

I don't know any more about politics than you do, but I judge there is a significant chance that, come 2009, all three branches of the Federal government will be Populist. There are two things to understand about populists:

- 1) What populists want is not the next four years—it is the next twenty years.
- 2) They know that the reason they have been out of power so long is campaign money.

Compensation of managers of big public companies is as visible to them as it is to us. Changing the way these companies are governed can go a long way toward solving their money problems.

But the issue is too big to be treated so casually. Abu Ghraib, Katrina—the public sector manages both, makes terrible decisions. Before we abandon the current model of the public company, we should at the very least make the effort to understand it.

In their 1932 book The Modern Corporation and Private Property, Berle and Means gave the populists this justification: if the key to capitalism is putting the decision maker's wealth at risk, then there's a serious problem with the big public companies,

Most investments are irreversible. Although one investor can sell his mistake to another investor; the second investor won't knowingly pay for the first investor's mistake. So the original investor—the investor who commits society's resources to the investment—will bear the loss. This knowledge focuses the mind of the original investor and gives him compelling reasons to make the right decision.

But what of the public company whose ownership and control are completely separate? If management makes a bad decision, don't the powerless shareholders pay for management's mistake? Doesn't this kind of public company undermine the justification for capitalism? The compensation of management is one measure of the problem; another is the takeover premium such companies enjoy.

When Ownership and Control are Separate

Berle and Means are looking for a legal link between ownership and control. When they don't find it, they conclude there is no private responsibility for the company's important decisions.

The actual link is no less important for not being legal. It is financial. Consider the ultimate case: shareholders have no control over the selection, etc., of management and management has trivial shareholdings. Assume:

- 1) public company, with active security markets
- 2) market value of equity is investors' estimate of how much value of company exceeds lenders' claims.
- 3) Freedom to manage, like any freedom, is the power to make decisions others don't understand or approve.
- 4) The power to spend is management's most important power. Management's freedom to spend is measured by the market value of the equity--the investors' estimate of what would be left for them if the company paid off all its creditors. Because the creditors aren't being paid to bear the investment risks in the company, their willingness to finance the company's spending depends on the size of that equity margin.

The actual owners—the people whose wealth is at stake—have no control over management, its selection or its decisions. But every market day they vote on management's power to spend. Thousands of individual shareholders make their best estimates, and then the market averages out their estimation errors in arriving at a price for the company's shares.

We see that, in such a company,

- 1) shareholders care greatly about management's decisions
- 2) management cares greatly about shareholders' opinions.

How it Works in Practice

Management of public companies make three kinds of decisions:

- 1) transparently in the interests of shareholders,
- 2) transparently in the interest of management,
- 3) in the interests of shareholders, but not transparently.

The first don't require any freedom to spend. The second, when they hurt the shareholder reduce management's power. The third are where management justifies its existence—decisions that only management with its special contacts and skills can understand. They will ultimately benefit the shareholders, but, in the meantime, they will hurt management's power to spend. Will management spend money on itself? Probably. Every time it spends money on itself it reduces its power to make the ambiguous decisions. Every time its ambiguous decisions turns out to benefit the shareholders, it increases its power to spend money on itself.

Stakeholders

...would like to spend the public company's money. When they do,

- 1) the value of the shareholders' investment is reduced;
- 2) Management's power to spend is reduced.

Inevitably, stakeholders don't get the degree of cooperation they would like

On the other hand, spending on stakeholders will often increase the company's value (net). And it can also be valuable for management in ways that don't help the company or its shareholders.

So one way of viewing spending on stakeholders is as a special case of management spending:

- 1) transparently beneficial to shareholders
- 2) beneficial to management
- 3) beneficial to shareholders in ways only management can appreciate.

The Power to Spend

Regarding (1), spending that is worth more to shareholders than it costs will raise the value of the equity, giving management more freedom to spend.

Regarding (2), spending on management that doesn't benefit the shareholder will reduce the equity, hence management's freedom for further spending.

Regarding (3) spending that actually benefits the shareholders, but for reasons that only management with its special skills and information can appreciate, will lower the value of the equity temporarily. In order to be free to spend in ways the shareholders don't understand, management must have enough equity to hold out until their benefits are clearer to the shareholders.

Three points about type (3) spending:

- 1) it is precisely the kind of spending where management justifies its existence.
- 2) when the equity margin gets too small, management can't afford to do this type of spending.
- 3) Freedom is the power to act without first justifying our action to someone else.
The corporate manager's freedom is the power to act without justifying his action to his shareholders.

The value shareholders assign to the equity reflects their judgment about the relative frequency of (2) and (3). If they don't trust management, they won't impute enough value to the equity that management has any power to spend on benefits to management. In that case the only decisions it can make are the ones that don't require any special knowledge or expertise. The Result: the company is worth less to the shareholders without management, but worth less to management without the shareholders.

The manager with limited equity can undertake modest projects with quick payoffs. But only the manager with a large equity can undertake big projects with delayed payoffs. The latter has more freedom than the former in the same way that generals in the army have more freedom than colonels.

Corporate managers' freedom comes from their shareholders. Some will be too timid with their freedom, some will be too bold. But they will all cherish their freedom just as much as you and I cherish our freedom.

Freedom may sound like an abstraction, but it is as real as the right to breathe. Management can spend on itself, but every time it does so, it reduces its freedom. On the other hand, every time it spends on something that's worth more to shareholders than it costs, management increases its freedom. (This insight is not in Berle & Means).

In the 1968 edition, Berle and Means added a new final chapter arguing that the laws governing big public companies should be changed in ways that moved these companies from the private sector toward the public sector. The key to their argument: the legal link—what they called the Trust Model—by which the shareholders exercise control over the managers, has broken down. Among their proposals:

B&M 1968

p. 303	Private enterprise, individual initiative, the profit motive, wealth, competition...are inapplicable to...enterprise as carried on by the great corporations
305	Set of individuals held powers over an enterprise, but have almost no duties in respect to it which can be effectively enforced.
306	[shareholders' wealth is]...liquid, impersonal and involving no responsibility...
307	[] At the very pinnacle of the hierarchy...can individual initiative have a measure of free play.
310	Demands are being put forward that the men controlling the great economic organisms be made to accept responsibility for the well being of those who are subject to the organization
311,12	Either the trust model or "an era of corporate plundering".

313	...assigning to each [of the various groups in the community] a portion of the income stream on the basis of public policy. ¹
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The present system, which admittedly has created problems for populist politicians, works surprisingly well for a system in which there is no link between the owners and the decision makers. We have seen that the reason is that the link is financial, rather than legal. When populist politicians come to power, we need to be prepared to explain this link.

Campaign Contributions

...are a special case of Type 2 management spending: the benefit is entirely to management, whereas the cost is borne entirely by the shareholders.

It's possible that, in many political contests, the interests of the shareholders are different from—even opposite to—the interests of management. Because the owners

¹ If stakeholders were entitled to make nominations to the board of directors, they could arrange to concentrate their voting (stakeholders are nothing if not numerous.) The likely result is the election of directors representing particular groups of stakeholders.

Such directors will find it in their interest

- 1) to endeavor to be seen by their group of stakeholders as an energetic advocate;
- 2) to be very articulate about the needs of the group they represent
- 3) to make sure that their statements to the board get into the hands of reporters
- 4) to be quick to take issues with the board to the public.

A board dominated by representatives of stakeholders would be a collection of directors whose stake in the company's equity was relatively unimportant. Their motivation would differ from management's motivation in this critical respect. Such a board would be a debating society—a political organization rather than a financial organization. Decisions by a private sector dominated by such boards would be no more efficient than decisions in the public sector. There would be no—or almost no—private responsibility for the company's private-sector decisions.

and the managers are different people, one result is that the manager can make big corporate contributions with the owners' money. It's even possible that if the campaign contributions of the large public companies had come from the shareholders that the populists would have been in power for the last 20 years.

I don't know what changes in the laws governing large public corporations would be necessary to change the control over campaign contributions—and if I knew, I wouldn't tell.

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