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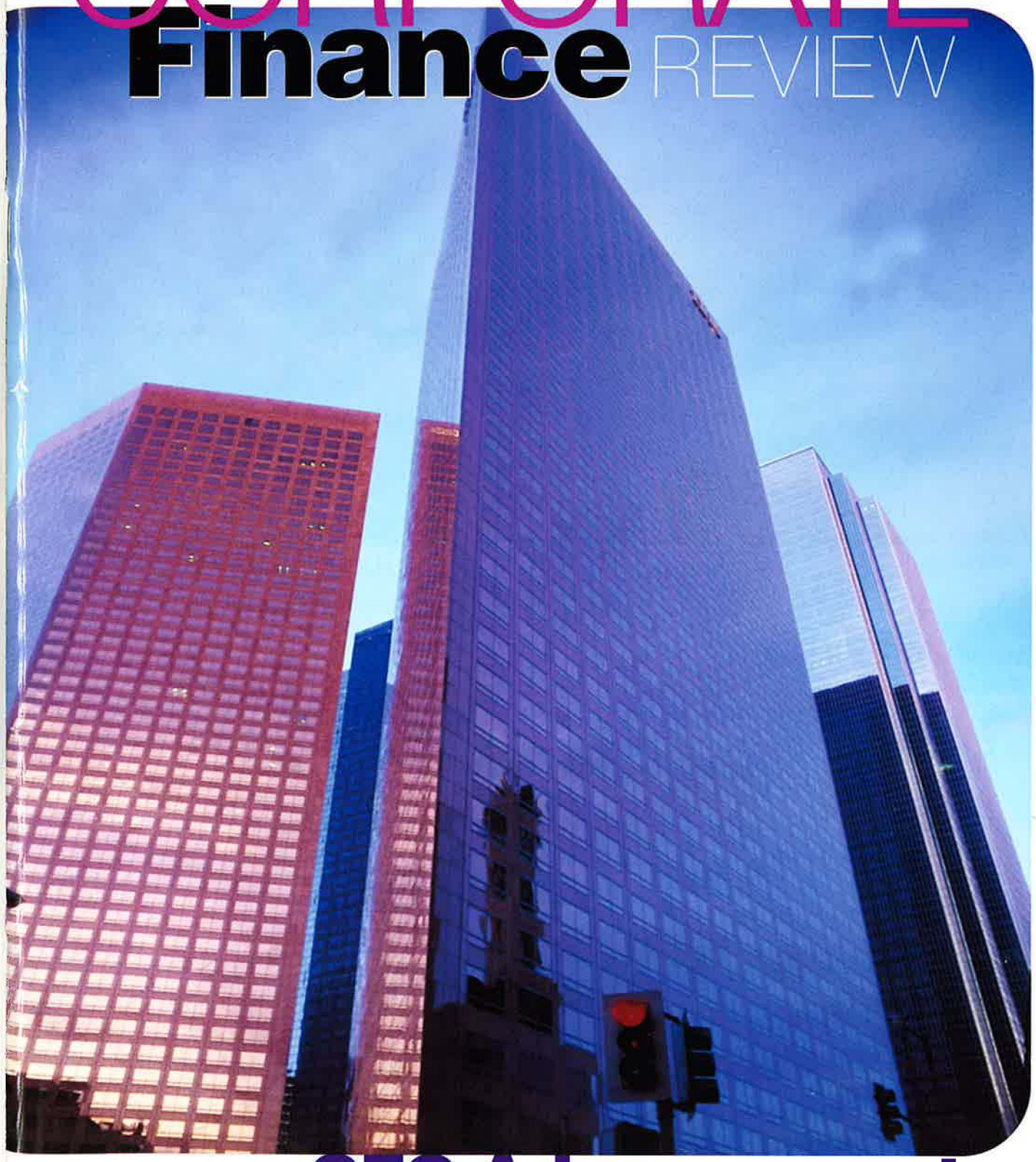

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CORPORATE Finance REVIEW

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EXECUTIVE COMPENSATION — 20TH AND 21ST CENTURY DISCUSSION AS "CONTROL" AND "OWNERSHIP" WAS BEING TRANSFORMED

There's one business topic that could be counted on as a perennial point of discussion over the past three or four decades — and that can at times raise interest and lead to sensational headlines in the popular press: the matter of executive compensation. What is fair? And to whom? And who should decide on what the top managers of large enterprises with dispersed owners should be paid? Should shareholders have a say in the matter?

The evolvement of the large industrial organization more than a century ago required new forms of "control" (or management) and new relationships between the suppliers of capital (financiers and "owners") and the hired professional managers. The evolution has created the need for close examination of the relationship between large private sector organizations and the public at large as well as business and the public sector of the United States (and other western democracies).

It's been a century and more since the western societies have evolved from primarily agricultural-based economic systems (with land ownership and/or control as the primary basis of building great wealth) to an industrial-based economy (with mass production) and, more recently, to a more services-based economy where intellectual private property is a means of generating wealth. As more people left the land to work in industry, the subject of financial reward or compensation became more of a topic of discussion (today, about 2 percent of the U.S. population works on farms, compared to more than half a century ago).

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Owner–managers in control

In the early days of American industrialization, the owners of the enterprise (who were also the managers) enjoyed the profits generated by the business: Think of Henry Ford and the Ford Motor Company, Thomas Edison and his early electric generating utilities, Isaac Singer and the Singer Sewing Machine Company, John D. Rockefeller and Standard Oil, Andrew Carnegie and Carnegie Steel, etc. These companies were run day to day by the founders, and while financial backers were involved, control and the rewards of financial success mainly accrued to the founder/manager and a few close associates. They were the royalty of the new world, usually handsomely rewarded for their business success and lauded by the populace as creators of great wealth.

Yes, there were financial backers and minority partners involved, but for the most part, the founders and a small number of majority owners of the early stage large industrial enterprises became the wealthiest business leaders, especially in the days before federal taxes on income.

Enter the modern corporation

The modern American corporation was created, it's been said, when Andrew Carnegie, once the richest man in

America, sold his interests in his steel business and the new owners, guided by J.P. Morgan, created United States Steel Corporation. This was said to be the largest "public company" of its time (the first billion-dollar-plus company in terms of market capitalization). Other large enterprises issued stock, and the modern shareholder-owned company quickly became the dominant theme of American business. The familiar "generals" were primarily shareholder-owned enterprises — General Foods, General Electric, General Motors, etc.

To be sure, Wall Street leaders like Mr. Morgan helped to create large business enterprises, often by collecting smaller companies — Jim Hill and Commodore Vanderbilt "collected" railroad interests; John Rockefeller and associates assembling Standard Oil Company.

Founder Henry Ford's looming presence over the Ford Motor Company was legendary. He had an office on the factory floor and was at home among the machines and assembly lines (and less comfortable in the corner office). After buying out minority shareholders, Mr. Ford and his family held almost 60 percent of the stock in his "huge new company."[1]

In contrast, rival General Motors was organized with shareholder money and entrepreneurial companies acquired (such as Pontiac, Olds, and Buick), and the men in charge had the shareowners' interest uppermost in mind. Reflecting on that important aspect of company finances, founder and former chairman Alfred P. Sloan wrote in his autobiography: "We like to believe that we have made a contribution as an industrial leader. Employees, shareholders, dealers, consumers, suppliers — and the government to a large degree — have shared in the success of General Motors."[2]

Sloan: "How has the corporation served its owners? I believe this can best be seen by looking at the financial record of the business — how the funding was supplied or secured, and how they were used from the beginning to the present." (This was written in the late 1950s.)[3] GM was then the largest industrial company in the United States, and the shares were widely held by individuals and institutions. Ford Motor Company did not issue public stock until 1956 — almost a decade after the death of the founder. Even before that, his successor, grandson Henry Ford, was bringing professional managers in to run the business.

Segue: Owner–manager to professional manager

In the early years of the 20th century, the steady progression from the founder–owner–manager model of corporate management (with relatively few partners or shareholders) to a broad, diversified ownership base with elected boards of directors and appointed managers continued at a rapid pace. Many enterprises would not have reached the scale they did without greatly expanded access to shareholder capital — such as Radio Corporation of America (RCA), the darling of Wall Street investors before the 1929 crash. (It was the Apple or Google equivalent of its day in terms of market enthusiasm for the new, new thing — radio.)

Shareholders rise and need protection

After the October 1929 crash of the American stock market, protection of investors became a paramount concern for the U.S. Congress and newly elected President Franklin D. Roosevelt and his advisors (his "brains trust," including academics and reform-minded bureaucrats from the days of his New York governorship).

The result was passage over two years of the first comprehensive approach to regulating the capital markets and, to some extent, corporate behavior — the Securities Act of 1933 and the Securities Exchange Act of 1934. Neither addressed limits on executive compensation.

This writer has returned from time to time to review the prescient views of two of those early 1930s presidential advisors, who examined the foundations of the new large-enterprise corporate model and the relationships of the dispersed base of shareholders to the elected boards of directors that represented their interests. The boards were there to hire, oversee, and fire the professional managers

IN THE EARLY YEARS OF THE 20TH CENTURY, THE STEADY PROGRESSION FROM THE FOUNDER-OWNER-MANAGER MODEL OF CORPORATE MANAGEMENT (WITH RELATIVELY FEW PARTNERS OR SHAREHOLDERS) TO A BROAD, DIVERSIFIED OWNERSHIP BASE WITH ELECTED BOARDS OF DIRECTORS AND APPOINTED MANAGERS CONTINUED AT A RAPID PACE.

(most of whom owned tiny amounts of the stock of the companies that they managed, unlike their owner–manager predecessors of previous generations).

Those advisors were influential authors — Columbia University faculty members Adolf A. Berle, Jr. and Gardiner C. Means with their book, *The Modern Corporation and Private Property*. Their work was instrumental in the shaping of corporate law and attitudes toward the new corporate models, thoughtful examinations of the foundations of the modern economy, and control of the corporation as well as the rights of shareholders.[4]

The Modern Corporation and Private Property

Authors Berle and Means published their landmark work in 1932 — and while the original version can fetch millions of dollars at auctions (when one can be found), *The Modern Corporation and Private Property* is still in print for today's readers. The book was prepared as a study of then-recent trends in corporate development under the auspices of the Columbia University Council for Research in the Social Sciences, which was acting on behalf of the Social Science Research Council of America. A.A. Berle was a lawyer and law school professor; Gardiner Means, a Columbia University economist.

THE INSTITUTION OF PRIVATE PROPERTY ENABLED THE EVOLVEMENT OF MODERN DAY ECONOMICS AND SPURRED ON THE INDUSTRIAL REVOLUTION.

Berle wrote in his July 1932 introduction to the work that "it is of the essence of revolutions of the more silent sort that they are unrecognized until they are far advanced. This was the case with the industrial revolution, and is the case with the *corporate revolution through which we are passing* [emphasis added]." What "revolution" was that? "The translation of perhaps two-thirds of industrial wealth [of the United States] from individual ownership to ownership by the large, publicly-financed corporations vitally changes the lives of property owners, the lives of workers, and the methods of property tenure. The divorce of ownership from control...almost necessarily involved a new form of economic organization of society."

In his introduction, Professor Berle acknowledged that understanding the role of the large industrial corporation would take a lifetime of work. The project was intended as a start on that effort, to break ground on exploring the (new) relationship to private property (and inherent rights of private ownership).

One important question that he posed continues to be discussed more than 80 years later: "...there will remain the problem of the relation which the corporation will bear to the state — whether it will dominate [the state] or be regulated by the state or whether the two will coexist with relatively little connection." How much influence will the corporation have on the public sector...and vice versa?

They pondered the question: Will large corporations dominate as an *economic force* or a *political force*? Nine decades on, in the 21st century, we see a blurring of lines — the large, publicly held corporation is indeed both. And the public sector has shaped many elements of the modern corporation. The relationship is symbiotic and interdependent.

Who controls and benefits?

On the benefits of control, Berle and Means were prescient in offering their perspective. They saw the modern, large, industrial corporation as a new institution of private property, succeeding the models for economic activity that stretched back to medieval days and the times of the feudal system with its serfs and lords of the manor (the large landowners, the basis of wealth). The institution of private property enabled the evolvement of modern day economics and spurred on the industrial revolution. Even before the industrial revolution was well underway, in Scotland, Adam Smith, "as student and professor" at the University of Glasgow, was authoring *Wealth of Nations*, which recognized the basic importance of economic self-interest and the nature of ownership of property (and therefore "wealth").[5]

Berle and Means recognized this in what they viewed as the emergence of the "quasi-public" corporation, with many more individuals "owning" the company,

and that ownership would continue to "atomize," with managers of great enterprises owning insignificant pieces of the business — and many more individuals would own the publicly available shares that were issued to raise capital.

But this was key: Stockholders "surrendered" (or yielded) their control to professional, hired managers, under which power and control would be very concentrated.

The new economic system — With corporation as anchor

What this author comes back to from time to time is the critical observation: "This [new economic] system bids fair to be all-embracing as was the feudal system in its time. It demands that we examine both conditions and trends, for an understanding of the structure upon which will rest the economic order of the future..."

The large, publicly owned enterprises that seemed to be closely examined by Berle and Means were United States Steel and American Telephone and Telegraph. These were then-prominent examples of companies where stock distribution was widespread and control was "virtually in the hands of a small, self-perpetuating board of directors." The public (at that time) showed little interest to quarrel with the arrangement, and the problems with control seemed to be academic, or would be in another generation.[6]

Berle and Means did not address directly the issue of executive compensation. Two decades earlier, the 26th president, Theodore Roosevelt, proposed a tax on the very rich (who were very often the owners and managers of large business enterprises), proclaiming in August 1910, "The really big fortune, the swollen fortune, by the mere fact of its size, acquires qualities that differentiate it in kind as well as degrees from what is possessed by men of relatively small means. Therefore, I believe in a graduated income tax on big fortunes." Three years later, the progressive political forces had their federal income tax (authorized by constitutional amendment).

The original top rate was 7 percent on incomes over $500,000 — $8.5 million in constant dollars according to the CPI Inflation Calculator.

Theodore's sixth cousin, President Franklin D. Roosevelt (#32), raised the top rate to 79 percent in 1935 (in the depths of the Great Depression, when one in four heads of household was unemployed). During World War II (1941–1945), to prevent profiteering by government suppliers, the rate was raised to 94 percent on top incomes, and tax withholding was introduced as many more workers paid income taxes. The high rates would stay in effect for another generation.[7]

In 1967, economist John Kenneth Galbraith, writing in his book, *The New Industrial State*, observed under what he termed "the managerial revolution" that "management does not go out ruthlessly to reward itself — a sound management is expected to exercise restraint. At this stage, in the accepted view of the corporation, profit maximization involves a substantial contradiction. Those in charge forgo personal reward to enhance it for others." Professor Galbraith saw in the mid-1960s "few corporations in which it would be suggested that executive salaries are at a maximum."[8]

Over the following decades, compensation for the senior managers of public companies would continue to rise and draw the attention of the "atomized owners" that owned the shares of the enterprise.

OVER THE FOLLOWING DECADES, COMPENSATION FOR THE SENIOR MANAGERS OF PUBLIC COMPANIES WOULD CONTINUE TO RISE AND DRAW THE ATTENTION OF THE "ATOMIZED OWNERS" THAT OWNED THE SHARES OF THE ENTERPRISE.

Executive pay in the 21st century

With the passage of the Sarbanes–Oxley package of legislation in July 2003, and adoption of rules for listed companies by the New York Stock Exchange and NASDAQ, certain aspects of executive compensation would be governed not only by boards of directors, but also by federal laws and regulations. In the boardroom, compensation committees would have to act independently, and disclosure about compensation of top officers would have to be greatly expanded. Following the financial market collapse of 2007–2008, the U.S. Congress passed Dodd–Frank, which calls

for rules to define various aspects of executive compensation.[9]

In future commentaries, we will explore 21st century executive compensation and the continued dynamic tension between owners and those who control the large enterprise — and have great discretion over such matters as executive compensation.

Summing up

As the large, industrial business enterprise evolved, a revolution in the nature of owner and manager relations took place, with separation of ownership and control. While control remained in the hands of a relatively small number of professional managers, the ownership of the corporation "atomized," in the words of Berle and Means. Over time, the federal government would exert influence over many aspects of corporate behavior, eventually even over matters related to compensation of those in control. ■

NOTES

[1] Lacey, R., *Ford, The Men and Machine*. (New York: Little Brown & Company, 1986). "In mechanical terms, Henry Ford appears to have consecrated most of his twenties and thirties to the joy of tinkering." Some of Ford's early backers were also investors in (Detroit) Edison Illuminating Company. Ford detested investors and shareholders, as biographers have pointed out.

[2] Sloan, Jr, A.P., *My Years With General Motors*. (New York: Double Day & Co., 1963). Sloan passed two years later. GM was emblematic of the "new" industrial companies of the 20th century, with professional managers in charge and the "owners" remotely connected through their investments. Famed management expert Peter Drucker would profile General Motors in his first book, published in 1946, *Concept of the Corporation*, which he described as "the first study of management as a discipline, the first study of a big corporation from within, of its constitutional principles, of its structure, its basic relationships, its strategies and policies." (From the 1990 introduction to the updated Sloan autobiography.)

[3] *Ibid*.

[4] Berle, Jr, A.A. and Means, G.C., *The Modern Corporation and Private Property*. (New York: The MacMillan Company, 1932).

[5] Smith, A., *The Wealth of Nations*. (London: W. Strahan and T. Cadell, 1776).

[6] *Op. cit*. note 4.

[7] Folsom, Jr, B. and Folsom, A., FDR's class warfare: A tutorial for Obama, *The American Spectator* (Dec 2011–Jan 2012). This essay is available at: http://spectator.org/archives/2011/12/08/fdrs-class-warfare-a-tutorial/print (Burson Folsom, Jr., professor of history at Hillsdale College, is also the author of *New Deal or Raw Deal* (New York: Simon & Schuster, 2008)).

[8] Galbraith, J.K., *The New Industrial State*. (Boston: Houghton Mifflin Company, 1967). This book contains his examination of postwar large companies. The book was begun a decade earlier but was interrupted when President John F. Kennedy asked Harvard Professor Galbraith to become U.S. ambassador to India, after serving as economic advisor to the president.

[9] National Association of Corporate Directors (NACD), "Dodd-Frank: Where Do We Stand" (March 2012). This paper shows the top issues at a glance for directors of public companies. The research paper deals with such issues as mandated shareholder approval for compensation (say-on-pay) — including say on "parachutes," independent compensation committees and consultants, pay-for-performance and pay-ratio disclosures (top pay and other employees' pay), executive pay clawbacks, employee- or director-hedging disclosure, and other issues.