promote the long-term success of the company for the benefit of all major stakeholders. Changes announced by the Department of Business, Energy and Industrial Strategy in June 2018 (The Companies Miscellaneous Reporting Regulations 2018) go some way towards this by requiring directors to report on how they have engaged with a wide set of duties contained in section 172. This requires them to have regard, among other matters, to the interests of employees, supplies, customers, the community and the environment, and to act fairly as between members.

utives should be encouraged to recognise the significance of this high level of ethical responsibility. Companies should report on how directors and senior executives have engaged with their fiduciary responsibilities.

*Proposition 5*

Company managers should be rewarded for their value-creating activities with generous fixed salaries and modest bonuses. The interests of shareholders and managers should be aligned by requiring executives to invest cash bonuses in company shares or by rewarding them partially with restricted stock. Highly leveraged long-term incentive plans incorporating complex performance conditions are not the answer.

*Proposition 6*

We should not assume that there is a general problem of executive motivation. The greater risk is that high-powered performance-based incentives will crowd-out intrinsic motivation. The remuneration committee's dilemma cannot be solved by designing more sophisticated incentives. Instead, the dilemma must be "dissolved" rather than "solved"[15] by placing greater focus on intrinsic motivation. We want top executives who are, in the terminology of Julian Le Grand, more "knightly" than "knavish".[16]

*Proposition 7*

Shareholders own shares, which have rights to dividends, votes, and assets in a winding-up, but they are not in any other meaningful sense the sole "owners" of public corporations. Others, especially employees who have made investments of specific human capital in their employing companies, also have stakeholder participation rights, which should be reflected in governance arrangements.

*Proposition 8*

There should be broader participation in company governance. Major shareholders should form investor committees modelled on Swedish nom-

[15] In the same way that Karl Popper resolved the problem of induction by turning it on its head and focusing on falsifiability rather than verifiability, I am suggesting that the remuneration committee's dilemma can be "dissolved" (in the sense of being "made to go away") by placing more attention on intrinsic, rather than extrinsic, motivation.

[16] Le Grand, J. (2003). *Motivation, Agency and Public Policy*. Oxford: Oxford University Press.

ination committees to advise companies on the appointment of directors and executive pay.[17] Other individuals who are affected by resource allocation rules should have representation rights in company governance systems. These might include works councils, employee advisory panels, and worker representation on company boards or major committees, including the remuneration committee.

*Proposition 9*
Rewards should be allocated in proportion to inputs, including both capital and labour. Rules that respect proportionality are more likely to be regarded as equitable, whereas rules that dis-proportionately benefit elites will be perceived as unfair. Perceived fair pay is an important characteristic of high-trust organisations. If shareholders, and employees generally, believe that senior executive pay is excessive, then confidence in top management will be undermined. Companies should be encouraged to produce "fair pay" reports.[18]

*Proposition 10*
Where necessary corporate law should be amended in order to bring about change. Otherwise, companies should be encouraged to devise governance arrangements that are best suited to local conditions. Regulators should enable and support local governance that complies with the law and with these principles.

## Final Words

Professor Simon Deakin of Cambridge University concludes his 2012 paper "The corporation as commons", which I discussed at some length in Chap. 4, as follows: "the sustainability of the corporation depends on ensuring proportionality of benefits and costs with respect to the inputs made to corporate resources, and on the participation of the different stakeholder groups in the formulation of the rules governing the management of those resources".[19] Colin Mayer of Oxford University has issued

[17] See Chap. 4, n22.

[18] See, for example, the "fair pay charter" included in Standard Chartered Bank's directors' remuneration report for 2017 (p. 84 of the bank's Annual Report 2017).

[19] Deakin, S. (2012). The corporation as a commons: rethinking property rights, governance and sustainability in the business enterprise. *Queen's Law Journal*, 37 (2), p. 381.

a similar warning in his book *Firm Commitment*.[20] The very future of the public corporation is at stake.

As an epigram to this short book, which has sought to repair agency theory in so far as it applies to shareholders and executives in public corporations, I recall a remark once made by the famous economist Alfred Marshall: "the work I have set before myself is this – how to get rid of the evils of competition while retaining its advantages".[21] Marshall urges other scholars of business and economics to work to similar ends. His concerns about the "evils of competition" apply to capitalism in its entirety. For all its strengths as a wealth production system, unrestrained capitalism has major flaws, as we have found out once again. One such flaw is the remuneration committee's dilemma—the risk of executive pay inflation that is not good for the economy or for society. We must fix this problem.

*Further Reading*

This chapter has referred to a number of books which are relevant to the future of capitalism and the public corporation. In particular, I would recommend Jacobs, M., & Mazzucato, M. (2016). *Rethinking Capitalism*. Wiley Blackwell, and Mayer, C. (2013). *Firm Commitment: Why the Corporation is Failing Us and How to Restore Trust in it*. Oxford University Press.

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[21] Quoted by Keynes, J. (1956) "Alfred Marshall, 1842–1924". In A. Pigou (Ed.), *Memorials of Alfred Marshall*. New York: Kelley & Millman, Inc, p. 16.

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