CASE STUDIES:
CORPORATIONS IN CRISIS

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CASE STUDIES: CORPORATIONS IN CRISIS

General Motors

GENERAL MOTORS AND PIERRE DU PONT

In 1915, the Treasurer of the DuPont Company, Jacob J. Raskob, persuaded Pierre S. du Pont to buy 2,000 shares of a fledgling company called General Motors (GM). Raskob had been interested in the motor vehicle industry for some years, believing that it would enjoy enormous growth when life settled down after the war.

General Motors at this time was a motley grab-bag of small companies including Buick, Cadillac, Oldsmobile, and Oakland, which later became Pontiac. The companies were joined only by the fact that they had been bought by GM's founder, the visionary but unpredictable William Crapo Durant. Durant, at one time a highly successful carriage engineer, had been acquiring small motor companies and parts manufacturers since 1904. By 1914, GM was the second largest automaker in the country, though admittedly a very distant second to the mighty Ford.

Pierre du Pont's personal investment of 2,000 shares proved bountiful. By December 1915, the shares that du Pont had bought for $82 had shot up to $558. The rise did not reflect GM's growth so much as the massive industrial expansion generated by the war effort. However, the rapid increase in value was enough to persuade du Pont that he had stumbled on a very promising business. In 1915, Pierre du Pont joined GM's board, unofficially as chairman. (In line with convention, we will refer to the company as DuPont and the person as du Pont.)

In fact, GM was dogged by uncertainty; mismanagement constantly threatened to throw the company into bankruptcy. Durant was regarded by contemporaries as too much of a genius to be a successful businessman. GM's headquarters consisted only of Durant, a few assistants, and a handful of secretaries, so that Durant had neither the time nor the resources to exert central control. Moreover, he planned only on the basis of ever-increasing sales producing consistently improving cash flow, so that even the slightest recession could leave Durant unable to pay his workers or suppliers. In 1910, such a drop had left GM close to collapse. The company was only rescued by the infusion of a $15 million loan from Durant's bankers, who assumed control of the company as collateral. In 1915, with GM's stock price booming once again, Durant set out to reclaim his company from the banks. By April 1915, Durant had been able to buy 50 percent of General Motors stock via a series of hastily constructed deals. Durant claimed that he had the support of du Pont — an assertion that Pierre read with astonishment in his Delaware newspaper.

Pierre du Pont agreed to serve as chairman because he wished to protect his investment. While he admired Durant's drive and imagination, he believed him to be financially haphazard and without discipline. He wished to impose some of the rigorous financial controls and committee structures that characterized Pierre's own DuPont Company. Durant had other ideas; he wanted du Pont's financial backing, but not his advice. In the words of business historian, Alfred Chandler, Durant "had no intention of working with his board. He
considered it merely a paper organization that he had to have to meet legal requirements and accepted business practices. The founder, who had regained his company, was going to run it by himself.”

Durant contemplated a five-man board, a three-man executive committee, and no finance committee. Raskob and du Pont refused, believing that strict financial control was the only thing that could prevent Durant from running amok. They insisted on a large board, with both financial and executive committees. Not that this rendered Durant accountable. As Chandler writes, “The meetings of the board itself were called only on the shortest notice and then at the initiation of the president, not the chairman.” The result was constant friction between du Pont and Durant. Pierre demanded monthly balance sheets to be presented to the finance committee, but often didn’t receive them. He insisted that Chevrolet be merged with the GM parent to sort out some of the financial tangle that existed between the two companies and to create an ordered, single corporation. Durant gave in reluctantly.

Ultimately, du Pont gained the upper hand in the relationship because he had the money. Increasingly, Durant relied on du Pont to help out his cash-starved company. After rising at the beginning of the war, auto stocks collapsed as the market recognized that people wouldn’t be buying cars for a while. In late 1917, it became apparent that GM would not survive without the kind of investment that only the DuPont Company could provide.

DuPont at this time was rich, with $90 million earmarked for investment. Of that, only $40 million was to be spent on the chemical industry, leaving $50 million for outside projects. Pierre du Pont thought a stake in a business that was sure to expand postwar made perfect sense. After long negotiations with the DuPont board, the company bought $25 million of GM common stock in January 1918. This was equal to a 23.8 percent stake.

A crucial part of the deal was that, in exchange for its cash, DuPont would gain control. Pierre insisted that the finance committee be comprised of a majority of du Ponts and be chaired by Raskob. Pierre’s idea was that if DuPont could exert strict financial control, Durant could take charge of operations. Pierre wished to exploit Durant’s drive and imagination but to keep it under his own disciplined oversight.

GM, meanwhile, was engaged on an ill-advised program of expansion, as the company set out to integrate its operations vertically by buying a major supplier, dramatically increasing production capacity. It also bought Fisher Body Corp. for nearly $28 million, and GM’s workforce increased exponentially. As the expansion continued, DuPont was required to add fresh infusions of capital. By the end of 1919, DuPont had increased its investment in GM to $49 million, equal to a 28.7 percent stake.

The strategy did not survive the onslaught of the postwar recession. As demand collapsed still further in the ravaged American economy, Ford slashed prices, knowing that GM would have a hard time doing likewise. Ford took an even greater slice of market share, capturing 60 percent in 1921, up from 45 percent in 1920. GM’s market share fell from 17 to 12 percent over the same period. GM was capturing a diminishing share of a diminishing market. The company’s sales declined three-quarters between the summer and winter of 1920, and, in January 1921, the company recorded an all-time low in the production of vehicles.

The combination of the expansion and the recession was disastrous. Worse, Durant made a desperate single-handed effort to prop up GM’s collapsing stock price. Borrowing money from whatever sources he could, he bought up GM stock as it was dumped by the market. In November 1920, Durant’s debt amounted to some $38 million as GM neared financial collapse.
Pierre du Pont was faced with a choice. He could abandon the troubled company and cut his losses on the investment or he could stand by his initial belief that GM represented a potential high-growth company and take steps to ensure its survival. He opted for the second choice, bringing his financial credibility to bear in persuading J.P. Morgan to refinance GM. At the same time, DuPont contributed still more money, raising its stake to 36 percent.

Having restored the company’s ability to operate, Pierre du Pont took a huge step in ensuring that GM wouldn’t run into such problems again. In December 1921, Durant was forced to resign and Pierre took over the presidency of the company himself. He set about reorganizing and revitalizing GM, making DuPont’s investment spectacularly profitable. By 1928, when Pierre retired as chairman of GM, the company had surpassed the once unassailable Ford as the nation’s number one automaker. GM still holds that distinction today.

Part of the reason for du Pont’s success at GM was his recognition of the management genius of Alfred Sloan, who would continue to be involved at GM until after World War II. Pierre stayed on as president until 1923 – just long enough to ensure GM had sound financial foundations – before handing it over to Sloan. Sloan, in turn, was responsible for the reinvention of the motor car as a work of style and design, in contrast to Ford’s one-type-only Model T.

Sloan’s leadership also transformed GM’s operations, creating the multidivisional structure that still characterizes the company today. Since the 1920s, GM has remained divided into five automaking divisions: Chevrolet, Pontiac, Oldsmobile, Buick, and Cadillac. The five represented very different automobiles aimed at very different markets. GM operated under what Sloan called a “price pyramid,” so that Cadillac, at the top, had the highest price and the lowest volume and Chevrolet, at the base of the pyramid, had the lowest price and the highest volume. The aim, as Sloan put it, was to manufacture “a car for every purse and purpose.”

Pierre du Pont also succeeded because he was much more than an idle investor. For instance, in 1923, du Pont committed more than a quarter of his GM shares to fund a stock purchase plan for senior GM managers. In Sloan’s words, du Pont was fixed “on creating a partnership relationship between General Motors’ management and itself.” Possibly it was the close relationship between DuPont and GM that prompted antitrust regulators to intervene. In 1957, the Supreme Court forced DuPont to dispose of its stake in GM. The court did not find that DuPont had violated the law; they merely concluded that the potential for abuse existed.

William Taylor, associate editor of the Harvard Business Review, identifies three critical factors in du Pont’s involvement:

First, the size of the investment created a real stake for both sides. Will Durant could not afford to ignore the opinions of a 25 percent owner, and du Pont could not ignore problems with his company’s largest outside investment. Second, there was commitment. Du Pont did not own shares in Ford or in any of GM’s other competitors, so GM could provide him with confidential plans and information without worrying that they would be misused or end up in the hands of rivals. Finally, there was expertise. Pierre du Pont was named chairman of GM’s finance committee in 1917; by 1920, he had a good sense of the company’s operations, people, and strategic blind spots – the hard and soft data that are invisible to most outsiders but are the essence of why big companies function poorly or well.4
DuPont’s power at GM was impressive, but there was also a remarkable sense of its responsibilities. Unless GM grew and prospered, there would be no profit... At times the only sensible course, and the one du Pont followed, was to commit further resources... In the troubled days after WWI there was pressure to dismember GM and to recoup DuPont’s investment, as part of what now would be called a ‘restructuring.’ DuPont was able to extend itself, partly because it had the wherewithal to do so but more profoundly because from the outset its decision about GM had been as particular and deliberate as it was significant. DuPont understood why it invested in GM, and neither the dramatic downturn of 1920, the predatory pricing by Ford, nor the failures of GM’s management shook that faith. And somehow neither the initial losses nor the later profits ever blurred the separate identity of the two companies. DuPont never contemplated merger, but neither was GM just part of a portfolio that could be dumped at the first hint of a quarterly downturn.5

Both these commentators regard the DuPont–GM relationship as a model of “relationship investing,” in which the providers and managers of capital work together to achieve their mutual goals. Indeed, Lowenstein comments dolefully, “It is tempting to think about whether GM would have stumbled so badly in the 1970s and 1980s if the DuPont company had still been there.”

GENERAL MOTORS: WHAT WENT WRONG?

THE POST-WAR PERIOD

In the dazzling firmament of America’s postwar industrial success, there was no brighter star than General Motors. Along with Ford and Chrysler – the “Big Three” – GM rode the coat-tails of the United States’ spectacular journey to worldwide commercial dominance. The American middle class grew in size and wealth; a network of highways opened up the continent; gas prices remained absurdly low; Americans developed a romance with the road and a love of driving. Under these blissful conditions, Detroit’s automakers captured nearly 90 percent of the North American market, with GM itself responsible for nearly half of all cars bought in the US.

Thanks to Sloan’s legacy, GM was organized to match a person’s progression in car buying. A 16 year old would pick up a cheap but trusty Chevrolet; married with no children, he might trade in for a classier, racier Pontiac; when the kids arrived, he’d need a bigger car to pack in the crew and would aim for maybe an Oldsmobile; when he’d aged a bit, he’d plump for the nice, safe Buick; and if he was old and rich he’d cruise to the country club in a Cadillac. In other words, if a customer bought a Chevy and liked it, he remained locked into buying GM for life.

In 1952, GM’s president, Charlie Wilson, testified to the Armed Services Committee that: “What’s good for the country is good for General Motors, and what’s good for General Motors is good for the country.” His statement captured the arrogance of the largest corporation on
earth. Indeed, GM’s greatest fear in the 1950s and 1960s was to keep its market share down so as to avoid a possible antitrust suit from the federal government. Its dominance continued into the 1970s. In 1972, GM was the fourth largest company on earth with a stock market valuation of over $23 billion – nearly four times the value of the family-dominated Ford.

In two short decades, this bright picture dimmed. In 1992, GM was the fortieth largest company in the world, its stock market valuation only $22 billion – less than it had been 20 years earlier. Its market share had plummeted to less than 35 percent, causing GM’s core North American operations to lose $7 billion in 1992 alone.

The scale of GM’s decline became obvious in December 1991, when CEO Robert Stempel announced a huge downsizing. Six assembly plants were earmarked for closure, with 15 other plants to follow by 1995. A total of 74,000 jobs would be lost as a result of the cuts – reducing the GM workforce to half its 1985 size. The layoffs merely worsened GM’s already testy relationship with the United Auto Workers (UAW) union.

At the time of this announcement, GM’s stock traded at a four-year low, about half what the stock was worth in 1965, though the S&P 500 had quadrupled in that period.

In October 1992, the GM board did what no GM board had done since 1921. It pressed for the resignation of the chairman and CEO, Robert Stempel. Stempel, who had only had the helm of GM since August 1990, was pushed out for moving too slowly on downsizing the company, streamlining operations, and improving efficiency. A new breed of managers took over, their mission to fix General Motors.

In 20 years GM had gone from being a golden corporate success to being what Fortune magazine called a corporate “dinosaur.” What went wrong?

The history of GM is an instructive story in how success can breed failure; how being the biggest and the best can lead to arrogance and an inability to adapt. GM was the premier car company in the world for so long that it failed to see the need for change. The company was so used to being leader that it couldn’t contemplate following others. It was this mindset, this overwhelming belief that it was GM’s divine right to be the most successful automobile company on earth, that condemned the company to two decades of disaster. When GM did finally see the need to adapt, it did so with wild ineptitude, spending tens of billions in the 1980s for little reward.

As we review what went wrong at GM, and why, keep in mind our corporate “tripod” of shareholders, directors, and management.

- Which group should have been responsible for seeing that GM adapted to a new competitive environment? All three?
- Or some other group, less intimately involved in GM and less beholden to its culture: suppliers, consumers, employees, the government?
- Given that it is in none of these groups’ interests to see GM fail, and given the company’s enormous resources to compete, why did no one (or at least no one in a position to do anything about it) see GM’s decline coming?
- And why couldn’t anyone head the crisis off before billions of dollars were wasted and tens of thousands of jobs lost?

GM was not alone in its failure to reposition itself for a new competitive environment. Ford displayed equal hubris in the face of the Japanese and suffered just as badly; Chrysler was only saved from bankruptcy by the intervention of billions of dollars in federal loan guarantees. However, both companies, being smaller, were able to respond to their respective crises with more rapidity. GM, by contrast, became living proof of the old boxing maxim: the bigger they are, the harder they fall.
THE GM “CULTURE”

GM was such a powerful, dominant company that its cars, and its name, were an American institution. The trouble was that the company was managed like an institution. It was highly risk-averse, chronically slow to change, endlessly bureaucratic, and contemptuous of competition.

GM employees were expected to display unwavering loyalty to the GM organization, subsuming their personality to that of the corporate giant. Employees were expected to be “team players,” meaning that they never questioned a decision, never contradicted the boss, and conformed with the corporate stereotype. One author describes a GM employee driving 40 miles each morning to pick up his superior’s newspaper, and saying he didn’t mind the chore because one day he would be promoted and have someone perform the task for him.6 A second writer tells the story of a GM executive who required his morning orange juice to be a certain temperature, so each day an underling would check the glass of juice with a thermometer.7 Risk and creativity were not in the GM lexicon. A memo circulated by a senior GM executive in 1988 said, “Our culture discourages frank and open debate. The rank and file of GM personnel perceive that management does not receive bad news well.”8 Automotive analyst and author Maryann Keller quotes one executive who told her, “If you raised a problem, you got labeled as ‘negative,’ not a team player. If you wanted to rise in the company, you kept your mouth shut and said yes to everything.” Keller asserts that the guiding principle of GM corporate life was, “Above all, be loyal to your superior’s agenda.”9 This culture was matched by the decision-making process. Decisions were shuttled higher and higher up a hierarchy of committees so that if anything went wrong, nobody would ever take the blame. Orders flowed from the top down; ideas seldom percolated up. It was a system in which no one took responsibility for any decision, so no one had any need to be accountable for one. The same 1988 memo pointed out that fewer than 100 salaried workers (out of over 100,000) were dismissed annually for poor performance between 1977 and 1983.10 Keller points to a 1980s study by the McKinsey management consulting firm that highlighted the accountability problem. The study detailed how an engineer, faced with a defect, couldn’t simply offer a solution to the manufacturer. Rather, “you have to produce 50,000 studies to show that it’s a better solution, then you have to go through 10 different committees to have it approved.”11 The stultifying bureaucracy resulted from the fact that GM concentrated more on “making the numbers” than on making cars. This derived from the dominance of the financial wing of the company.

From 1958 and the appointment of Frederick G. Donner as chairman, GM was headed by a succession of finance men – “bean counters” as opposed to “car guys.” The understanding was that an engineer, left to his own devices, would spend limitless amounts of money in pursuit of the ultimate car, and it was important for the financial people to keep the engineers in check.

The rule of the finance department was that no idea was worth introducing if it didn’t directly boost the bottom line. In the 1950s, GM couldn’t afford to raise its sales – to do so would be to arouse the ire of federal antitrust regulators. Instead, GM sought to increase earnings from the same level of sales by cutting costs and thus raising the profit margin per car. Corporate heroes were those who could shave a dollar from a manufacturing process. GM never chased grand new ideas because there was no need. When existing car lines were capturing half of the US car market, what was the point of spending millions of dollars developing a different model that might not sell? What was the point of offering seat belts when customers were perfectly ready to buy GM’s cars without them? As one observer notes, “It was much easier for GM to add a $20 piece of chrome or a $5 sports stripe and call the car a ‘new model’ than take a chance with costly new technologies, such as antilock brakes or multivalve engines.”12
GM AND QUALITY

GM sold so many cars that there was no reason to slow up assembly lines to improve quality – after all, dealers only complained that they weren’t receiving enough cars, not that the cars being delivered were defective. Again, the pressure was to “make the numbers” and produce the required number of cars. GM’s only worry was whether it could produce enough vehicles to serve its massive market, so cars were subjected only to routine inspections. If a customer bought a dud, he could always send it back.

Shoddy quality was never fixed because bad news never traveled far in the corporation. If too great a percentage of GM cars failed their quality inspection, the standards were simply lowered so that more cars could pass. Keller interviewed one truck executive who learned the hard way. In the late 1960s he reported to the executive committee that few GM trucks lasted even a single year without a breakdown, so poor was manufacturing quality. After the meeting, the boss approached him and said, “We don’t talk about things like that in administrative meetings.” This combination of factors meant that Detroit continued to make much the same cars in much the same way year after year. The lack of innovation was startling. This didn’t escape the notice of some GM executives, notably John DeLorean.

“My concern was that there hadn’t been an important product innovation in the industry since the automatic transmission and power steering in 1949. That was almost a quarter century of technical hibernation. In the place of product innovation the automobile industry went on a two-decade marketing binge which generally offered up the same old product under the guise of something new and useful. There really was nothing essentially new.”

THE “FOURTEENTH FLOOR”

The fourteenth floor of General Motors’ Detroit headquarters became the living symbol of GM’s size and dominance. Here was Executive Row, housing the offices of GM’s most senior officers, people who almost invariably had spent their whole working life at GM. Behind two sets of locked glass doors, near the private executive elevator (that ran down to the heated executive garages) and close to the private executive dining rooms, the most vital issues concerning the corporation were decided.

John DeLorean, who quit shortly after being promoted to the fourteenth floor, describes how he found himself buried in paperwork, wrapped up in endless committee meetings, and cut off from the business of building automobiles. DeLorean describes one executive meeting (which he says often put a third of attendees to sleep) in which a minor point of compensation was being discussed. Suddenly the chairman, Richard C. Gersternberg, barked out some orders:

“We can’t make a decision on this now…. I think we ought to form a task force to look into this and come back with a report in 90 to 120 days. Then we can make a decision.” He then rattled off the members of the task force he was appointing. There was
an eerie silence after the chairman spoke. It lasted for what seemed like half a day. The whole room was bewildered but no one had the courage to say why. Finally, Harold G. Warner, the snow-white-haired, kindly executive vice president, who was soon to retire, broke the silence. “Dick this presentation is the result of the task force that you appointed some time ago. Most of the people you just appointed to the new task force are on the old one.”

GOVERNANCE AT GM: CORVAIR, NADER, AND “CAMPAIGN GM”

One episode sums up most of what was wrong with GM. The story concerns the Chevrolet Corvair, built in 1959. Even in the testing stage, Chevrolet’s engineers noted some alarming safety defects, particularly the car’s tendency to spin out of control when taking turns at speed. The president of Chevrolet wished to add a stabilizer bar to the vehicle, at a cost of $15 per car. He was overruled by the finance department, which claimed that the bar was an unnecessary cost. The Corvair rapidly gained a reputation as a lethal vehicle, but rather than admitting to the Corvair’s faults and making changes, GM continued to market the dangerous car. In a sop to the critics, GM spent $1 million on safety studies.

General Motors was subjected to embarrassing congressional hearings led by Senators Abraham Ribicoff and Edward Kennedy. Chairman Frederick Donner was unable to recall GM’s earnings from the year before and had to ask an aide to come up with the $1.7 billion figure. Kennedy said that $1 million spent on safety out of such enormous profits was a meaningless gesture.

GM’s main nemesis turned out to be a young consumer advocate named Ralph Nader. Nader exposed the safety defects of the Corvair in a book entitled *Unsafe at Any Speed*. Instead of responding to the allegations, GM assailed Nader. The company hired private investigators to tail Nader and produce whatever dirt they could. Rumors were spread that the consumer advocate was a homosexual and anti-Semitic. Ultimately, GM’s president, James Roche, publicly apologized to Nader and admitted the defects in the Corvair. A stabilizer bar was finally added to the car in 1964, but by then Corvair’s name was already damaged beyond repair.

Nader wasn’t finished with GM, however. In 1970 he, along with three other public-interest lawyers, set up the “Project on Corporate Responsibility” to raise public consciousness about corporate behavior. GM was their first target, not only because of Nader’s experience with the company, but because GM was such an obvious epitome of the giant American public corporation.

Originally, “Campaign GM” called for Nader to run as a candidate for the board but Nader declined the offer. Instead, the project submitted shareholder proposals for GM’s 1970 annual shareholders meeting, calling for three reforms: an amendment to the corporate charter stating that GM’s operations would be consistent with “public health, safety and welfare”; the establishment of a shareholder committee on corporate responsibility; and the expansion of the board to allow for three public-interest representatives. Within three weeks, six more proposals were added concerning auto safety, pollution control, mass transit, and minority hiring, but the Securities and Exchange Commission (SEC) ultimately permitted all but two to be excluded from the proxy. The remaining two – concerning a shareholder committee and the expansion of the board – were enough to make the 1970 annual meeting a spectacle. Three thousand people attended the May meeting, which turned into a lengthy question-and-answer session regarding GM’s commitment
to social issues. Although neither proposal gained 3 percent of the vote, meaning that Campaign GM could not resubmit the proposals the next year, GM did make changes in response to the public pressure. It went on to create a public policy committee and a special committee of scientists to monitor the corporation’s effect on the environment. It also appointed an air pollution expert and its first black director to the board.

In the end, as Campaign GM showed, the company could be moved. The disaster of the Corvair, and the weight of public pressure, were enough to force GM to make a few, mostly token, gestures. But Campaign GM took place 11 years after the introduction of the Corvair and seven years after Nader’s book detailing its defects. In the rarefied, conservative atmosphere of the fourteenth floor, it took that long for the company to see the need to change. GM refused to be accountable either to a congressional investigation or to a consumer advocate, and it took years for GM to see the need to be accountable to the market. In the 1980s, as we shall see, this mindset was critical in causing GM’s decline.

The point is well made by automotive journalist and author Doron Levin, in his account of the Corvair episode:

“The company had failed to appreciate its impact on, and its duties to, society. Instead of perceiving Nader’s activism as a symbolic warning to heed public sensibilities, GM was confident he was an isolated nuisance. GM clung to the outdated notion that it was powerful enough to create its own social and economic landscape.”

NEW TRENDS: EFFICIENCY, QUALITY, SAFETY, THE JAPANESE

At the peak of GM’s power – in the 1950s and 1960s – Americans liked their cars big and showy. Power was vital, fuel efficiency irrelevant. When the Japanese showed up in the late 1960s and early 1970s with their small, non-gas-guzzling vehicles – “shitboxes,” as they were known in Detroit – GM paid no attention. If there was a market in America for small cars, ran the reasoning, GM would already have cornered it. Rather, the company pledged to continue the lines that had always made money, the big, wide, and heavy cars that could carry a family in comfort and the rich in luxury.

General Motors could be forgiven for its lack of vision in 1970. It was quite true that small cars did not sell in America, and the Japanese competition at this time was terrible, producing badly designed, badly made cars. However, by 1980, Japan was making good small cars and Americans were buying them. GM’s market share dwindled year after year as a result. This was not just a failure to guess where the new markets might be, it was a failure to adapt to a current market that was right before GM’s eyes.

In retrospect, we can identify the 1970s as the decade when the American car industry should have changed its ways. Three factors combined to reshape the competitive environment:

1. ever-improving Japanese quality and design;
2. two oil crises that drove up the price of gas; and
3. federal regulations demanding better fuel efficiency and safety standards.
Of course these factors were related. It was the oil crises that awoke the federal government to the need for fuel efficiency and it was Detroit’s reluctance to treat quality and reliability as important issues that allowed the Japanese a huge head-start in that field.

In 1973, in response to America’s support for Israel in the Yom Kippur war, the Organization of Petroleum Exporting Countries (OPEC) agreed to impose an oil embargo on the West. As America and Europe scrambled to step up the search for oil in the North Sea, Alaska, and the Gulf of Mexico, Western leaders also looked for ways to avoid being put at the mercy of OPEC again. One solution was to use less oil.

The oil crisis of 1973 – or the energy crisis as it came to be called – came as a particular shock to Americans, who were used to paying about 30 cents a gallon for gas. Overnight, it was a dollar. People found themselves lining up all day for a commodity that had been almost as readily available as water. Suddenly, driving a car that only ran ten miles to the gallon was no longer affordable. The move to smaller, lighter, more efficient cars was lightning fast. There was one group in a position to respond: the Japanese.

At the time of the 1973 oil crisis, Japanese cars accounted for about 10 percent of the car market, compared with the 80 percent share commanded by the Big Three. Japanese automakers were still finding their feet in the early 1970s; they were not proficient in body design or engine production. Moreover, they had little idea about the market, producing cars in designs and colors that failed to appeal to Americans. However, the Japanese response time was incredibly quick. Sensing a massive market for smaller, cheaper cars, Toyota and Honda worked at producing just that. They focused on quality, efficiency, and reliability – issues that Detroit, with its massive guaranteed market share, had ignored.

Japanese management practices, in contrast to GM’s bureaucracy, were lean and highly flexible. They had none of the burdensome committee structures that crippled Detroit, none of the rigid hierarchies, and none of the acrimonious labor relations. The result was an altogether more efficient operation. As late as 1981, a GM internal study found that the Japanese could build a car for $1,800 less than it cost GM.

The Japanese were not burdened by GM’s institutional culture. Rather, the Japanese stressed innovation and customer service. Manufacturers and designers, labor and management worked in teams with the lowliest assembly-line workers, all seeking ways to make jobs easier and products better. At the same time, Japanese firms guaranteed their workers employment for life, engendering a loyalty to the company that was matched only by a loyalty to the customer. As a result, quality was built into the system. In Detroit, cars were pulled from the assembly line to correct defects or were sent to the market on the basis that discontented customers could send them back. In Japan, cars were built right the first time. Even in 1993, Japanese companies manufactured nine out of the top ten quality-ranked vehicles, according to one survey. Japan was able to respond to consumer trends in a fraction of the time that it took the Big Three. As Americans moved toward smaller cars, the Japanese were there. As customers increasingly sought quality and reliability, the Japanese were there again. Even today, Japanese automakers are able to get a new model to the market a year quicker than their American counterparts. In the 1970s, this meant that Japan was able to get a massive head start in the race to build small, efficient cars.

A second oil crisis in 1979, prompted by the overthrow of the Shah of Iran, merely accelerated the Japanese invasion. By 1980, the Japanese had raised their market share to 20 percent, double what it had been in 1970. In less than a decade, the Japanese had made quantum leaps in design and styling, and the small car market had become far more than a niche.
However, GM continued to underestimate the threat. As Keller comments, “GM never understood their foreign competitors. They were viewed as opportunists who got lucky during the oil crises.” As Detroit continued to ignore the Japanese, so too did it ignore the trends that were making the Japanese successful. Partially, the problem lay with the federal government. Following the 1973 oil shock, the government initiated a host of regulations concerning fuel efficiency, clean air standards, and safety. Detroit’s designers found themselves trying to develop cars that matched these standards. The Japanese, already ahead in the efficiency game, concentrated on quality and customer satisfaction.

The Big Three’s response to new federal regulations was to lobby for loopholes. In 1975, Congress passed the Corporate Average Fuel Economy (CAFE) law, which established increasingly stringent fuel efficiency standards for US cars. The intention was to double car mileage by 1985. The law encouraged smaller cars, since automakers were bound only by the average that their fleet recorded – larger cars could under-perform the CAFE standard as long as smaller cars could make up the difference. The CAFE law grew progressively weaker as Congress approved loophole after loophole. By 1986, GM had failed to meet the standards for four years in a row, but had paid no fines thanks to laws lowering the mileage requirements or approving new methods of measurement that allowed GM to record higher fuel efficiency. In 1986, an attorney for Ralph Nader’s Public Citizen consumer group told the Wall Street Journal, “If all the [CAFE] statute is designed to do is ratify what GM and Ford want to do on their own, there isn’t much point to the statute.”

Detroit also resisted efforts to improve safety standards. In April 1971, listening devices in the White House (made famous by the Watergate scandal) recorded Ford executive Lee Iacocca telling Richard Nixon that a federal law mandating airbags would cost US automakers crippling sums of money. He told Nixon that airbags represented a possible $4 billion annual cost to Ford, “and you can see that safety has really killed all of our business.” Iacocca’s pitch was successful – Nixon delayed federal laws mandating airbags.

Safety features such as airbags actually represented a competitive advantage for the Big Three – they were way ahead of the Japanese on safety technology. However, they failed to anticipate increasing consumer demand for safety features, stressing the paramount importance of protecting the earnings column.

Detroit responded to new CAFE and safety standards by arguing that efficiency and safety standards were low among consumers’ priorities compared with comfort and reliability. The automakers argued that they would provide more efficient engines and safety features just as soon as buyers demanded them. As we shall see in our discussion of the import restraints of the 1980s, the Big Three were very quick to abandon this free market position.

As small cars became increasingly popular, GM tried half-heartedly to compete. In 1970, it introduced its “import buster,” the Vega. The car was a lemon. It failed to meet any of its projections for weight, length, or price, and arrived at the market costing $300 more than the VW Bug. It was also riddled with mechanical defects. The car was outsold by the Ford Pinto in its first year and was canceled the next in the wake of a violent strike at the Vega plant. GM didn’t mind. Executives resisted the opportunity to improve the Vega, believing that its failure merely proved that the small car market was ephemeral and a distraction.

By the late 1970s, when it was clear that small cars had arrived to stay, GM was still confident of its leadership. In a momentous, high-cost decision, the company planned to shift away from heavy, gas-guzzling rear-wheel drive cars to more efficient front-wheel versions. The generation of “X-cars,” due to hit the streets in 1980, would show that GM’s engineering was still the best there was.
The X-cars were disastrous. GM underestimated the huge changes that were necessary to switch from rear-wheel to front-wheel drives, and failed fully to re-engineer engines and transmissions. The result was that X-cars achieved a reputation of being shoddily made and unreliable. In 1981, GM unveiled the J-car project, another car series that was meant to send the Japanese packing – GM President F. James McDonald called the J-cars a $5 billion “roll of the dice.”21 The J-cars suffered from the same cost-cutting problems as the X-cars, borrowing unsuitable engine and transmission designs from earlier models. The result was that the J-cars, like the X-cars, were panned both by the automotive press and the buying public. Indeed in 1981–2, GM recalled more cars than it produced.22 The X-cars also looked bad – hardly surprising since GM didn’t bother with consumer market research until 1985. By contrast, the Japanese had made huge strides in styling, creating glossy paints and friendly interiors with appealing trim. They had developed features like internal trunk and gas cap releases, things that appealed to the driver as a “user.” Detroit was still relying on decorative gimmicks like a chrome strip.23

THE 1980S

The X-cars were meant to show the world that GM still led in automotive engineering, but they only showed how out of touch the automaker had become. In 1980, GM lost over $700 million, its first loss since 1921, as its sales dropped 26 percent. However, the scale of GM’s problems was overshadowed by the crises threatening Ford and Chrysler.

In 1979, Ford recorded a $1.5 billion loss, followed by losses totaling a further $1.75 billion over the next two years. This volume of red ink was almost enough to leave Ford bankrupt. 1979 was an even worse year for Chrysler. Iacocca, traveling to Washington as Chrysler’s new CEO, told the federal government that without a massive loan guarantee the company would fold with the loss of tens of thousands of jobs. The next year, 1980, the government approved $1.5 billion in loan guarantees. The loans covered Chrysler’s $1.7 billion loss and allowed the company to survive.

It wasn’t just Chrysler that received help from the government. All three members of the Detroit trio joined to lobby for protection from the Japanese. In other words, Detroit sought to keep the Japanese out of the United States rather than compete with them.

In 1981, after months of negotiation with both the UAW and the federal government, Japan agreed voluntarily to limit the number of cars it would ship to the US each year. The first year’s limit was set at 1.68 million vehicles – significantly reducing the Japanese threat. Detroit had negotiated itself a breathing space; indeed the uncompetitive market allowed the Big Three to enjoy record profits over the next few years. It was a golden opportunity to take charge of the auto market, improve efficiency and quality to Japanese levels, and compete fairly and squarely with the Japanese, but the hard-won lull proved brief – especially for GM.

Ford and Chrysler’s perilously close journey to the brink of collapse forced them to rethink. Clearly, they could no longer run their companies as they once had – the world had moved, and they had to move too if they were to survive. As a result, the two automakers showed some brave developments through the decade: Chrysler with the reintroduction of the convertible and in the production of minivans, Ford with a new aerodynamic design. As a result, Ford and Chrysler made it through the 1980s. Both companies had mixed results through the decade, but both were vastly better positioned to compete in 1990 than they had been ten years earlier.

GM was not driven to change by the same fiscal crises that beset its Detroit counterparts. In 1980, GM was still a massively wealthy corporation, protected by its size and its financial strength. Not that GM went untouched by the changes made at Ford and Chrysler; it too saw the need to
upgrade and compete. In 1981, GM appointed a new chairman and CEO who was determined to drag GM into the twenty-first century – Roger Bonham Smith.

THE SMITH ERA

Roger Smith had a consuming vision of the GM of the future. He saw the car as not just a mechanical object but an electromechanical one, in which on-board computers and circuitry were as important as the actual engine. He saw cars manufactured in “lights out” factories, where the only employees were people supervising the robots and computers. Smith also envisioned a world in which high-tech smoothed the process of buying a car. The customer would reel off his order – tinted glass, automatic transmission, color blue, power windows – to a salesman who would tap the particulars into a computer. The information would be relayed to factory robots that could custom-build every vehicle. The consumer would no longer be forced to choose between competing models, since every car could be tailor made.

Clearly, Smith was thinking long, long term. He had a vision of the industry as it might develop in the twenty-first century. He was determined to put GM on the fast track toward that future, and to block the Japanese from using their superiority in microelectronics to dominate the car market as they had the consumer electronics market. With a cast-iron balance sheet and mountains of cash, Smith was determined to remake GM into the world’s strongest automaker.

Over the next decade, GM spent nearly $90 billion reforming itself. By most accounts, this money was all but wasted. GM lost market share throughout the 1980s and became a high-cost, inefficient producer. The company’s continued decline set the scene for the massive downsizing of 1991, and the ouster of Robert Stempel in 1992.

Why did the 1980s prove so disastrous for GM? An examination of Smith’s strategy reveals three main themes:

1. reforming GM’s bureaucracy;
2. purchasing advanced technology; and
3. attempting to instill an entrepreneurial spirit in the company.

Organizational reform

The CEO, Roger Smith, was acutely aware of GM’s bloated, blundering organization. He knew that GM would have to become leaner and meaner if it wished to compete. In 1984, Smith set out to reorganize totally the outdated GM structure.

Through the 1960s, as the men from finance had increased their control over the separate divisions, GM had become more centralized. Alfred Sloan’s rule of “centralized policy and decentralized administration” was being eroded by the demands from the fourteenth floor. This problem was compounded in the 1970s by the onslaught of federal efficiency and safety regulations that limited design possibilities.

Also, all car bodies were made by a single division – Fisher Body – and assembled by another – GM Assembly. These two divisions were able to impose their own authority over the designers and engineers at Chevy and Pontiac, etc. The result was that Sloan’s structure of five semi-autonomous divisions had become an anachronism. The extent of the problem became apparent during the 1970s, when GM experimented with “badge engineering.” Under this scheme, divisions shared as many parts as possible to keep costs down, while small stylistic changes were meant to identify
a particular car as a Pontiac or an Oldsmobile. “Badge engineering” was not a success since it resulted in cars that looked too much alike.

Although GM was becoming increasingly centralized, each division maintained its own design and marketing operations, so that resources were duplicated across GM. The company was organized the wrong way round – several design centers produced a range of similar cars.

Smith wished to accomplish two goals: decentralize authority back to the manufacturing divisions and streamline the company’s resources so that the divisions didn’t duplicate each other’s work. Smith reorganized GM into two main groups. Chevrolet–Pontiac–Canada (CPC) would design, manufacture, and market small cars. Buick–Oldsmobile–Cadillac (BOC) would take charge of the big ones. The regrouping eliminated two whole divisions – Fisher Body and GM Assembly – in a move that eliminated thousands of jobs and created thousands of others. It was a wholesale shift of personnel in which reporting structures were realigned and channels of communication redirected. The reorganization might have been a good idea in theory, but in practice it created chaos. As Fortune put it, “The shakeup froze GM in its tracks for 18 months.” The problem was that while the old structure had been dismantled, a new structure had not been constructed in its place. The result was an organization in which no one knew who was responsible for what. Suppliers complained that they could never find the right representative, or when they did, he or she soon changed jobs. In the melee, new layers of management were created to try and sort out the mess. Indeed, CPC wound up adding 8,000 people following the restructuring.

In 1985, CPC produced 3.5 million cars a year – roughly the same as Toyota – but CPC employed 160,000 people in contrast to Toyota’s 60,000.

General Motors became more, not less, inefficient, causing more people to be hired. In 1983, the total GM workforce was 691,000. By 1985, it had climbed to 811,000.

The confusion led to chaos in GM’s basic manufacturing. In one absurd instance, it became efficient for a Chevrolet plant to build Cadillacs, while Buick assembled Pontiacs. One GM observer told Fortune that GM started producing 17 ignition systems where three would have been enough, and 40 types of catalytic converters instead of four. Even as late as 1992, GM produced more than a dozen separate caps for windshield washer fluid bottles. Smith’s reorganization seemed to have exactly the wrong effect. Rather than chasing the Japanese dream of leanness and efficiency, the plan had made GM more confused and cumbersome.

**GM-10**

The failure of the reorganization was most acutely felt in Smith’s other big shake-up, the GM-10 program. One academic called GM-10 “the biggest catastrophe in American industrial history.”

GM-10’s aim, like that of the 1984 reorganization, was to streamline the resources of the five divisions to create a consistent, nonduplicative car line. Starting in 1982, GM set out to replace all existing midsize cars produced by Chevrolet, Pontiac, Oldsmobile, and Buick. Under GM10, each division would manufacture a coupé, a sedan, and a station wagon. The plan called for seven plants, each to assemble a quarter of a million of the new cars, which would account for 21 percent of the US car market – a bigger market share than Ford’s. According to Fortune, “It would be the largest new-model program ever, the ultimate expression of GM’s ability to capitalize on its enormous economies of scale. But GM couldn’t pull it off. The world’s largest corporation choked.”

The 1984 reorganization played havoc with the management of GM-10; people working on the project were moved; responsibilities shifted or were left undefined; the program manager in charge of GM-10 was replaced, as was his successor; responsibility for the program was moved to CPC; finally, and most gallingly, GM was forced to change the styling of GM-10 cars so they didn’t
appear to be replicas of the Ford Taurus, introduced in 1986. As GM-10 suffered setback after setback, GM pulled back from the grand vision that had initiated the program. First, GM downsized the project, dropping the station wagon and cutting back the plants involved from seven to four. Then GM found it couldn’t afford to produce all eight GM-10 cars simultaneously, so it rolled the cars out to market over two years, two-doors before four-doors. However, even in this, GM guessed wrong. Baby boomers who wanted coupés in 1980 now wanted family-size sedans. Ford, for instance, never introduced a two-door Taurus, yet in 1988, GM was rolling out four brand new two-door coupés. In 1990, eight years after the GM-10 program was launched, the final cars hit the showrooms. They were a disaster. In 1989, GM lost over $2,000 on every GM-10 car it produced. In 1979, Oldsmobile had sold 518,000 models of a car scheduled for replacement under the GM-10 program. Twelve years later, in 1991, Oldsmobile sold only 87,500 models of the new GM-10 version. When asked by Fortune why GM-10 was such a catastrophe, Roger Smith replied, “I don’t know. It’s a mysterious thing.”

Look-alikes
Other errors compounded the manufacturing problems. In attempting to unify the disparate sections of the five divisions, GM endeavored to create a corporate “look” so that consumers could identify a GM vehicle at a glance. GM took this plan too far and created a line of identical-looking cars. GM shrank its luxury cars to such an extent that they no longer looked different from their cheaper counterparts – a $9,000 Pontiac ended up looking similar to a $25,000 Cadillac.

The results were disastrous for GM’s luxury end, traditionally the company’s most profitable business. GM resorted to cosmetic changes, such as adding a three-inch fender extension to one Cadillac model to make it appear longer. The irony was plain to all. Once, GM had cornered the large-car market. Indeed, during the 1970s it seemed that those were the only cars GM made well; now the company couldn’t even seem to do that right.

Purchase of new technology
If there is one characteristic of Roger Smith that came to dominate his tenure as chairman, it was his love of technology. To Smith, GM’s future lay with high-tech, and he was determined that GM should be the leader. In his ten-year tenure as CEO, Smith spent over $50 billion on technology projects. As Bob Eaton, chief of GM’s advanced engineering, put it, “When you told Roger about new technology, he’d get excited and ask, ‘Where do I sign?’”

The list of GM’s high-technology projects through the 1980s is a long one:

- When Roger Smith was appointed chairman, GM had 300 robots. Smith made a pledge to acquire 14,000 by 1990. To fulfill this promise, Smith engaged in a 1981 joint venture with the Japanese robot manufacturer Fujitsu-Fanuc. GMF Robotics would build robots for the US market, with 70 percent of the output earmarked for GM. Via this joint venture, GM became the largest manufacturer of robots in the world.
- Detroit also poured money into an acquisition binge of small-time European car manufacturers. GM bought 48 percent of Lotus for $20 million and half of Saab for $600 million. The hope was that GM could exploit the advanced engineering of these companies.
- In 1983, Smith unveiled Saturn, the “car of the future.” The plan was to reinvent the way GM made small and mid-sized cars. Saturn would be built in new plants, employing the newest technology and the most productive management practices, and sold in standalone showrooms.
Quality would be the watchword of the new vehicles. Saturn held out the promise that GM could manufacture small cars as well as the Japanese.

- Smith also spent money to learn directly from the Japanese. In 1983 he formed the New United Motor Manufacturing Inc. (NUMMI), a joint venture with Toyota. NUMMI was set up in an idle GM factory in Fremont, California, and set out to build Chevy Novas, using American labor and Japanese management.
- In 1984, GM bought Electronic Data Systems (EDS) for $2.55 billion. The Texas concern, headed by Ross Perot, was fully bought out by GM, yet remained independent within the company, trading under a separate GM “E” stock. Smith hoped that EDS would speed up GM’s huge data processing operation, and put GM on the cutting edge of information technology. The purchase of EDS made GM the world’s largest data processing company.
- In 1985, GM offered $5.2 billion to purchase Hughes Aircraft, an aerospace manufacturer. Smith hoped that Hughes’s space-age engineering could be used to juice up GM’s cars.

Smith didn’t just pursue high-tech. GM bought two major mortgage companies that overnight turned GM into America’s largest home-mortgage holder.

- Smith’s plan was to use technology to make GM responsive to niche markets. Rather than employing a blanket strategy, in which GM produced “a car for every purse and purpose,” Smith intended GM to cover niches as they appeared. As consumer trends developed, GM would respond, bringing the right car rapidly to the market.

- The high-technology dream never materialized; nor did Smith’s “rapid response” to niche markets. GM was so big that scale economies didn’t kick in until large numbers of cars were sold. GM needed to sell over 100,000 cars of a new model to make its development profitable. The Japanese made money selling models in volumes of 40,000 or less.

- Nor could GM speed up its production time. The C-car line, due to hit the showrooms in the fall of 1984, wasn’t ready until December 1985. Other lines failed to satisfy their target markets. A good example concerns the Pontiac Fiero, a zippy two-door sports car, aimed particularly at young females. GM spotted the market and dominated it, selling over 100,000 Fieros in both 1984 and 1985. Encouraged by initial sales, GM continued to manufacture and market the car as if there were no tomorrow – and no threat of competition. Both came, and GM was not ready to face either one. For instance, during Fiero’s development, to keep costs down, GM had eliminated power steering. As it turned out, however, power steering became a popular feature with women since it makes a car so much easier to park. The Japanese picked up on the trend, GM didn’t. Toyota shipped its MR-2 with retrofitted power steering and ate into the Fiero’s market. As Fiero’s sales sunk, so GM found it couldn’t afford to compete in the market. The MR-2 was produced throughout 2007 and Mazda’s Miata is still on sale today, unlike the Fiero, canceled in 1988. General Motors found that the new technology created more problems than it solved. Typical of the problems were those experienced by the Hamtranck plant in Michigan. The plant was opened in 1985–6 at a cost of $600 million, and was to be a showcase for GM’s brave new manufacturing world. Hamtranck boasted nearly 2,000 computers on its assembly line, requiring 400 workers to be trained for a year before the plant opened. Doron Levin tells of the travails experienced at the plant when it finally began operations:

> GM engineers were having a devil of a time de-bugging the hundreds of advanced machines and laser-guided devices. No sooner did the robots in the body shop weld sheet metal properly than the new modular painting robots commenced spraying one
another... If GM had tried to introduce one or two glitzy automation projects instead of dozens and dozens, the [Hamtranck] plant might have opened smoothly. GM’s software and engineering expertise, under extreme deadline pressure, just wasn’t sufficient for the job."

Despite the advanced machinery, Hamtranck never operated at more than 50 percent capacity. The Wall Street Journal commented in 1986 that the plant “instead of a showcase, looks more like a basket case.” Just 25 miles away, Mazda opened its own plant for a quarter of the cost of Hamtranck. With 1,500 fewer employees, the Mazda plant made just as many cars, of better quality.

The results of the technology improvements did not justify their huge cost. In a 1986 management conference report, executive vice-president of finance F. Alan Smith pointed out that GM projected to spend $34.7 billion between 1986 and 1989. That sum, he argued, was equal to the total market capitalization of Nissan and Toyota combined. Theoretically, GM could buy out both companies, increasing its worldwide market share to 40 percent. What was GM’s $34 billion going to buy them that would generate that kind of sales increase?

**Deteriorating results**

In actual fact, GM became only less competitive as the spending continued. Alan Smith’s report pointed out the nasty numbers. In 1983, GM had the highest operating margins in the game – it earned 2 percent less on sales than either Ford or Chrysler. By 1985, those two companies were both 3 percent more efficient. Over the same two-year period, GM’s sales increased 22 percent, though earnings declined 35 percent, and whereas, in 1980, GM could produce a car for $300 less than it cost Ford or Chrysler, by 1986, GM’s costs were $300 more than both.

GM lagged its crosstown rivals by other measures.

- In 1985, GM’s profit margin was 4.1 percent, compared with 7.7 percent for Chrysler.
- An investment in GM during 1983–5 returned 16.2 percent, compared with 22.9 percent in Ford over the same period.
- According to GM’s calculations it took the company 35 hours to assemble the average GM-10 car, compared with the 18 hours it took Ford workers to build a Taurus.
- In 1985, GM recorded 12 vehicles produced per employee, compared with 18 for both Ford and Chrysler.
- In 1986, GM achieved an annual revenue of $100 billion. Yet in the same year, the company earned less money than its smaller rival, Ford.
- In 1986, in a booming economy that produced record auto sales, GM lost money.

Market share continued its depressing downward spiral: from 44.6 percent in 1984 to 42.7 percent in 1985 to 41.2 percent in 1986. Each lost percentage point represented about $1 billion in annual revenue, and 6,000 jobs at GM and its suppliers.

In 1986, the chairman of the Chrysler Motors unit of Chrysler told the Wall Street Journal, “There was a day when the gorilla said ‘jump’ and you jumped, because GM was the pricing leader and the styling leader. They’ve lost that. They aren’t the low-cost producer. The industry no longer marches to their tune.” GM said that the poor results could be expected as a result of its reorganization and predicted rapid recovery. In 1987 there could be no such complacency.
CASE STUDIES: CORPORATIONS IN CRISIS

• Market share plummeted nearly five points to 36.6 percent.
• Oldsmobile alone sold nearly 400,000 fewer cars in 1987 than it had the year before.

The skid resulted from a combination of problems:

• GM’s costs were still huge. GM’s production cost of the 1985 S-car line was twice that of Isuzu for a similar model.
• Those who had bought GM in 1981–2 and had been disappointed by the quality and reliability of the X-cars had not come back to GM next time round.
• GM’s shrunken Cadillacs and the “look-alike” problem damaged the higher end divisions.
• GM’s smaller line of A-cars came to the market in 1985 just as gas prices headed downwards again, revitalizing the large car market. GM continued to market its older models, damaging sales of the new models and causing confusion among customers.
• GM lagged the competition in styling. The 1985 Ford Taurus revolutionized the sales of “aero”-look cars, even as GM was still producing boxy, square-shouldered vehicles. Meanwhile, Chrysler took a huge head start in the minivan market.
• Smith wanted GM to develop cars more quickly, but in the effort to rush new models to the market, it failed to concentrate on quality. Most GM models produced through the 1980s were not as good as the vehicles they replaced.
• GM still retained the production capacity to serve a 50 percent share of the US market, despite the fact that its share was less than 40 percent and slipping. The result was that GM operated fearfully under capacity, with six car factories even running at half-capacity. The fixed costs of running auto plants at anything less than full capacity were huge.
• GM remained stuck in the past in other ways, as discussed in a 1986 Wall Street Journal report. The article discussed a 53-year-old GM plant in Ohio that turned out 19,000 car brakes daily, shipping the parts for inclusion in every GM car from Chevy to Cadillac. The plant typified the massive vertical integration that had once made GM the most powerful company on earth. In 1986, however, GM spent 15 percent more on manufacturing its own brake parts than it would cost to buy them from an outside supplier. Ford and Chrysler, by contrast, purchased their brakes from suppliers as far away as Brazil, and saved money.40

Saturn
Like Smith’s other projects, Saturn was hugely ambitious. Saturn had to sell 500,000 cars a year over the long haul to be profitable. That is as much as Nissan sells in the US each year. A Wall Street Journal article explained how Saturn’s ambition may be its downfall:

“Everything at Saturn is new: the car, the plant, the workforce, the dealer network and the manufacturing process. Not even Toyota Motor Corp., everyone’s candidate for the world’s best automaker, tackles more than two new items on any single project.”

The very size of the undertaking meant that GM was unable to complete it cheaply. Moreover, it did not get as much “bang for the buck” as did its chief competitor, Honda.42 Honda’s US factories cost $600 million, employed 3,000 workers, and turned out 300,000 cars a year.
GM’s new Saturn plant cost $5 billion, employed 6,000 workers, and would turn out, at most, 500,000 cars a year.\(^4\)

Saturn was launched in the fall of 1990 in a $100 million blaze of advertising and publicity. The opening months proved far from auspicious...

- GM hoped Saturn would sell 150,000 in its first year. In the first nine months of production, Saturn built 24,000 cars and sold 15,000 of them.
- Six months after opening, Saturn was operating at half-speed, and selling only half of what it produced. One manager told the *Wall Street Journal* that the plant makes cars at full speed for maybe a few hours, “then we run into a snag.”\(^4\)
- Despite its emphasis on quality, the division has not delivered. In Saturn’s first months, some 35–40 percent of the car’s plastic panels were sent back with defects.\(^4\)

Despite the glitches, Saturn was very popular with its buyers, the only problem being there weren’t very many of them. Saturn opened just as the US was slipping into a recession – inhospitable circumstances for the launching of a new car line. Saturn also proved to be cannibalistic – 41 percent of Saturn owners already owned a GM vehicle.

**Japan roars back**

Just as GM was making a terrible mess of reinventing itself, the Japanese were plotting their return. Anyone who thought that the import restriction would hold Japan at bay for long was sorely mistaken.

Japan adopted a two-pronged strategy. In the first place, it circumvented the import restrictions by building plants in mainland America rather than shipping them from Japan. In this respect, the voluntary restraint helped the United States – Honda, Toyota, and Nissan invested billions of dollars and created tens of thousands of jobs – but it didn’t help Detroit. The Japanese, more than ever before, were competing in the Big Three’s back yard.

- In 1980, Honda announced that it would open its first US assembly plant in Ohio.
- In 1986, Toyota opened a factory in Kentucky.
- In 1989, Honda opened a second plant, and Subaru and Isuzu announced that they too would open US-based operations.

By 1990, there would be eight Japanese manufacturing plants in the United States. The investments paid off. By 1992, Japan would be assembling 1.4 million cars and trucks on the American mainland. Their lines would include two of the three best-selling vehicles and five of the top 12. By contrast, GM produced only the fifth best-selling vehicle and could only manage four in the top 12.

Second, the Japanese targeted the luxury car market. Since they were limited to a number of vehicles they could export, it made sense for the Japanese to export higher priced vehicles that carried a greater profit margin per car. Hence the arrival of Acura in 1986 and Lexus and Infiniti in 1989. In 1992, these three divisions sold over $3.5 billion-worth of automobiles. While this was money made partly at the expense of the leading European luxury carmakers – Mercedes, Volvo, BMW, and Jaguar – it also heavily dented Cadillac’s performance.

General Motors found it was not merely being outclassed in the small car market but in the expensive, classier range as well. GM remained dominant in the luxury car market – Cadillac was positioned at first, fourth, and seventh in the top-ten selling luxury cars in 1992 – but the Japanese had nabbed spots three and six. Japan did not dominate the big car market as it did the small, but
it was a serious competitor in a market GM had once owned. All of this contributed to GM’s ever-dropping market share.

It was not technology that made the Japanese better competitors, it was superior, participatory management.

- Japan’s automakers made do with five levels of management; GM had 14.
- NUMMI, run with GM labor under Toyota managers, produced the lowest-cost, best-quality cars in GM. Yen for dollar, they spent less but received more.
- GM’s own quality audit found that the Honda and Nissan plants in the American South produced cars with one-fifth as many defects as did GM’s.46 In other words, the difference between Japanese and American quality was not labor. The Japanese could beat the United States in the United States.

The Japanese success was encouraged partly by the US automakers. The voluntary restraint agreement forced the Japanese to raise their prices by as much as $2,000 a vehicle. It presented a perfect opportunity for Detroit to exploit their price advantage and recapture market share. Instead, the Big Three raised their own prices, creating a short-term boom in profits. The VRA merely raised the cost of cars for consumers and did nothing to restore American competitiveness.

Labor relations

Labor relations had never been good at GM, dating back to violent strikes in Flint, Michigan, in the 1930s. However, even as the Japanese showed the way in creating a friendly working environment, relations between GM management and labor grew ever worse.

Seeing the need to cut costs, GM signed a new contract with the UAW in 1982. Management stressed “shared sacrifice” to get through difficult times and wrung a $2.5 billion concession out of the union, in the form of a freeze of the cost of living adjustment (COLA). The very same day, GM’s proxy statement was mailed to shareholders. One of the items under consideration was a new bonus scheme, awarding 5 million shares to 600 senior executives. In the firestorm of criticism that resulted, Smith cut his own pay, and that of other bonus-eligible executives, by $135 a month — the same deduction as the UAW had agreed to take. The notion that millionaire Roger Smith (who had taken an 18.8 percent rise in base pay the year before) and a $12-an-hour machinist taking the same pay cut entailed “shared sacrifice” was, of course, nonsensical. Smith only fanned the flames of the controversy.

To develop better relations with the UAW, GM began a profit-sharing program for blue-collar workers. In 1985, GM workers were paid $384 as part of the program, compared with the $1,200 Ford workers were paid under a similar scheme.

Roger Smith regarded labor as opposition, to be replaced by machines wherever possible. In negotiations with the UAW, Smith said, “Every time you ask for another dollar in wages, a thousand more robots start looking more practical.”47 In 1986, Smith initiated an aggressive cost-cutting drive, which included the closure of 13 plants and 25,000 white-collar layoffs. The next year he promised to cut a further $10 billion out of GM’s costs.

THE 1980S: A DIFFICULT DECADE

Clearly, Smith’s strategy failed. GM ended up spending tens of billions of dollars for little or no reward. Despite the high-tech, GM became less, not more, efficient. Its cars found no favor with the public. Its market share dropped. When its competitors burgeoned in a booming auto market, GM lost money.
General Motors suffered throughout the 1980s because its board and management failed to address its basic problems with sufficient alacrity or aggression. The Chrysler and Ford crises, and the relentless Japanese onslaught, should have shown GM that it needed to compete, that it could not take a 50 percent market share for granted any longer. The massive vertical integration that had served GM so well for so long was out of date.

At the time of the voluntary restraint agreement in 1981, the Japanese had shown that they could produce high-quality cars in a fraction of the time it took GM. To stay in step, GM needed to show that it too could efficiently produce a well-made car. Given the breathing space afforded by the import restraint, GM could have committed itself to streamlining operations, and cutting away the layers of the organization that stood between the makers of the automobile and their customers.

The import agreement brought record profits to the Big Three, but the windfall was wasted. GM didn’t put the money back into its core operations, upgrading them to Japanese standards. GM didn’t reinvest the money in ways that would lower the cost and improve the quality of cars that went to the showrooms. GM failed in the 1980s because it tried to solve problems without addressing their fundamental, underlying causes. As Keller comments, “Acquiring EDS and Hughes was like the four-hundred-pound woman coloring her hair and doing her nails. It wasn’t tackling the real problem.” Its problem was not that it was short of technology; it was that it was a badly organized, insular, backward-looking, and inefficient producer of motor vehicles. Smith’s obsession with technology made no impact on GM’s ability to compete.

Its failure was also a failure of leadership. Smith failed to realize that GM’s most important commodity was its people. GM could not become a twenty-first century automaker without the company’s employees – its engineers, machinists, and assembly-line workers – coming along for the ride. Smith treated labor as a problem to be limited, not as a resource to be nurtured. Indeed, with all his talk of a “lights out” factory and robot automation, one could be forgiven for thinking that Smith wanted to dispose of labor altogether. How could Smith hope that GM’s employees would pursue his vision if all it promised them was the sack?

**AND THE BOARD PLAYED ON…**

Where was the GM board of directors when Smith’s strategy started to come apart at the seams in 1986? The answer to this question is important because the ultimate problem – and solution – for GM lay in the realm of corporate governance. It is a truism of the corporate system that management must have sufficient freedom to take risks and experiment. Inevitably, not every risk-taking venture succeeds. Plenty of companies adopt strategies that ultimately prove to be costly mistakes. It is at this point that governance becomes important. It is the board’s job to see that management has adopted a sound strategy and executes it competently, and it is the board’s responsibility to replace management when it fails in these duties. In turn, the board is beholden directly to shareholders, and indirectly to stakeholders such as consumers, suppliers, and employees.

As we saw earlier in the discussion of the Corvair episode, GM did not appreciate outside critics. This same view dominated board–management relations through the 1980s. As * Fortune* put it:

> Roger Smith kept the board on a very short leash. He withheld key financial data and budget allocation proposals until the day before meetings and sometimes distributed them minutes before the participants convened. The monthly sessions were rigidly structured and Smith adjourned them promptly at five minutes to noon, leaving little room for
Circumstances and personality enabled Roger Smith to exercise his iron control. Quick to anger, he was intolerant of criticism. Few directors had the ability or desire to take him on.\textsuperscript{49}

One outside director told the \textit{Wall Street Journal} that board meetings “were like ceremonial events, with no real information.”\textsuperscript{50}

Smith was able to exert control via the board committees. Increasingly, the full board became just a ratifying council for the work of the various committees. This allowed Smith to keep loyalists on key committees. The makeup of the board allowed Smith to exercise such control. In 1989, three members of the board (not including Smith) were GM executives who reported directly to Smith. Among the 11 nonexecutive directors, four had little or no business experience – Anne Armstrong, former ambassador to the Court of St. James; Thomas E. Everhart and Marvin L. Goldberger, both academics; and the Reverend Leon H. Sullivan. Of the seven remaining directors, two were retired and a third ran GM’s chief Detroit bank.

The nonexecutive directors were paid average fees of $45,000 a year and received a new GM car for their own use every quarter. However, these material benefits paled in comparison to the prestige conveyed by sitting on the board of General Motors. Doron Levin speculates on the motivations of one outside director, Edmund T. Pratt, chairman emeritus of Pfizer Inc.:

\begin{quote}
Ed Pratt had served on numerous corporate boards of directors. None of the posts, including his chairmanship of Pfizer, one of the nation’s leading pharmaceutical firms, carried as much prestige or clout as his GM director’s seat. In Pratt’s eyes, GM was an American institution, the country’s dominant single business force. Hell, GM was America! For a businessman such as himself...association with the nation’s premier corporation was an immense honor.\textsuperscript{51}
\end{quote}

However, the honor he felt belonging to the GM board did not inspire Pratt to commit much personal wealth to the company. In 1988, Pratt owned 100 GM shares, despite being on the board for 11 years. In other words, he had purchased about nine shares each year he was a director. Pratt was not alone. Five other outside directors owned 500 shares, and three owned 200 shares.

This was the group responsible for probing, challenging, and, if necessary, changing Smith’s strategy. Yet, for many critical years it did nothing of the sort. GM’s directors let themselves be browbeaten by the CEO’s personality and blinded by the honor of serving on the board. They had too much to gain – and too little to lose – from the status quo to shake it up. Thus, the GM story is one not just of management failure, but also of failure of the board.

In the rarefied atmosphere of the fourteenth floor, GM executives were cut off not only from the vast body of GM’s employees but also from the board of directors and the shareholders the board was meant to represent. Management was accountable to no one. The truth of this statement will be made clear when we examine the courtship, brief marriage, and messy divorce between GM and Texas billionaire, and later Presidential candidate, Ross Perot. The Perot episode shows how completely the governance structure had collapsed at GM, and how unwilling the board was to challenge management, no matter what the circumstances.
GENERAL MOTORS AND ROSS PEROT

No one was more frustrated by GM’s hidebound culture than Roger Smith. He was frustrated and confused at his company’s inability to turn its operations around. He felt burdened by GM’s insular, backward-looking culture, and he tried hard to break it. Smith liked to explain his vision in the form of an allegory: a GM manager clinging to a tree stump, unwilling to swim across a fast-moving river. Smith’s job, as he saw it, was to convince the manager to let go and swim hard, aiming for some unknown spot on the other side. The tree stump was GM’s old way of doing business, the river was the fast-moving marketplace, the unknown place on the opposite shore where the swimmer ended up was GM in the next century. In Smith’s view, GM could no longer cling to the past—it had to swim for it. The question was, how could he persuade GM to let go of the stump?

Smith did not believe incremental, evolutionary changes would work. Rather, GM would need to be revolutionized. Programs such as Saturn, NUMMI, and the purchase of Hughes were ways of wrenching GM dramatically from the past and forcing it into the future. Ross Perot and his company, Electronic Data Systems (EDS), seemed to present an ideal opportunity. On the one hand, GM was held back by outmoded data processing and computing methods (how could GM be lean and responsive without modernizing its paper-driven bureaucracy?) and, on the other hand, EDS was headed by a feisty, no-nonsense Texan entrepreneur who could lend some zip to GM’s stodgy style. Smith liked successful entrepreneurs; they represented everything that GM wasn’t. That was why Smith wasn’t content just to hire EDS, but rather buy it and make it part of GM. Smith hoped that some of what had made EDS successful would rub off on the GM giant.

Roger Smith and Ross Perot were perfect for each other. Smith sought an aggressive entrepreneur, not beholden to GM and ready to speak his mind. Perot was lured by the challenge of lending his services to such a giant corporation and, born with a strong patriotic streak, he liked the idea of helping out America’s most established company.

General Motors was assiduous in its pursuit of EDS, seeking to overcome Perot’s reluctance to sell the company he had spent his life building. The essence of the agreement appeared paradoxical: GM would pay $2.55 billion to buy EDS, yet EDS would remain independent inside the parent company, managed by EDS executives, setting its own compensation practices, and answerable only to Roger Smith and the GM board. In other words, within the buttoned-down establishment of GM would exist a group of autonomous, nonconformist, Texan rebels.

The deal worked as follows:

- GM issued promissory notes to EDS executives that their new ownership in “E” stock would not be worth less than $125 in seven years—that is, if, in seven years, “E” traded at only $100, GM would make up the $25 difference. It was a way of guaranteeing EDS officers a wonderful return on their holdings in EDS as well as creating an incentive for them to stay for seven years.
- Ross Perot would receive $1 billion for his interest in EDS and 43 percent of the newly created “E” stock. Perot instantly became GM’s largest individual shareholder, and one of the largest overall, owning 0.8 percent of the stock, or 11 million Class E shares. By contrast, Smith had acquired 26,500 GM shares in a 36-year career.
- EDS was guaranteed long-term, fixed-price contracts for its work on GM. The contracts guaranteed EDS $2.6 billion of new business, a sum that was 33 times EDS’s current earnings.
- To merge EDS with GM’s own data-processing operation, 10,000 GM employees would be transferred to EDS.
No sooner had the vows been exchanged than the problems began. The new couple started fighting before the honeymoon had even started. As EDS’s senior executives arrived in Detroit, they were given a glacial reception – indeed, many GM-ers seemed not to have been briefed about EDS’s arrival at all. One account of the merger tells how some senior EDS executives were introduced to Alex Cunningham, executive vice-president of North American operations. Cunningham uttered not a word to his visitors before showing them out of his office with the words, “It will be a cold day in hell before I’m going to help pad the pockets of a bunch of rich Texans.”

General Motors executives were not the only ones to oppose the arrival of EDS. For the 10,000 GM data processors who would be transferred to EDS, the move meant an end to the strict hierarchy and chain of command they were used to. Instead, they were told to accept lower pay, lower benefits, and more job risk under EDS management. GM employees wondered how EDS could be owned by GM and yet be in charge. Some of the data workers applied to the UAW for affiliation, a move that upset EDS’s traditionally union-free labor relations.

Meanwhile, Ken Riedlinger, EDS’s most senior officer in Detroit, was receiving hate mail, obscene phone calls, and was finding his car tires slashed almost daily. Ultimately, he quit. Perot himself received a cold shoulder. On arriving for his first meeting of the board of directors, he found that he had been placed on the public policy committee, the least influential of any of the board committees. Perot believed that the holder of 11 million shares should be closer to the beating heart of GM’s decision-making, on the finance or executive committees. Perot’s irritation, however, was minor compared to the fundamental difficulties of getting GM and EDS to work together.

The agreement that EDS would have a monopoly over GM’s data processing business soon broke down. GM, because of its size, was used to being able to bully its suppliers. EDS, by contrast, charged premium prices for the vast numbers of computers and processors it wished GM to purchase. The data processing department felt it should be receiving discounts. EDS replied that if GM wanted a twenty-first century computer system, then it needed to pay what it cost. Anyway, advanced systems would help lower costs for GM in the long term. By the same token, EDS was astonished by examples of spectacular inefficiency and money-wasting inside GM, but felt it wasn’t given the opportunity to cure them. EDS felt its efforts were being sabotaged by its own client. The result was constant bickering over pricing and contract terms, so that it was not until April 1986, nearly two years after the merger, that GM and EDS finalized a pricing agreement for EDS’s services. The compromise settled little – just months later, Perot considered suing GM for its failure to sign long-term contracts with EDS. Increasingly, EDS-ers found themselves appealing to Perot and GM-ers to Smith for help in defending their turf. The two chief executives found that their main role in the merger was as peacemakers.

Another increasingly bitter bone of contention concerned compensation. GM employees were used to climbing up an utterly predictable career ladder, with guaranteed annual salary increases, regular bonuses, a generous package of benefits, and a secure retirement. Compensation at GM was utterly risk-free and never spectacular. Roger Smith certainly made a lot of money – more than most executives in the country – but even Smith’s pay paled in comparison to the fortunes amassed by EDS’s senior officers. EDS was a place where spectacular fortunes could be made in a relatively short time. Base salaries and benefits were small – far smaller than GM’s – but the possible rewards via stock options and performance grants were the stuff of dreams. Perot loved incentives: if his people performed, he rewarded them lavishly. For instance, his number two, Mort Myerson, was promised a salary equal to 1 percent of EDS’s 1984 profits – the sky was the limit. Perot believed that this motivated not just his top employees, but everyone in the company, since even the lowliest
worker could see that hard work and success were rewarded with wealth. Perot believed that such a system was essential to the success of EDS.

Compensation soon became a thorny problem. The nature of the original merger agreement meant that even as relations between the two companies grew worse and worse, EDS-ers continued to expect huge rewards. However, GM dragged its feet on the lavish stock bonuses promised in the merger agreement. Under EDS’s pre-merger stock incentive plan, shares were due to have been distributed late in 1984. Following the merger, the award was postponed until early 1985. By midsummer, no decision had been reached, despite Perot’s frequent reminders to Smith. Perot became annoyed. Not only did he regard the stock awards as his prime means of employee motivation, but they had been categorically guaranteed in the GM–EDS merger agreement.

The cause of delay was Roger Smith. He was insulted by how much wealth was already being transferred to EDS employees and the proposed grants were far richer than the grants made to any GM executive, including Smith. GM had already made EDS’s top executives multimillionaires – Perot was worth nearly a billion, Myerson a hundred million – and Smith couldn’t justify any extra largesse. By GM’s calculations, the award would cost GM a further $300 million – paid to people already vastly wealthy thanks to GM. In Smith’s view, the payouts were obscene. In Perot’s view, that was the way EDS had always worked and, under the merger agreement, would continue to work.

Finally, Smith told Perot that he was vetoing the grants, and he traveled to Dallas to explain why to the top EDS officers. The meeting was not a success. According to Levin’s account, Tom Walter, EDS’s CFO, told Smith that he was overstating the cost to GM of the stock grants because he was working from a false set of numbers. Levin writes:

> Walter didn’t get a chance to finish his point.

> People in the room later would remember Smith’s angry explosion as being wondrous and terrifying at the same time: wondrous for the extreme colors and sounds it brought to the room, terrifying because none of them had ever seen someone lose his temper so completely in a business meeting...

> ‘Don’t tell me my numbers aren’t correct,’ Smith sputtered. His already ruddy expression flushed a furious scarlet. His voice rose almost to choking, and he slammed his briefing book on the table.

> Inadvertently, Walter had delivered the most humiliating insult possible to a GM financial executive. Smith might have endured accusations of being a poor marketer or manager. Telling a GM finance man he had ‘bad numbers’ was invitation to a brawl.

> ‘I didn’t come here to be insulted,’ Smith shouted. By this time flecks of saliva had formed at the corners of his mouth. The EDS officers stared in disbelief as the chairman of the world’s biggest and most powerful company lost it.51

The outburst was the first step down a slippery slope that led to Perot’s separation from GM. Despite all the problems involved with integrating EDS into GM, and despite all the petty rows and disagreements and frustrations, Perot had always believed that the merger would work. He had expected difficulties, and he had expected it to be hard to merge a small, lean, entrepreneurial company with a vast, old, and bureaucratic one. Ultimately, however, Perot had believed it could be done. He felt that he and EDS had something that could help GM. Following Smith’s
outburst, he began to doubt it. He began to doubt that Roger Smith was a man with whom he could do business or that GM could overcome its culture. Perot thought he had been brought on board to shake GM up a little. Now he wasn’t so sure it could be done. Was Smith really ready to do what it would take? Was he going to talk about revitalizing GM, or was he actually going to do it?

Perot was more than just the man who had created EDS. He was also GM’s largest shareholder, with tens of millions of dollars tied up in the company’s performance. As grave as EDS’s problems with its new corporate parent might be, Perot was first and foremost a member of the GM board of directors.

Perot was concerned that even as GM’s massive capital spending program was failing to solve the company’s fundamental problems, Smith was intent on spending big bucks to acquire Hughes Aircraft. To Perot, the purchase was simply money down the drain at a time when GM was taking bigger and bigger hits to its market share.

Perot’s increasing dissatisfaction at GM and its management reached a climax at a board meeting held in November 1985. One of the items of the agenda was for final board approval to buy Hughes Aircraft for $5.2 billion. To Perot, the planned purchase represented everything that was wrong with the way GM was being run – big, thoughtless spending with no regard for the company’s most basic problems.

In a dramatic speech to the board, Perot explained his opposition. First, he outlined where he thought GM had gone wrong. He explained that the company was “procedures oriented, not results oriented” and that business matters that should be decided in minutes took days or weeks shuttling up the hierarchy in a series of unproductive meetings. “Senior management is too isolated from the people,” Perot concluded. Perot told the board that he had attended a Cadillac dealer’s conference where the common complaint had been that it was impossible to sell Cadillacs when they were riddled with defects. Perot had asked the dealers why the problems were so pervasive: “The answer was ‘GM doesn’t give people the responsibility and authority to get things done – and the GM system avoids individual accountability.’”

Perot asked the directors why they should approve a $5 billion purchase for space-age engineering when GM couldn’t even build a reliable car. He argued that throwing money at the problem was not going to solve it: “The experiences of our successful competitors demonstrate that people – plus the intelligent application of capital – are the keys.” Whether Perot meant it to be or not, this was a sharp dig at Smith’s entire strategy.

Perot did not just attack management, he also went after the board. He called for the board to become a genuine decision-making body, not a silent ratifying counsel: “We must change the format of board meetings from passive sessions with little two-way communication to active participatory sessions that allow us to discuss real issues and resolve real problems.” Months earlier, Perot had sought approval from Smith for meetings of the outside directors alone. He felt the board would be better able to assert its independence if it was freed from the counterweight of the executive board members. Smith refused Perot’s request.

Perot reminded the directors of their duty to represent the stockholders:

“They own this company. We must make it clear that the management serves at the pleasure of the shareholders…. The managers of mature corporations with no concentration of owners have gotten themselves into the position of effectively selecting the board members who will represent the stockholders.”
When it came to a vote on the Hughes purchase, Perot’s was the lone dissenting vote. It was the first such dissension in the GM boardroom since the 1920s.

Relations could not but deteriorate. Perot and Smith continued to haggle over compensation and bonus formulas, an issue that Perot believed was none of GM’s business. Meanwhile, Perot forbade GM to audit EDS’s books. In a series of increasingly combative letters to Smith, Perot demanded that EDS be left to run its business independently – the way the merger agreement intended. In a letter of May 19, 1986, Perot accused the automaker of trying to “GM-ize EDS.”60 Of course, the entire point of the merger had been to “EDS-ize GM.”

In background interviews with the Wall Street Journal in the spring and early summer of 1986, Perot explained where the EDS–GM merger had gone wrong. He went far beyond the difficulties of combining the two companies; instead, he discussed why GM was failing in the marketplace. “Until we nuke the GM system,” he said, “we’ll never tap the full potential of our people.”61 He was even more critical of Roger Smith than before, saying that “he talks a good game” about turning GM around but that he failed to understand how to do it.62 Perot criticized management for its obsessive attention to executive perks and bonuses – and even demanded that GM scrap its executive dining rooms! Perot believed the trappings of power interfered with management’s ability to see the company in an honest light.

Perot reserved further ire for the board: “Is the board a rubber stamp for Roger? Hell, no! We’d have to upgrade it to be a rubber stamp.”63 Perot believed that the board knew nothing of GM’s fundamental problems. Each outside director received the latest GM model every three months – what would they know about reliability? Perot bought his own cars and sometimes visited showrooms incognito, trying to discern problems. He came across GM dealers who were now selling Japanese cars to stay competitive. How could the directors, receiving a new car every 90 days, hope to know anything about problems like these?

The Wall Street Journal published Perot’s comments – much watered down – in an article entitled “Groping Giant.” The article showed how GM, despite its pricey automation drive, was less efficient than its rivals and losing market share as a result. “Poised for the 21st Century?”64 asked the Journal, the first paper to criticize Smith’s highly lauded strategy. The criticisms were backed by the poor performance of the year. The rest of the financial media pricked up its ears and Perot was willing to talk. In a series of interviews, Perot continued to assail GM, telling Business Week that “revitalizing General Motors is like teaching an elephant to tap dance.”65

As the battle between Perot and Smith became ever more public, so the chances of reaching an understanding became ever more slim. Smith was infuriated by Perot’s public ridicule of GM; senior executives were distressed by the lack of respect Perot showed for what had for so long been the most respected company in the world. The marriage between GM and EDS had broken down irreparably and divorce became the only option.

Perot’s lieutenants and GM counsel negotiated a buyout of Perot’s holding in GM. On December 1, 1986, the board agreed to pay Perot $742.8 million for his stake in GM. The buyout offered $61.90 for shares that were then trading at about $33. In return, both GM and Perot agreed that neither side would criticize the other, on penalty of $7.5 million. In other words, if Perot continued his attacks on GM, he would have to return $7.5 million to GM. The buyout was so preferential to Perot that he could not believe the board approved it. He thought the price was so great that the directors could not but oppose Smith. Perot was dumbstruck that not one director dissented from the decision to send him packing with so much of GM shareholders’ money. In court testimony two years later, Perot said, “My attitude all the way was no one will ever sign this agreement on the GM side, it’s not businesslike. I underestimated the desire on the GM board to get rid of me.”66
Perot was concerned the press would report that he had bribed GM, that he had offered the deal as the price of his silence. He was determined to show that GM had initiated the deal. So he offered the money back. He put the money in escrow and gave the GM board two weeks to rethink the decision to buy him out. If, after two weeks, the board of directors thought that ridding GM of Ross Perot was in the shareholders’ best interest, he would take the money. If not, Perot would pay the money back and continue to work at GM. In a press conference held immediately after he signed the buyout agreement, Perot told reporters, “Is spending all this money the highest and best use of GM’s capital?...I want to give the directors a chance to do the right thing. It is incomprehensible to me that they would want to spend $750 million on this. I am hopeful that people will suddenly get a laser-like focus on what needs to be done and do it.”67 Following the announcement of the buyout, and Perot’s press conference, GM stock declined $3, and EDS stock lost $4.50.

Ross Perot’s involvement in GM caused almost immeasurable bad publicity for GM. Roger Smith and his fellow board members were painted as corporate villains. One group particularly incensed was, unsurprisingly, the shareholders. One sizable shareholder, the State of Wisconsin Investment Board (SWIB), wrote a letter to GM directors saying the buyout “severely undermines the confidence we have in the board and in the officials of General Motors.” SWIB was prepared to back up its letter with a shareholder resolution or a lawsuit, but one phone call from GM to the governor of Wisconsin threatening to shut down some planned developments in the state quickly put an end to the protest.

This last story is, if nothing else, indicative of the governance structure at GM. Roger Smith ran his company unchallenged by either the board or the shareholders the board was meant to represent. Smith wanted to revitalize the company, but it had to be done his way.

Was this mode of operation in the best interests of GM’s shareholders?

GENERAL MOTORS AFTER PEROT: SMITH AND STEMPEL

From 1984 to 1986 Smith garnered universal praise for his effort to push GM into the future and won just about every business award going. In 1985, the New York Times Magazine featured him in an enthusiastic cover story. In 1986, he was named 1986 Executive of the Year by both Financial World and Chief Executive. However, the tide turned that same year. Not only did the Perot affair leave Smith with egg all over his face, but the company’s performance demonstrated that Smith’s strategy, now five years old, was not achieving results. Instead, Smith’s drive for automation had merely turned GM from the lowest-cost producer among the Big Three to the highest.

The combination of these results and the devastating adverse publicity of the Perot episode changed many perceptions of GM. Suddenly, Smith was no longer seen as a corporate wizard, but as a bully who could not take criticism.

Roger Smith certainly wasn’t to preside over an upturn in GM’s fortunes over the last years of his tenure. In his last four years at GM, Smith found himself under pressure from all sides as GM’s results continued to deteriorate. The company still suffered from excess capacity, bearing huge fixed costs. Smith was faced with either raising sales, and thus productivity, or downsizing the company in line with GM’s diminishing market share.
On the eve of Smith’s retirement, GM’s results were worse than ever.

- By 1989, GM was recording a market share of 34.4 percent. This was down from 44.1 percent in 1979. This decline meant nearly $10 billion per year in lost revenue to GM.
- Between 1980 and 1990, the S&P 500 rose 227 percent and it appreciated 27.3 percent in 1989 alone. GM, by comparison, had achieved 69 percent and 1.2 percent respectively.68
- Harbour & Associates, an automotive consultancy based in Troy, Michigan, found that over the 1980s, GM’s assembly efficiency had improved 5 percent compared with 17 percent at Chrysler and 31 percent at Ford.

THE POST-PEROT BOARD

The Perot affair had some impact on the board. The Wall Street Journal reported years later that directors such as John G. Smale, then CEO of Procter & Gamble, and former ambassador Armstrong were afraid their personal reputations would suffer if they didn’t do something about the “pet rock” image that they had acquired as a result of Perot’s media barnstorming. The Journal quoted one source as saying, “There’s a feeling that perhaps [the board] wasn’t as involved in some past decisions as it should have been.”69 They were backed by GM’s outside counsel, Ira Millstein, a partner at the New York firm of Weil, Gotshal & Manges, who was a vocal governance advocate. Millstein counseled the outside directors to assert more independence in the face of some of Smith’s requests.

There were other signs of increasing discontent among board members. In 1988, GM’s general counsel Elmer Johnson quit. Johnson had been brought in from outside – a rare move for GM – as part of Smith’s plan to nudge the GM system. Johnson had been motivated by the hope that he might achieve the presidency, but he soon became disillusioned at his lack of ability to change the GM establishment. Shortly after, James D. Robinson, chairman of American Express, resigned from the board after a short tenure. Even he, a stern ruler of his own fiefdom, was frustrated by the lack of power board members possessed in the face of Smith’s determination to manage GM his way.

The board got its chance to assert its independence in 1988. Smith proposed to add three further GM officers to the board. The move would have meant that insiders made up 40 percent of the board. Smith was rebuffed. It was the first time anyone could remember a GM chairman not getting his way with the board.70 Another factor in the board’s new independence could have been the growing activism of some of GM’s shareholders. GM’s owners were becoming increasingly uneasy about the company’s management and the stock’s continued stagnation. The year before Smith retired, GM’s board voted to raise executive pensions. Smith himself would see his pension rise from around $700,000 to $1.25 million. The raised pensions would affect 3,350 managers and cost $41.6 million annually. GM said such a move was necessary to attract top talent. Many shareholder groups, including Institutional Shareholder Services, agreed, saying the increase was needed to bring GM’s executive pensions up to par with those offered by GM’s competitors.

Though the board had the sole power to approve the increased pensions, they decided to seek shareholder ratification none the less. In doing this, GM was attempting to rid itself of the shareholder-unfriendly image it had acquired, thanks to Ross Perot. In the 1990 proxy, the board sought a shareholder vote on the move. Though the measure ended up being overwhelmingly approved – by 87 percent in favor – the size of the increase caused a blaze of criticism for management and the board. For instance, the local public employee pension fund, the Michigan State Retirement System, voted to oppose the moves. Smith described the idea to permit a shareholder vote on the
raise as a “corporate governance experiment gone astray” and said that he regretted involving the shareholders in the decision to raise pensions.

As Smith’s retirement neared, shareholders made their presence known once again. Traditionally, the leadership transition at GM was uncontroversial. The outgoing CEO generally tapped his successor long before any retirement date. The result was a smooth succession of GM loyalists. Since 1958, the baton had always been passed to a finance chief. It was also customary for the outgoing CEO to retain a seat on the board.

The succession process was worrisome to two of GM’s largest owners, the California Public Employees’ Retirement System (CalPERS) and the New York State Retirement System (NYS). Both were pension funds serving the public employees of their respective states, and both were vocal governance activists. The two groups were worried that the clone-like succession process at GM was contributing directly to GM’s decline. It was particularly nettlesome to these investors that the retired CEO could continue to exert influence over his successor via his seat on the board. There was no room for an outsider, someone who might have fresh ideas or a new approach. The process, like everything at GM, seemed geared to conservatism, making sure the company continued to be run in the same way it always had – clearly not a good idea at this point in GM’s history.

Ned Regan, the New York State Comptroller at the time, asked what “processes and criteria” the GM board would use to select Smith’s successor. Regan cited some of GM’s dismal results, saying, “presumably these figures point to a management problem.” CalPERS wrote a similar letter to GM’s directors, adding a specific recommendation: that Smith not be retained on the board. This was a major development in the evolution of shareholder activism, prompted by frustration, a sense of urgency, and a growing understanding of the power and responsibility of large investors.

The directors never even responded to the shareholders’ concerns, preferring to leave their answer to a corporate spokesman, who replied, huffily, “Corporate governance, which includes the selection of officers, is the board’s responsibility.” According to one report, Roger Smith even called the governor of California to complain about CalPERS’ unsolicited advice.

CalPERS and other shareholders lost that round, but they went on to win others. In 1990, at shareholders’ urging, GM adopted a provision against greenmail, prohibiting the company from buying shares at above-market prices from anyone who has held more than 3 percent of the company’s voting stock for less than two years. In 1991, GM adopted CalPERS’ proposal to have a bylaw-mandated majority of outsiders on the board.

Of course, both of these victories were symbolic only. There was no chance that any raider was looking to be paid greenmail by GM, though the clause would prevent anything like the Perot buyout from ever occurring again. The bylaw merely confirmed what had been the case for many years. The “outsiders” selected by management had not been able to provide effective oversight.

In April 1990, GM picked a new CEO, Robert Stempel. Stempel had spent his GM career as an engineer, and his appointment constituted a significant departure from the run of finance men who had headed GM since 1958. One person overjoyed at the news was Ross Perot, who told the Washington Post, “This is too good to be true. This is an all carmaker team. It’s a terrific day for General Motors.” Stempel took over from Roger Smith on August 1, 1990, but Smith continued to hold his seat on the board.

Even during the succession process, the board failed to impose its authority. Stempel wished to have Lloyd Reuss as president, in charge of North American Operations. The board vacillated. They didn’t have much faith in Reuss’s abilities, but they capitulated in the face of Stempel’s demand that he pick his own management team. As a signal of displeasure, the board withheld the title of chief operating officer from Reuss.
Stempel had a great first day as CEO. On his second day, Iraq invaded Kuwait, setting off a period of unease in America and a worldwide recession. GM, Stempel would later reflect, headed into a “kamikaze dive.” The fundamental premise behind doing business in as cyclical an industry as that of cars is to make money hand-over-fist in good times and try to retrench and curb losses in bad. The excellence of the good years should make up for the depressed conditions of the bad. However, GM lost money in the boom market of 1986–7; now it had no brake shoes to slow its own drive downward as the economy skidded into recession. The reality of Smith’s failure became vividly and shockingly clear during the next two years.

Before 1990, GM had never recorded back-to-back yearly losses. During 1990–2, GM suffered three. As the 1990s wore on, it became ever more apparent that GM was suffering more than a downturn; it had struck a full-scale crisis. The root of the problem was the disastrous state of GM’s North American Operations, which suffered from being the highest cost producer in the flattest auto market since 1982.

- 1990 ushered in the worst yearly loss in GM’s history.
- In the final quarter of 1990, GM recorded its worst ever quarterly loss, $1.6 billion.
- Between June 1990 and September 1991, GM recorded five straight quarterly losses, totaling $5.8 billion.
- North American Operations lost approximately $10 a share in 1990.
- In 1991, North American Operations lost $7.1 billion, that is, $1,700 on every car and truck it sold in North America.
- During 1990–2, North American Operations racked up losses of almost $15 billion.
- A 1992 Harbour & Associates study showed that GM spent $795 more to assemble a car than did Ford. This translated into a $4 billion per year disadvantage.

Stempel continued the downsizing that Smith had begun in 1986. In October 1990, GM announced the closure of seven plants, requiring a charge to earnings of $2.1 billion. Months later, in February 1991, GM announced it would cut a further 15,000 white-collar jobs from the workforce by 1993, with 6,000 employees being pared in 1991 alone. The aim of the downsizing was to reduce GM’s huge capacity in line with its diminished market share. GM hoped to become competitive by running fewer factories faster. Smith’s $90 billion spending had failed to achieve this simple aim.

The closing of plants, and the layoffs they involved, usually evoked a storm of protest from the UAW. This time around, however, the union stayed silent. That was because of a contract, signed between GM and the UAW in March 1990, in which GM guaranteed to keep paying its 300,000-plus blue-collar workers up to 95 percent of their salary for as long as three years if they were laid off. From GM’s point of view, the contract bought peace, enabling the company to downsize quietly and quickly.

In practice, the contract only damaged GM’s ability to compete during the recession. By paying even those workers it laid off, GM turned what was normally a modest variable cost into a gigantic fixed one. Generally, automakers lower costs during times of slow production by laying off workers who are not needed. The company can then rehire them when sales pick up. In this instance, however, GM was struggling through a recession with a payroll better suited to boom times, employing as many as 80,000 workers to stay at home.

The contract destroyed GM’s ability to control the cost of its workforce. It cost GM $500 million within a few months of its signing. GM had pledged $4 billion to the job security fund, to last through 1993. Now, some GM officials felt that might not be enough.
General Motors’ competitors were having a field day. In 1990, Japanese automakers acquired four points of market share in one year, for a total of 29 percent. General Motors needed new infusions of capital to repair its balance sheet. In 1991, GM was able to raise $2.4 billion via new common and preferred stock issues, but this equity was matched by increased debt. GM’s long-term debt nearly doubled between 1985 and 1991, to 35 percent of equity – not a crippling ratio by the standards of the time but an alarming contrast to GM’s traditionally rock-solid balance sheet. Given the terrible state of the auto market, the heavy debt load threatened GM’s ability to borrow further. The company took steps to conserve cash.

- Early in 1991, GM nearly halved its annual dividend, slashing it to $1.60 from $3. The cut saved GM over $840 million a year.
- GM slashed its capital spending by $1.1 billion for the years 1992–3.77

As GM ran low on cash to support its operating expenses and stock obligations, the credit rating agencies threatened to downgrade. In November 1991, Standard & Poor’s announced that it was putting GM on a credit watch, with potentially disastrous consequences for GM. Fortune wrote, “For a company that once routinely luxuriated in triple-A ratings, the prospect of a downgrading was not only an embarrassment but a financial menace. Borrowing costs for GMAC, which is GM’s finance arm, could increase by $200 million or more annually.” By the end of the third quarter of 1991, GM had $3.5 billion in cash – half the amount it usually kept to meet payroll demands and pay suppliers, and less than half the amount of cash kept on hand by Ford.78

Another element of GM’s shaky finances was the under-funding of GM’s pension fund by nearly $17 billion in late 1993.79 From 1989 onward, to make up for its cash shortage, GM began diverting money earmarked for the pension fund to operations. To keep the pension fund looking healthy, GM made generous assumptions about the rate of return it would achieve. For 1992, GM had targeted an 11 percent rate of return, but only achieved 6.4 percent.

While Stempel denied that the cash squeeze would harm GM’s ability to develop new models, analysts remained skeptical. One plant due to produce a new model of a successful Chevrolet truck was forced to stand idle until 1994.80 Given these problems, the board could not stay stuck in neutral. By late 1991, it became obvious that GM had to undergo a massive overhaul to survive. Moreover, GM could no longer resort to the Roger Smith solution of throwing money at the company’s problems. The GM board finally pressed Stempel to take the necessary, savage, steps to put North American Operations back on the road to profitability.

In December 1991, Stempel announced the most sizable cuts to date. GM would close 21 plants over a three-year period, cutting 74,000 jobs in the process. The aim was to reduce GM’s capacity by one-fifth so it could operate profitably on a 35 percent market share. It appeared likely that at least some of the plants scheduled for closing were ones that had been renovated and modernized in the 1980s at a cost of billions. Fortune called it “the greatest upheaval in [GM’s] modern history.”

The board was still not satisfied. They wanted Stempel to drive a sense of urgency through every part of GM, instilling the kind of cultural change that Smith had so longed for. It was becoming apparent to the board that nothing short of a revolution at GM could cure its ills. However, Stempel was a reluctant revolutionary, insisting to the board and shareholders alike that the company would pick up with the economy.

On April 6, 1992, the board put Stempel on notice. Stempel was demoted from his post as chairman of the executive committee (a group created in 1989, but seldom convened). At the same time, Lloyd Reuss, Stempel’s right-hand-man, lost his job running North American Operations and was
removed from the board. In a candid press release, the board said, “Regaining profitability requires a more aggressive management approach to remove excess costs.”

The *Wall Street Journal* put Stempel’s “wing clipping” into its corporate governance context: “He became the first GM chief executive in more than 70 years to lose control of his board.”81 It also reported the comment of one outside director: “[Stempel’s] heart is in the right place, but bold moves aren’t in his nature. He needs to be prodded. That’s where the board comes in.”82 The newfound boardroom activism put GM’s stock up $1.25 in a heavily down market.

Reuss was replaced at North American Operations by John “Jack” Smith, who had previously run GM’s profitable European operations in the mid-1980s, turning a big loss-maker into GM’s most profitable operation.

The media engaged in a frenzy of speculation as to which directors had demanded the move and how the decision to scold Stempel publicly had been reached. The *Wall Street Journal* reported that Roger Smith, who was still a board member, had not been invited to some of the key meetings. Smith apparently thought the board had acted hastily, just as GM’s fortunes were on the upturn. According to the *Journal*, Smith told friends that if the board had held off for six months, they would not have acted at all.83

The energy behind the announcement of April 6 was apparently Millstein, GM’s outside counsel. Millstein had been doing a busy job as go-between, meeting not just with GM board members but with big, angry investors such as CalPERS. In the January 1992 board meeting, when Stempel was accompanying Bush to Japan, the outside directors met alone with Millstein – a rebellion that would have been unthinkable under Roger Smith.

The media also speculated that Stempel’s demotion would undermine his leadership, leaving him looking over his shoulder, uncertain if he had the confidence of the board. From April onwards many were simply awaiting the moment at which Stempel would be replaced. In October 1992, as rumors flew, the GM directors issued a statement saying that the board “continues to reflect upon the wisest course for assuring the most effective leadership for the corporation.” This was hardly a vote of confidence.

As the pressure to remove Stempel became overwhelming, other changes seemed to be waiting in the wings. Analysts contemplated the possibility of another dividend cut; shareholder activists waited to see if Roger Smith would be forced off the board or if GM would separate the roles of CEO and chairman.

The end, when it came, was almost anticlimactic. On October 26, 1992, Stempel resigned as chairman and chief executive officer. On November 2, the board approved the appointment of Jack Smith as CEO and John Smale as chairman of the board. Thus, Smith would be in charge of day-to-day operations but would have to report to Smale as chairman. Roger Smith resigned from the board and three new directors were named. GM also slashed its quarterly dividend to 20 cents a share. In an interview with *Time*, one outside director commented nostalgically on the seismic shake-up that had taken place at GM. “This is not the company it once was,” he said.84

**LESSONS FOR THE BOARD**

Following Stempel’s ouster, the GM board was hailed for its activism. Trumpeting “The High Energy Boardroom,” the *New York Times* hailed “the outside directors that shook GM.”85 The *Wall Street Journal* responded similarly, with an op-ed that declared, “Board Reform Replaces the LBO.”86
In fact, the board deserved as much criticism as either Roger Smith or Robert Stempel. The directors took hold of their duties only years too late. After Stempel’s departure, one outside director told *Time*, “There is going to have to be special oversight by the board for the next three years.”

*Why had there been no special oversight in the 12 preceding years?*

The GM board learned something between the buyout of Ross Perot in 1986 and the edging out of Robert Stempel in 1992. They learned that no company can remain unaccountable to the market forever. For years, GM’s size and wealth protected the company from the competitive forces that caused change at Ford and Chrysler. Ultimately, however, GM could not escape from its own failed strategy. Having spent itself into financial peril, with no commensurate increase in quality, productivity, or sales growth, GM was brought to the brink of collapse. There was even speculation that GM, once the defining symbol of American industrial success, would file for Chapter 11 bankruptcy protection.

It was only at this point that the board got a grip. It took the bold step of opposing Smith in 1988 and the departure of Robinson and Johnson sent another strong signal of frustration. However, the board continued to play a waiting game. Smith’s tenure would soon be over and change could be effected through the succession process, but in all the time the board waited, GM’s results grew worse and worse, and the company’s basic flaws went ignored.

In 1990, the board rejected the idea of appointing an outsider as CEO, though they considered that possibility. They believed that Stempel, a car guy, could tackle GM’s problems with sufficient aggression, but as the recession sent GM into a nosedive, the board became convinced it had been mistaken. Stempel was not the right man for the top job. Barely 18 months after his appointment, Stempel was put on public notice to do better. Six months later, he was fired. Eventually, finally, tragically late, the board did the right thing.

In the five years that the board took to summon up the courage to do its duty, GM dug itself into a hole of such proportions that it could take even longer for the company to climb out. The price has been paid by GM’s shareholders, its suppliers, its employees, and most everyone with an interest in the economy of the mid-west.

The GM board determined that the same mistakes would not be made again. GM’s bosses declared a new commitment to corporate governance. In a November 1993 *Fortune* article, GM’s chairman John Smale outlined eight rules for building a better board, which reflected principles being adopted in the GM boardroom.

1. There should be a majority of outside directors.
2. The independent members of the board should select a lead director.
3. The independent directors should meet alone in executive session on a regularly scheduled basis.
4. The independent directors should take responsibility for all board procedures.
5. The board should have the basic responsibility for selection of its own members.
6. The board should conduct regularly scheduled performance reviews of the CEO and key executives.
7. The board must understand and fully endorse the company’s long-term strategies.
8. The board must give an adequate amount of attention to its most important responsibility – the selection of the CEO.
GENERAL MOTORS: THE 1990S

Ross Perot liked to say that getting GM moving again was like teaching an elephant to dance. *Fortune* magazine took an in-depth look in 1997 and found that, unfortunately, this monster company was proving as difficult as ever to shift.

On the good side, GM’s famously rock-solid finances had largely been restored – the company ended 1996 with $14 billion in reserve, thanks to a considerable consolidation of assets. In 1996, for example, GM’s defense electronics business was offloaded to Raytheon for $9 billion. A 20 percent stake in the Delphi parts-making business was also offered to the public. International operations continued to perform strongly, as did the GMAC finance arm in the 1990s, and, in the core domestic market, GM made money on trucks. However, in its own back yard, the company still could not turn a decent profit making cars.

In 1996, North American Operations returned just 1.2 percent on sales. If you exclude the contribution from the parts-making subsidiary (according to GM’s own accounting policy), NAO’s return does even worse – a mere 0.8 percent return. This does not compare well with the company’s target of 5 percent. NAO, said *Fortune*, “remains burdened by its past.”

*Fortune* asked: “Why is it so hard to get this monster moving?” and then answered its own question by suggesting that, “GM dithers over almost everything.” The magazine pointed the finger at many of the problems that we saw in the Roger Smith era – confusion and internal rivalry between the six vehicle divisions and infighting between powerful groups of suppliers, dealers, and unions. Labor relations, *Fortune* commented, hit a “postwar low.” In 1996, UAW strikes prevented GM building 300,000 cars at a cost of $1.2 billion after tax.

The chairman and CEO, Jack Smith, told *Fortune* that his task is to get GM to “run common.” This sounded like an uncomfortable echo of what Roger Smith was trying to achieve two decades previously.

GM had long been identified as a sprawling, cumbersome beast, but even when it streamlined operations, the company was still left playing catch-up. *Fortune* outlined how duplicative and wasteful the simple process of metal stamping was. GM spent $850 million to standardize the die production at 13 plants and reduce the number of press line set-ups from 57 to 6, but when the reform was complete, GM was still spending 20 percent more on metal stamping than Toyota.

This competitive disadvantage was mirrored in other key areas. GM took 29 hours to assemble a Pontiac; Toyota assembled a Camry in 20. GM’s domestic plants spent an average 3.5 months getting production of a new car up and running at full speed in an assembly line; Honda did it in a weekend.

Nor was GM any better positioned in the contemporary domestic market. For example, the demand for trucks, sports utilities, and minivans grew at such a pace that they accounted for 50 percent of the total US auto market, but three of GM’s six divisions continued only to make cars.

The result? GM continued to be seen as old fashioned and backward looking – a view that was reflected in sales. At Oldsmobile, sales went from 1.1 million in 1986 to 331,287 in 1996. *Fortune* commented: “If GM had decided to kill Olds in 1992, it would have been euthanasia.” Ultimately, that decision came in 2000. As a whole, GM’s market share for the first two months of 1997 was 30.3 percent, down from 32.5 percent for the same period a year before. *Fortune’s* conclusion: “Fixing GM has turned into a decade-long project that few people – investors, analysts, or company executives – can have foreseen.”
In the early twenty-first century, General Motors continued to be an exemplar of the top corporate governance issues of the era. As capital transcended the borders of domicile countries and “corporate raiders” of the 1980s were repackaged as hedge fund managers and “shareholder activists,” billionaire Kirk Kirkorian announced on May 4, 2005 that he intended to buy 9.9 percent of General Motors, an increase from his holdings of just under 3.4 percent. The required disclosure provided assurances that this was purely for investment purposes; in other words, no interference with management or the board was under consideration. He had previously taken a position in Chrysler and had a representative added to the board. After Chrysler merged with Daimler, he filed an unsuccessful lawsuit challenging the deal. It turned out that he did not plan to be a passive investor in General Motors. He pushed for representation on the board and his colleague Jerome York became a director. He also pushed for an alliance between General Motors, Nissan, and Renault, stating that “such a global alliance has the potential to materially strengthen the competitive positions of all three companies in the increasingly challenging worldwide automotive industry.” Renault owns a 44.4 percent stake in Nissan and Nissan owns a 15 percent stake in Renault. However, General Motors rejected the deal, reportedly over an inability to agree on a control premium. York left the board and Kirkorian sold his stock. He made about $100 million, but was unable to change the direction of the company.

**GM’s Phoenix Years: General Motors’ Bankruptcy and Return to Profitability, 2009–10**

General Motors’ collapse, culminating in its 2009 bankruptcy, was consistently predicted in the preceding years, yet its increasing certainty and the measures necessary to avoid it seemed to be virtually ignored by GM executives almost until the global economy entered freefall. In 2005, GM’s increasingly poor market position led the credit rating agency Standard & Poor’s to downgrade GM to BB: a “junk bond” status that denoted a high degree of default risk on its bond payments. A small success at tempering these bankruptcy fears in 2006 was GM’s sale of 51 percent of GMAC (since converted into a bank holding company and renamed Ally Financial) in an effort to decouple the bank so GM could secure loans at lower interest rates. However, the move sacrificed GM’s majority ownership of what had previously been a consistently profitable unit, and the move ultimately had little positive effect on GM’s ability to obtain financing. Considering the companies to remain too interconnected, the rating agencies worried that GM would have to pay a large capital infusion into the faltering GMAC as the bank’s own balance sheet and credit rating were devastated by the falling housing market and subprime lending crisis. Adding to GM’s woes, it continued to diminish as the American auto industry leader: its US sales declined precipitously through the 2000s, falling to a total of just 2.9 million vehicles in 2008, in contrast to highs of over 6 million sold in the 1970s and 1980s. Though GM continued to do well expanding its markets overseas, it could not counteract the failures in its principal market, the United States. And of course, between 2004 and 2008, GM astoundingly lost more than $70 billion, burning through its cash reserves at a rate of over $1 billion a month. In an interview for the *Fortune* Magazine cover story “The
Tragedy of General Motors” published in February, 2006, CEO Rick Wagoner prophesized the myriad pitfalls that could cripple GM:

“But this is a company whose auto operations had a negative cash flow last year of nearly $6 billion. Suppose that repeats this year? Or suppose – Wagoner himself volunteers this – that the price of gas goes to $3 a gallon? Or that industry sales of autos drop by, say, 5 percent, or there’s an outright recession?”

Unfortunately for GM, its shareholders – and Mr. Wagoner – all of these possibilities would hit the company simultaneously, more disastrously than they (at least publicly) anticipated.

In mid-2008, GM began to recognize its dire situation. The problems of maintaining eight separate brands with so little variation between their offerings continued to mount; though GM produced four mass-market midsize sedans (the Chevy Malibu, Buick Lacrosse, Pontiac G6, and Saturn Aura), its combined offerings sold nearly 100,000 less vehicles than the Toyota Camry.94

The inability to differentiate its products, along with its unshakeable reputation of poor quality, high production costs, and painfully slow transition from SUVs and trucks to the small car market combined to GM losing its position as the worldwide sales leader for the first time in 77 years, selling just 8.35 million vehicles in comparison to Toyota’s 8.97 million.95 With the recession pounding, credit markets drying up, unemployment exploding, and demand for vehicles in the United States falling another 25 percent year-over-year from 2008,96 GM continued to blindly devote itself to a sisyphean effort to return to profitability through a restoration of its market share.97

Though management publicly insisted “nothing is off the table” in terms of changes to GM’s business strategy, analysts increasingly doubted the company’s ability to remain afloat.98 These changes included a plan to cut $10 billion in costs over 18 months through massive reductions – in advertising spending, the company’s dividend payment, white-collar employees, engineering costs, capital expenditures, even delaying the replacement of wall clock batteries – proved to be too little, too late;99 the moves helped, but GM still posted a $15.5 billion loss in the second quarter of 2008 alone.100 As losses mounted in ever more staggering numbers, it became clear that if the auto industry was going to survive, it would require massive government subsidy or intervention. That fall, Mr. Wagoner, along with CEOs Alan Mulally of Ford and Robert Nardelli of Chrysler, famously jetted (once, then later drove) down to Washington to plead for ultimately an additional $50 billion in federal loans to keep themselves out of bankruptcy, and GM and Chrysler held on-again off-again merger discussions.101 In the companies’ testimony to Congress, speeches and advertisements, the executives argued that a GM (or other Big Three) bankruptcy would unleash a “cascading set of bankruptcies among [associated] part suppliers, [and] other automakers,” devastate pension funds and leave millions of Americans unemployed.102

However, the Congress and general public’s increasing distaste for government bailouts, coupled with doubts about the Big Three’s continued viability, limited the companies’ initial access to government loans and bailout funds.103 When Congress ultimately failed to approve additional funding, the Bush administration decided not to force GM and Chrysler into bankruptcy, distributing $13.4 billion in loans remaining from the financial industry bailout funds to GM with a requirement to produce a plan for long-term viability by spring: if it could not, the Obama administration would have the option to require repayment of the loans within 30 days, effectively killing the company.104 Following the inauguration of President Obama, the company limped along on billions of additional government infusions, continuing to cut costs through worker buyouts and reductions
in its executive ranks; even with these new measures, GM’s auditors concluded the company “may not have the resources to continue as a going concern.” The final straw for Wagoner came on March 30 as the Presidential Auto Task Force, or “Team Auto,” determined that GM’s viability plan required by its federal loans was dead on arrival and failed to take aggressive steps to reduce the company’s high costs, superfluous brands, and excessive number of dealerships, and made overly optimistic assumptions about future success. The same day, Wagoner announced his resignation at the order of the Obama administration, who also instructed the company to replace the majority of its board of directors. When Wagoner took over as CEO in 2000, GM shares traded at over $70, and the company’s market capitalization was nearly $43 billion; when he left, it was worth $2.21 billion. Soon, the Administration decided that a “pre-packaged Chapter 11 debtor-in-possession” bankruptcy was the best course of action for GM. In April, Chrysler declared bankruptcy, and on June 1 GM followed, filing the fourth largest bankruptcy petition in American history. An event previously unthinkable for the company once considered a proxy for the United States itself, the company listed $82 billion in assets and $172 billion in liabilities: a debt load greater than the nation of India. GM split into two parts – the bad assets of the former General Motors Corporation, to be sold over several years, became the Motors Liquidation Company or “Old” or “Bad” GM; the best, profitable assets and brands were sold to the “New GM.” When GM emerged in May, one could alternatively call the new company “Government Motors,” as the United States invested $30 billion of new loans into the company, taking a majority 60 percent position in the equity shares, alongside Canada’s 12.5 percent stake; the two countries, along with the persisting VEBA, shared the right to appoint a new board of directors. While GM’s previous bondholders received 10 percent of New GM, its previous shareholders walked away with nothing.

The New GM’s 41-day sprint through bankruptcy, guided by Team Auto in a manner similar to that employed by the private equity funds many of its members had previously worked for, accelerated the cost-reducing steps GM undertook in the past decade as the company attempted to wean itself from reliance on vehicle platforms consumers did not want and pare itself down to a more manageable size through the closure or divestiture of expansions made in headier days. The first to go in 2004 was the venerable Oldsmobile, founded in 1897, 11 years before GM itself. Though the brand exceeded one million in sales during the 1980s, by 2000 that number was down to less than 300,000, tracking the brand’s increasing irrelevance. At the end, its models were almost indistinguishable from those of GM’s other brands; for example, there were few noticeable differences between an Oldsmobile Alero and a Pontiac Grand Am. The large SUV era ended next: with gas prices exceeding $4 per gallon in early 2008, GM executives unanimously voted to terminate the company’s “CXX” project. A next-generation full-size SUV platform in which the company had already sunk $2 billion, the decision ended any possibility of further developing what had just a few years earlier been its most profitable class of vehicles. With its future in large SUVs gone, the next division on the chopping block was Hummer, whose vehicles were perhaps the quintessential image of American largesse and inefficiency in the 2000s. Originally expecting to entertain offers as high as $500 million for the brand, GM liquidated Hummer in 2010 after Chinese government regulators vetoed an estimated $150 million dollar purchase offer by Sichuan Tengzhong Heavy Industrial Machinery, and no other serious buyers emerged. In January of 2010, GM sold Saab to the Dutch company Spyker Cars; GM had been preparing to close the Swedish automaker as its previous attempts to sell the division failed. An attempt to sell further European-based subsidiaries Opel and Vauxhall failed, but rather than close those divisions like Hummer, European governments successfully pressured GM to reinvest in the brands and keep some of their European plants open. GM also shut down two more of its original, iconic brands: Pontiac, once third in the nation in sales behind Chevy and Ford through strong sales of famous
muscle cars such as the GTO, closed in October 2010.\textsuperscript{121} Efforts to sell Saturn to Penske Automotive Group fell through as well, and GM decided to liquidate the brand rather than struggle to keep the likely–never–profitable division alive.\textsuperscript{122}

Out of bankruptcy in a new, efficient form, GM set about regaining its edge through improved products, government incentive programs, continued global expansion, and a little bit of help from missteps by its competitors. GM’s reputation for poor quality began to slip as models like the Malibu and Cadillac CTS increasingly became favorites of critics and customers alike, and the forthcoming electric–hybrid Volt generated excitement with its promise of stunning gas mileage and 40 miles of electric–only driving.\textsuperscript{123} The Car Allowance Rebate System or “Cash for Clunkers” federal program boosted sales tremendously in the summer of 2009 for American (and foreign) automobile makers; offering cash incentives of $3,500 to $4,500 to new car buyers who returned their vehicles with low gas mileage, the program proved so popular Congress authorized an additional $2 billion in funding.\textsuperscript{124} Massive recalls in 2010 dealt a terrible blow to Toyota’s reputation for safety and reliability, and afforded GM an opportunity to win back the hearts of customers worldwide who had defected to the brand.\textsuperscript{125} The cost reduction and productivity improvement programs earlier undertaken by GM, which previously had labor costs $1,300 greater and assembly time 17 hours per vehicle higher than Toyota, may result in a lower cost and similar assembly time per vehicle in comparison to its competitors heading into the future.\textsuperscript{126} Malcolm Gladwell notes that while Team Auto and the Administration may want to take credit for GM’s successes in a belief the former executives may had been too removed from the day–to–day operations of GM, the real reason behind the company’s newfound success may be the favorable and expeditious cast–off of debt and costs by GM’s government–ushered foray into bankruptcy, as the foundations of a strong firm were laid before Team Auto’s management ability to have much structural effect.\textsuperscript{127} Overseas markets, particularly Asia and Latin America, have become GM’s brightest areas: for example, vehicle sales in China, GM’s fastest–growing market, were up more than 40 percent in 2009, and the company presently sells more than 1.75 million vehicles annually there.\textsuperscript{128} All of these positive steps have led to several consecutive profitable quarters and GM will hold a new initial public offering of more than $10 billion in late 2010 to raise funds to pay off its $50 billion of debt to the US government.\textsuperscript{129} Management concerns remain undecided, however; after Wagoner’s resignation as CEO, GM’s board soon asked his replacement, long–time GM executive Fritz Henderson, to leave as well. Chairman and CEO Edward Whitacre proved to be a strong and popular leader during his tenure, but he soon stepped down from the CEO in favor of Daniel Akerson, the former CEO of Nextel Communications and member of GM’s board after its emergence from bankruptcy.\textsuperscript{130} Time will tell if the new management can continue to develop GM’s upward momentum.

How differently might GM’s fortunes have turned out if Smale’s rules had been in place, and obeyed, at GM from 1980 onwards? Or from 1960 onwards?

Was Roger Smith right to choose revolutionary change over evolutionary change? Why did Smith fail? Did he have the wrong strategy, or was the strategy poorly executed? Was GM’s problem one of managerial incompetence or board neglect? Did Smith do anything more than just throw money at problems? How did he use his capital? How should he have used it?

To what extent was GM’s problem one of “culture” or bureaucracy? Was the company so poorly organized that it was capable of swallowing any amount of money with no constructive result? Could GM’s culture have been changed from the top – i.e., by a new type of CEO?
Is Smith characteristic of American CEOs today? Can you identify companies with a Roger Smith at the helm?

To what extent are the changes in GM attributable to competition from outside the US? Why couldn’t competition from within the US have been more effective? To what extent was the absence of strong domestic competition the result of GM’s influence with the government?

Does it appear that GM’s problems are uniquely American? Or will Daimler AG, Mitsubishi Heavy Industries, and ICI have similar histories? Is there such a thing as “large company disease”? How can it be treated?

What is the definition of boardroom negligence? Is there a standard of corporate poor performance that suggests the board is guilty of negligence? Should boards of directors, and more particularly board nominating committees, insist that any search for top officers, especially the CEO, includes candidates from outside the company? What are the benefits and dangers of promotion from within?

Since World War II, all the largest US institutional investors have held GM stock. They continued to hold it through the 1980s and 1990s. To what extent were those investors negligent in failing to demand better performance? What should, or could, the shareholders have done?

The narrative arguably demonstrates the failure of management, the board, and the shareholders to prevent GM’s decline. Does this suggest a basic failure in the governance structure? What other structure might work better?

What might have happened in the 1970s and 1980s if an investor such as the DuPont company had owned 30 percent of GM’s stock?

At what point in the narrative should the directors have intervened?

Ross Perot owned less than 1 percent of GM’s shares. Was Ross Perot’s stake too small to ensure his continued involvement in the company? To what extent can Perot be accused of “selling out”? If Perot had owned 5 percent, or 10 percent, would he have agreed to the buyout?

What might have happened if each of GM’s outside directors had held 25 percent of their own net worth in GM stock?

Was there a way to “make the elephant dance” without the drastic solution of temporary government takeover? Would reorganization under Chapter 11 have produced the same result?

NOTES

2. Ibid., p. 444.
3. Ibid., p. 460.
5. Ibid.
6. Ibid.
15. Ibid., p. 27.
20. It took a long time for US automakers to exploit their advantage on safety features, though by the 1990s, Lee Iacocca was appearing in Chrysler commercials stressing that more Chrysler cars came equipped with airbags than did those of Japanese competitors. “Who says you can’t teach an old dog new tricks?” said Iacocca in a 1988 advertising campaign.
25. Ibid.
28. Ibid.
29. Ibid.
30. Ibid.
31. Ibid.
32. Ibid.
34. Ibid., p. 99.
37. Ibid., p. 175.
40. Ibid.
42. Lee, *Call Me Roger*, p. 20.
45. Ibid.
47. Ibid., p. 25.
52. Ibid., p. 178.
55. Ibid., p. 258.
56. Ibid.
57. Ibid., p. 259.
58. Ibid.
59. Ibid., p. 260.
60. Ibid., p. 276.
61. Ibid., p. 284.
63. Ibid.
66. White, “Low Orbit.”
70. Ibid.
78. Ibid., p. 29.
81. White and Ingrassia, “Eminence Grise.”
82. Ibid.
83. Ibid.
84. Greenwald, “What Went Wrong.”
86. Ingrassia, “Board Reform Replaces the LBO.”
87. Greenwald, “What Went Wrong,” p. 44.
98. Ibid.
103. Ibid.


108. Ibid.

109. Put simply, the terms mean the creditors of the debtor (GM) are negotiated with in advance, and the debtor (GM) maintains possession and usage of its property during the reorganization process, even though it is bankrupt.


114. Malcolm Gladwell, “Overdrive,” The New Yorker, Nov. 1, 2010. From February to July 2009, the task force was headed by Steven Rattner, a co-founder of the Quadrangle Group private equity firm and popularly known in this new capacity as the “Car Czar.” As of this writing, SEC charges against him for engaging in a “pay to play” scandal involving Quadrangle and the New York state pension fund remain unresolved.


127. Ibid.
At the spring annual meeting of shareholders in 1977, James D. Robinson III was elected chairman of American Express, the New York-based financial services company known for its travelers’ checks and its unique “charge now, pay now” credit card. His ambition was to take the splendid cash flow that the card and checks business generated and use it to create a giant “financial supermarket.” According to Business Week, Robinson “set about transforming American Express into a financial empire of unequaled proportions.” Financial diversification was all the fashion in the early 1980s (witness Sears, Roebuck’s acquisition of Dean Witter or General Electric’s of Kidder Peabody), and Robinson was determined that American Express would be the biggest, the best, and the brightest. As reporter and author Bryan Burrough notes:

“Jim Robinson outlined a vision of a financial empire that would offer all things to all people: charge cards, insurance brokerage services, money management, private banking. It would be unlike any other company ever formed, offering cradle-to-grave financial care for anyone in the world, anywhere in the world. The potential synergies were awe-inspiring: Shearson mutual funds and Fireman’s Fund insurance offered to American Express card holders; American Express travel planning offered to Shearson’s Wall Street clients. The combinations seemed endless.”

To this end, American Express acquired:

- in 1981, The Boston Company;
- by early 1982, regional brokerages Foster & Marshall and Robinson Humphries;
- in 1983, Edmond Safra’s Trade Development Bank;
- in 1984, Investors Diversified Services;
- in 1984, Lehman Brothers Kuhn Loeb; and

Robinson pursued other targets with less success.

- In September 1977, he tried to buy Philadelphia Life, which was already the subject of a takeover bid from its largest shareholder, Tenneco Inc. When American Express launched an unsolicited $230 million bid, Tenneco upped its offer and swept AmEx aside.
- In 1987–8, Robinson wooed Disney and The Book-of-the-Month Club, but these overtures were rejected out of hand.
Then came McGraw-Hill in January 1979, when AmEx launched a “friendly” $830 million bid. The ensuing fight was far from friendly. McGraw–Hill responded with a series of aggressive newspaper articles, letters to shareholders, even a libel suit. At a press conference, Harold McGraw told of a letter he had sent to Robinson accusing him of a lack of integrity and corporate morality. AmEx withdrew. Bryan Burrough comments, “It was the low mark of Robinson’s career.”

Later in 1979, AmEx engaged in a joint venture with Warner Communications to form a cable TV company called Warner-AmEx. The operation continued to lose money until Robinson sold out in 1985, shortly before the business became spectacularly profitable.

ROBINSON’S TRAVAILS

Aborted mergers weren’t Robinson’s only headaches. Other events damaged AmEx’s bottom line, as well as the company’s prized image and integrity.

- In 1983, an AmEx-owned insurance firm called the Fireman’s Fund posted a $242 million pretax loss for the year, dragging AmEx’s overall earnings to barely $30 million. The crisis came to AmEx executives as a big surprise. The loss also spelled an end to AmEx’s cherished 36-year record of annual profit increases. “With virtually no warning, the myth of American Express’s financial supremacy had ended.”

- Also in 1983, Robinson merged the troubled American Express Bank with the Trade Development Bank owned by Edmond Safra. Lebanese by birth and one of the world’s richest men, Safra was the embodiment of exclusive, private banking. Robinson envied his franchise and felt that Safra’s name could boost AmEx’s reputation. The relationship between Safra and AmEx was a disaster. Safra withdrew from the company in 1985 and later resigned from the board. In 1989 he accused AmEx of leading a smear campaign against him. Robinson made a public apology and agreed to pay $8 million to Safra’s chosen charities. Robinson ended up selling Trade Development Bank in 1990.

- In December 1988, The Boston Company admitted “accounting errors.” The president confessed to overstating 1988 pre-tax earnings by $30 million. He was fired and two other senior executives promptly retired.

- In 1988, Shearson became embroiled in the battle for control of RJR Nabisco on the management side, which eventually lost the high-publicity battle to Kohlberg, Kravis & Roberts. Shearson’s role was savaged in a bestselling 1990 book about the contest.

- In 1991, Boston restaurateurs cut up their American Express cards and declined to accept the card at their establishments, in a highly public campaign against AmEx’s high merchant charges. The incident became known as “The Boston Fee Party.”

- In 1987, AmEx introduced its own credit card called “Optima.” Known as “Pessima” in financial circles, the charge card cost the company $112 million.

- In March 1988, Shearson’s Mergers & Acquisition department figured they could merge Koppers, a Pittsburgh chemicals manufacturer, with Beazer plc, a British construction firm. Shearson would kick in $50 million and provide a $200 million bridge loan. Koppers launched a fierce public campaign against both Shearson and AmEx, accusing them of siding with a British firm at the expense of American jobs. Pennsylvania Senator John Heinz threatened to introduce
legislation in Congress to block the takeover, while the mayor of Pittsburgh joined in a public cutting-up of AmEx cards. The negative publicity for American Express was devastating.

The biggest headache of them all, however, was Shearson.

- The company had been in a slide ever since its record year in 1986, and 1989 profits were running 88 percent lower than at their peak. The stock was trading at roughly half the $34 high it had reached in April 1987.
- By 1989, Shearson’s president, Peter Cohen, was pleading with AmEx to infuse more capital. In late 1989, Moody’s placed Shearson on credit watch.
- By the start of 1990, Shearson shares had fallen to as low as $10, one-third of their high.
- Talks in 1990 to merge Shearson with Primerica, run by former AmEx president Sandy Weill, deadlocked. Weeks later, Cohen was fired. When a second round of talks with Weill failed, as did a new issue of Shearson equity, AmEx announced it was going to purchase the remaining shares in Shearson that it didn’t already hold at a cost of $1 billion. Howard Clark Jr., the son of Robinson’s predecessor as CEO, was named the new Shearson boss.

By 1992, Robinson had served as chairman and CEO for 16 years, one of the longest tenures of any American corporate chief. The year was not a good one for American Express. The company was on its way to posting a $243 million profit, but that was down 39 percent from the previous year. Shearson lost $116 million for the year, while other Wall Street firms were showing record profits. These results set the stage for a battle inside the American Express boardroom.

INSIDE THE BOARDROOM, 1992–3

In late 1991, American Express director Rawleigh Warner asked CEO James Robinson to allow a new boardroom procedure: as a matter of regular policy, the outside directors should meet alone once or twice a year. Warner had joined the board in 1972, along with Richard Furlaud. They were the two most senior members of the 19-person board, and were the only ones elected before Robinson’s appointment as CEO in 1977.

Warner requested the meeting of outside directors “to protect ourselves against a charge that all we did was sit around and play patty-cake for Jimmy.”8 Robinson agreed and scheduled two such meetings for February and September 1992.

Before leaving the room to the outside directors at the February meeting, Robinson raised the question of his successor. Robinson said he wished to remain at AmEx for about two more years, until age 60. He identified Harvey Golub, AmEx president and the chief of the core Travel Related Services (TRS) division, as a replacement. The timing, he added, was perfect. Golub was relatively new to American Express and was unfamiliar with many parts of the sprawling AmEx empire. Golub was a man of prodigious talent, Robinson said, but he would make a better CEO given a couple more years’ seasoning.

The succession issue was raised more forcefully at the September meeting. As the outside directors gathered prior to an informal supper meeting of the board, Warner asked if he could make a statement. What followed was a biting 20-minute critique of Robinson’s tenure as CEO. He read out a detailed list of setbacks that had befallen AmEx under Robinson’s leadership, going back to the attempted takeover of Philadelphia Life Insurance Co. in 1977. He described the aborted
mergers, the problems at Shearson, the embarrassing episodes involving Safra and RJR Nabisco, the losses from Optima, and the erosion of the card’s market share. Terrible mistakes had been made, he argued, mistakes that had cost shareholders billions of dollars. Worse, the future was not looking any brighter. American Express was in a mess, he concluded, and James Robinson was not the man to bring it out. His proposal: Robinson should be asked to retire immediately, and a successor found forthwith.

The board’s reaction was mixed. Some were shocked by the sheer volume of evidence Warner had brought to bear against Robinson. At least one director was angry at Warner’s tactics, saying that Robinson was being made the victim of a boardroom cabal. Drew Lewis, CEO of Union Pacific, defended Robinson, saying that many of the problems that Warner had described were the result of industry-wide downturns and were not attributable to poor management. Henry Kissinger, the former Secretary of State, said the issue of Robinson’s ouster was difficult for him because Robinson was “a good friend of mine.” However, the weight of Warner’s argument was compelling. Fortune wrote, “Says one source close to the proceedings: ‘Jimmy was cooked.’” A compromise was reached. Robinson would be asked to retire, but not immediately. A committee would be set up to search for his successor and report its findings to the board; when the board had made its choice, Robinson would relinquish his post.

Robinson was informed of the decision. At the meeting of the full board the next day, the search committee was appointed. Five directors, including Robinson, were named to the committee, with Furlaud appointed as its chair. In a retrospective story covering American Express, the Washington Post wrote, “Both the Robinson loyalists and the Warner-led insurgents wanted to prevent the other side from seizing control of the search committee, sources said.”

The board’s decision was not made public, though in any company as closely watched as AmEx, secrets seldom stay secret for long. Fortune reported in December that Robinson had been pushed out by the board. The company responded by announcing that Robinson had decided to retire, but that he would only step down when the search committee had reached a decision. The suggestion that Robinson was the victim of a boardroom putsch was strongly denied. Warner said in a statement, “This is an orderly succession process initiated by and managed by Jim Robinson. To characterize it in any other way is totally inaccurate. Clearly, this is not a coup.” Richard Furlaud commented, “Prompted by Jim Robinson’s discussion of his own plan for retirement before age 60 . . . the board at its September meeting asked Jim to lead an orderly process to identify a successor CEO.” Robinson himself said, “I did not feel any pressure on the succession issue coming up to the September meeting. I told them that the time was right. The momentum was there.” When asked whether the board had pressured him to leave, Robinson said: “I think that would be a gross exaggeration.” The semantic difference between “coup” and “orderly succession process” was lost to investors. The news that AmEx was to have a new CEO gave a 6 percent bounce to the stock. Shares rose $1.38 to $24.75 on the news of the succession plan, raising American Express’s market value by $667 million.

The media speculated as to possible candidates to succeed Robinson. An obvious frontrunner was AmEx’s own Harvey Golub. Golub had moved to TRS after a spell as chief of IDS, the Minneapolis–based fund management group bought by AmEx in 1984. He achieved stellar performance at IDS and was a lead figure in TRS’s renaissance, responsible for a $1 billion cost-cutting plan and a more flexible approach to merchant charges. He was known to be Robinson’s first choice. The press suggested that possible outsiders included Sir Colin Marshall, president of British Airways, and Frito-Lay chairman Roger Enrico.

As the search committee continued its deliberations, it became apparent that the Golub-versus-outsider issue had become a bone of mighty contention. “Outsider Gains in American Express
Search,” reported the Wall Street Journal in January 1993. Three days later, it carried a different headline: “Decision Nears on American Express Search, Clash Looms as Robinson Seeks Support on Golub, Others Back an Outsider.” The story continued:

“According to one person close to the situation, Mr. Robinson believes he has enough support on the board to make Mr. Golub chief executive under an arrangement that would let Mr. Robinson remain chairman for an indefinite period. ‘Jimmy thinks he has between 12 and 14 votes and all he needs is 10 votes,’ the individual said. ‘Throughout the [search] process, he has been working like hell to line up [board] votes’ for Mr. Golub. Mr. Robinson’s goal has been ‘to make sure that it isn’t an outsider’ who succeeds him as chief executive, the individual added.

The same story reported that Enrico had issued an internal staff memo denying any interest in the job at American Express. Pundits also suggested that a recent scandal at British Airways – in which the airline had admitted a “dirty tricks” campaign against Richard Branson’s rival Virgin Group – had harmed Sir Colin Marshall’s chances. There was no indication that Marshall had been involved in the misdeeds, but it was thought that AmEx, still smarting from the Safra affair, would want to avoid even the whiff of scandal to restore its image of cast-iron integrity.

While no clear outside candidate emerged, doubts also circulated about Golub. They were not questions about his ability, but about his lack of experience as a senior AmEx executive and his unfamiliarity with large parts of the sprawling AmEx empire. The Wall Street Journal reported:

“An alternative to Mr. Golub is being sought, the person close to the committee said, because ‘Harvey is like the sophomore at West Point who is getting all As. But such a great company as American Express needs a general who has already fought a few wars.’

Another difficulty was the need to cater to Golub’s own ambitions. Having been groomed for the top job, he would be unwilling to remain at AmEx under another CEO. The company did not want to lose Golub’s talents, but if American Express did not offer Golub the top job, another company surely would.

On January 21, the search committee met to make their choice. Robinson brought two advisers with him – investment banker Felix Rohatyn of Lazard Freres and lawyer Joseph Flom. Both men advised the appointment of Golub as CEO but suggested that, given his lack of experience, and for the sake of continuity of leadership, Robinson should be kept on indefinitely as chairman. Flom and Rohatyn argued that it was no use waiting for the perfect candidate to arrive. A decision had to be made, and made quickly; the continuing speculation over the succession was harming morale and damaging the company’s reputation.

According to accounts of the meeting, members of the search committee were reluctant to accept this advice, knowing that a recommendation for Robinson as chairman would be rejected out of hand by some members of the board. The argument was persuasive, however. There was no outside candidate better suited than Golub, and there was no point running the risk of losing
Golub to another company by appointing an outsider just for the sake of it. Furthermore, there was the concern that Golub, while exceptionally talented, had little experience in AmEx's global operations and was unfamiliar with AmEx's problem-child, Shearson Lehman Brothers. Keeping Robinson on as chairman, ran the argument, would give Golub the chance to grow into the job under Robinson's experienced supervision.

A Robinson–Golub team appeared to solve all problems, except one: the outright opposition of three to four members of the board to Robinson's continued presence at the top of the company. No one believed, however, that they would carry a majority of the 19-member board. The search committee voted unanimously to recommend Golub as CEO and keep Robinson as chairman, but the committee did not end its decision-making there. They also addressed the question of who should lead the company’s troubled Shearson operation. Since the departure of Cohen in 1990, Shearson's CEO had been Howard Clark Jr., the son of legendary AmEx chairman Howard Clark Sr. The elder Clark had been Robinson's predecessor and was primarily responsible for Robinson's rapid progress to the executive suite. However, having groomed Robinson for the corner office, Clark had become increasingly disturbed by his protégé's performance. By 1992, he was one of Warner's closest allies in the bid to replace Robinson. Clark Sr., while not officially a member of the board, attended virtually every board meeting as a nonvoting participant.

While Clark Sr. had become disenchanted with Robinson, so Robinson had become disenchanted with Clark Jr.’s performance as CEO of Shearson. Nor was Robinson alone. Senior director Furlaud told *The Economist* that Clark Jr. “seems to have got lost a little bit.” Clark’s tenure at Shearson had not been auspicious. In the first two years of the 1990s, Shearson was the only business of its kind that wasn’t turning out record profits. Hamstrung with bad debts and high costs, the once-promising unit lost money hand over fist. In 1990 alone, Shearson reported a loss of $996 million, the largest ever for a US brokerage firm. The picture did not improve. Shearson lost $166 million in the last quarter of 1992 alone. The continued losses contributed to downgrading from the credit rating agencies.

AmEx had attacked Shearson’s problems in a number of ways. It had “deconsolidated” the firm, reducing AmEx’s holdings to 51 percent in 1988. Later, Robinson engaged in talks with Sandy Weill, Shearson's ex-boss, to sell the operation to Weill’s Primerica Co. The talks broke down twice before they were abandoned. Finally, in 1990, AmEx had bought back all the shares to inject further capital into the brokerage firm.

Robinson did not want to leave a troubled Shearson as his legacy. Shearson, perhaps more than any of the other businesses AmEx had bought under his tenure, represented Robinson’s pursuit of financial diversification. It epitomized Robinson’s entire acquisition strategy. If Shearson continued to drag on the earnings of its parent, nay-sayers would continue to criticize Robinson’s empire-building. On the other hand, if Shearson started to reap the kinds of profits that Merrill Lynch and Goldman Sachs were making, Robinson could be credited with making the “financial supermarket” work.

Robinson told the search committee that he wished to head Shearson. Not only did he feel personally responsible for the firm’s success, but he believed Shearson had the kinds of problems that he, with his experience as an investment banker and undoubted might in the Wall Street ring, could solve. As it stood, Howard Clark Jr. was out of his depth. *Business Week* quoted a source close to the situation: “Jim feels a personal obligation to get this done. He is in a do-or-die situation with Shearson.” All told, Robinson’s pitch was a bold one. He wished to remain as chairman in order to provide stability and leadership to his hand-picked successor and protégé, Harvey Golub, and he would take over day-to-day running of Shearson Lehman Brothers, replacing the son of a fierce
Robinson critic. Such a resolution would leave an awkward hierarchy. Robinson, as Shearson’s chief, would report to Golub as CEO. Yet Golub would be accountable to the board, chaired by Robinson. Both Robinson and Golub said they were happy with the set-up, and agreed to share an “office of the chief executive,” which would be the senior management decision-making body.

If the other members of the search committee were uncomfortable with this prescription, they weren’t for long. They resolved to offer such a solution to the board when it met four days later.

Robinson further strengthened his hand by informing Clark Sr. – who, as a board adviser, customarily attended board meetings – that he would not be welcome at this one. Clark was told by Robinson subordinates that his presence would be inappropriate since his son’s performance would be one of the topics under review. Clark was incensed. He believed he was being kept away for one reason: that he would oppose Robinson as chairman.

The question remained: would the board accept the recommendation of the search committee? There was no doubt that Robinson’s opponents, now numbering three – possibly four – and led by Warner, would vehemently oppose both Robinson’s continued chairmanship and his appointment to Shearson. They believed that, after 16 years as CEO, Robinson had served his time and now should leave. They would settle for nothing less.

It was harder to predict the reaction of the remaining members of the board. Would they reject Robinson’s gutsy power play, or would they side with the man who appointed them to the board in the first place?

With 19 members, American Express had a big board by Fortune 500 standards. Of these, only three were employees of the company: Robinson, Golub, and Aldo Papone, a senior adviser to the company. However, the presence of a large majority of outside directors did not free American Express from charges that its board was management’s patsy. The board of AmEx had a reputation as one of the least independent minded around. In the words of one board member: “The general belief was that the board was in Jimmy’s pocket because he’d appointed 15 of the 17 outside directors.”

As well as 19 regular directors, AmEx board meetings were regularly attended by four advisory members, selected by Robinson. Rawleigh Warner says the advisers “engaged in the dialogue, argued points, and made proposals just as if they were board members. The only thing they could not do was vote, and sometimes they forgot this caveat.”

Christopher Byron wrote in New York magazine, “In a sense, Robinson had created American Express’s board for just this emergency. Since every board member except Furlaud and Warner had been hand-picked over the years by Robinson himself, there was no question as to where its allegiance lay: the American Express chairman had instant rapport with – and could count on the support of – virtually every director ringed around him at the table.” AmEx was attacked for “stunt casting” in the boardroom. Henry Kissinger, the former Secretary of State, had served as a director since 1984 and President Gerald Ford was a special adviser.

Moreover, American Express paid nearly $500,000 in consulting fees to Kissinger’s foreign affairs advisory firm in 1991. Ford received a further $100,000. Both Ford and Kissinger were known to be close personal friends of Robinson’s, as was F. Ross Johnson, the impetuous ex-CEO of RJR Nabisco, and Vernon Jordan, the civil-rights lawyer who sat on the board of Revlon with Robinson’s wife. Other directors received substantial consulting fees for advice to Shearson and other AmEx units. Rawleigh Warner commented that these directors “seemed to me to be clearly under Mr. Robinson’s wing.”

Byron describes a network of interlocks that added to a sense of “clubbiness.” Furlaud sat on the board of American Express and Robinson sat on the board of Bristol Myers Squibb, Furlaud’s old
company, where Furlaud was still a director. At meetings of the Business Roundtable, Robinson would often bump into Drew Lewis, Frank Popoff, and Joseph Williams, all directors of AmEx.23 Lewis, former Secretary of the Department of Transportation, was now the CEO of Union Pacific Corp. He is described in media accounts as one of Robinson’s staunchest defenders in the whole succession affair. Not only did Robinson serve on the board of Union Pacific, he also served on the compensation committee, directly responsible for setting Lewis’s pay. Kissinger also sat on the board of Union Pacific.24

Other interlocks existed. Kissinger served on the International Advisory Committee of Chase Manhattan Bank, along with Furlaud, and the Council on Foreign Relations featured not just Kissinger and Furlaud but Robinson and Charles Duncan as well. Kissinger also sat with Beverly Sills on the board of Macy’s and with Armstrong at the Center for Strategic and International Studies. Byron concludes, “The effect of all these interlocks was to develop a cozy sense of belonging to a kind of corporate in-crowd – an arrangement that no one who was already ‘in’ would want to disrupt with something so unseemly as a vote to oust one of the insiders.”25 Rawleigh Warner later wrote, “It’s quite obvious that most of the American Express directors were under Jimmy Robinson’s thumb.”26 The board met on January 25, four days after the search committee had reached its final decision. News of their likely recommendation filtered out to directors over the weekend, and as the board met at 10 on Monday morning, Robinson’s opponents knew that they had failed in their bid to bring new management to American Express.27 Before the meeting had even been formally opened, Warner asked Robinson to leave so that discussion of his future would not be compromised. Robinson, with Lewis coming to his defense, said that he was a voting member of the board and would therefore stay.

Furlaud announced the decision of the search committee: Golub would assume the role of CEO and Robinson would remain chairman as well as taking over the top job at Shearson from Clark Jr. Joseph Williams said that the board had manifestly failed in its duty and that the directors had lacked independence in the face of Robinson’s determination not to leave.

Kissinger spoke in favor of the motion, noting that the proposal had been supported unanimously by the search committee. Others, including Byrne and Bowen, were troubled by the bundled nature of the proposal. They were happy with Golub as CEO, but did not want to see Robinson remain as chairman. A vote to separate the issues was defeated.

Golub was brought into the room for a final vote. Fifteen directors voted in favor of the search committee’s recommendation. Three directors – Warner, Williams, and Armstrong – voted against. Bowen abstained on the basis that he could support Golub but not Robinson. Warner immediately announced his resignation in light of his fierce opposition to the result. “I fought the good fight,” he told a Journal writer, “and I lost.”28 The next day two other directors resigned.

One director told the Washington Post that the would-be insurgents had underestimated Robinson: “We had been arrogant. We thought the facts were so much on our side that we turned our backs while Robinson was lobbying the rest of the board constantly. That’s how he beat us.”29 Another source, quoted by Byron, said, “What everyone missed in this situation is that Jim’s job was never really in jeopardy at all.”30 Another said, “In October not one director was ready to support Harvey. But in January they were. There had been a very, very well run campaign, a PR campaign, with Harvey leading dinner meetings with key directors. I realized, and other directors did too, that we were being spun by Robinson. He is an absolute master.”31

Robinson responded to the charge: “There was a campaign to make sure that the directors had full knowledge of the strategy in place and Harvey’s grasp of it.... If that is a PR campaign, I accept full responsibility.”32 The new management structure might have been approved by the board,
but it did not sit well with the market. “American Express Lineup Strikes Out with Investors,” reported the *Wall Street Journal*. On the day following the news, AmEx stock dropped 5 percent on five times normal trading. The stock slid $1.25 to $23.87 in the first full day’s trading, and the company’s market value dropped $835 million in two days.

The dissatisfaction stemmed from a belief that AmEx was badly in need of a radical shift in strategy and that Robinson’s “counter-coup” meant that no such shift was likely. Wilson Davis, analyst at Gerard Klauer Mattison & Co., told the *Wall Street Journal*, “Arrogance and self-absorption won out over the interests of shareholders. Mr. Robinson is a big negative. Whatever the P/E ratio is, it’s less with Jim Robinson in the company. Period.” Observers doubted that the shake-up represented much of a power loss for Robinson at all. Indeed, some thought Robinson had actually increased his influence by taking over day-to-day responsibility of Shearson. “Curiouser and Curiouser at AmEx,” said a *Business Week* headline. “The newly drawn lines of power seem to be at cross purposes.” A graphic accompanying the story showed how Golub and Robinson would report to each other under the new structure, and asked the question: “Who’s Really in Charge?”

Other investors criticized the board for not being more aggressive in its stance towards Robinson. Paul Ehrlichman, partner in Brandywine Asset Management, told the *Journal* that his group planned to sell its million-share stake in American Express. “This was very disappointing,” he said. “When you see politics win out over shareholders, once again it makes you think that Mr. Robinson is unique in his disregard for shareholders and control over the company.” In the same vein, *The Economist* carried a cartoon of Jim Robinson with the AmEx board wrapped around his little finger. “It’s incredible,” said one of AmEx’s largest institutional investors to Byron. “Think of just how out of touch that company’s board really was. Here was all of Wall Street expecting Robinson to be tossed out on his ear, then suddenly here was the board of directors saying he wouldn’t be going after all – and expecting investors to feel as if nothing had happened.”

There was trouble inside the company as well. On the day following the announcement, Robinson addressed a group of about 400 Shearson branch managers. He was not greeted favorably. “The reception was glacial,” one attendee told the *Wall Street Journal*. Another account reported that Robinson had walked out of the meeting early after some hostile remarks from the audience. The *Journal* also reported that Lehman Brothers bankers were complaining that winning clients had become harder because Robinson gave the firm a credibility problem. The *Washington Post* described another meeting on January 28, in which Robinson discussed some of his ideas for Shearson with the firm’s executives. The meeting ended in turmoil according to a source when one of the Shearson managers stormed out of the room having threatened to physically assault Robinson.

Golub, meanwhile, faced some difficult meetings of his own. On January 28, he attended a breakfast meeting with a dozen of AmEx’s largest institutional investors. The shareholders were not interested in Golub’s plan for the future – they just wanted to know how Robinson had managed to cling to, even increase, his power. Investors mostly approved of Golub’s assumption of the CEO post; it was just that with Robinson holding positions both above and below, it was doubtful how much power Golub would actually be wielding. As a plan for forging a bold new strategy at American Express, it looked like a nonstarter.

In an unprecedented display of concern, even the traditionally least active Wall Street funds registered their displeasure. Funds such as Alliance Capital Management, Putnam Management Co., and J.P. Morgan Investment Management pointed out the decline in share value since the announcement, and expressed reservations about Robinson’s continued tenure at the company.

In just over a week since the search committee had made its decision, American Express’s value had dropped 13 percent. It was clear to members of the board that more needed to be done. Robinson’s
counter-coup was damaging American Express in the marketplace, harming the company’s valuable reputation, and causing a collapse of employee morale. Three senior directors, the chairmen of various board committees, gathered to discuss what should be done. Later, Furlaud told Golub that Robinson should consider stepping down. Golub later discussed the issue with Robinson and Joe Flom over dinner. Golub suggested that Robinson step aside for the good of the company. In an interview with the Post, Robinson insisted that he was still undecided about leaving. He considered giving up the chairman role, but remaining CEO of Shearson, an idea that received short shrift from Golub. Robinson continued to vacillate through Thursday night and Friday: “I went through a whole series of permutations in my own mind about what would be most helpful to Harvey and the company,” he told one journalist. A source close to Robinson told the Post: “Jim’s mood was on again, off again, sometimes bitter and mad, sometimes conciliatory and realistic.”

Finally, on January 29, Robinson concluded that his position was untenable. He would resign from all positions at American Express. In a statement, he denied that pressure from the board had forced his hand: “A combination of things led me to the conclusion that it’s nuts to leave confusion over whether Harvey is really boss, so I decided to pull up stakes and get out of town.”

Robinson’s withdrawal gave the AmEx board the opportunity to appoint a nonexecutive chairman, a measure designed to salve the discontent of the company’s largest shareholders. Richard Furlaud was selected. Mindful of his aggressive turnaround of Squibb Co., observers believed that Furlaud would be forceful in advancing a clear strategy for American Express. “The company’s mission,” said a Morgan Stanley analyst to the Wall Street Journal, “has become a bit muddled. The mission needs to be made clear. Maybe someone of [Furlaud’s] stature can do that.”

However, Robinson’s ouster still rankled with certain members of the board. At a board meeting, held by telephone, to appoint Furlaud as chairman, a motion was made and seconded for Robinson to rescind his resignation, since he had been pushed out by outsiders. As Warner comments, “The outsiders, in this instance, only happened to be shareholders.” The motion never went to a vote.

American Express stock rose $1.37 in the two trading days following Robinson’s resignation and Furlaud’s appointment.

Later in 1993, Rawleigh Warner was elected “Director of the Year” by the National Association of Corporate Directors. Warner shared the lessons he had learned from the AmEx experience:

“The size of the board does make a difference. The American Express Board had 19 members and four advisers to the board. That large a board, I believe, makes for an unwieldy number and prevents an opportunity for each member to speak freely.

It is extraordinarily difficult to mount an attack on a CEO who has been in the job for a long time and who has appointed a majority of a board’s directors.

A small group of dissenting directors with a split board has very little capability to do battle with a CEO who is determined to hold on and has access to the full apparatus of the corporate public relations department.

It is imperative to have directors who are not only independent but who can tell the difference between a company that is having some difficulties but moving to correct them with reasonable chance of success, and a company that is in serious and potentially harmful trouble and under attack from the shareholders, media, and analysts for extended poor performance.

Directors unable to distinguish between such different situations tend to circle the wagons around the embattled CEO rather than represent the owner shareholders. This, I believe, was the case with Mr. Robinson and the majority of American Express directors.”
What does this case tell you about the relationship between management and the board?

“In the final analysis a board of directors can only be as effective as its chairman wants it to be” (Hugh Parker). Do you agree with this comment?

In an interview with the Washington Post, Robinson commented on Warner’s damning indictment of Robinson’s leadership. “I am amused at Rawleigh listing all this,” he said, “since he was on the board during all of this.”

Who should we blame for long-term under-performance – management or the board? Should Warner have acted sooner? Could he have done?

Most shareholders did not register their discontent with Robinson’s tenure until after the board elected to keep him on as chairman. Should they have acted sooner?

Compare the roles played by the public pension funds and the other institutional investors. How and why did they differ?

In 1993, at the annual meeting, shareholders re-elected a board of directors whose rearrangement of executive functions had five months earlier been utterly repudiated by these same shareholders. What does this tell you about the ultimate significance of the board? What does it tell you about the board’s accountability to the shareholders? How meaningful is the electoral process?

NOTES

3. One of the authors of this book, Robert A.G. Monks, was the chairman of The Boston Company at the time of its purchase by American Express. He can attest to both Robinson’s competence and integrity.
6. Ibid., p. 103.
9. Ibid.
13. Ibid.
14. Ibid.
16. Ibid.
24. Ibid.
25. Ibid.
30. Byron, “House of Cards.”
32. Ibid.
35. Lipin and Torres, “American Express Lineup Strikes Out With Investors.”
36. Byron, “House of Cards.”
39. Ibid.
40. Bleakley, Pae, and Siconolfi, “Robinson Quits at American Express Co.”
43. Ibid.
44. Fromson, “American Express: Anatomy of a Coup.”
Time Warner

Just about everything the courts said about the duty of directors to shareholders in the early takeover cases was reversed in the case involving the Time Warner merger. That case represents probably the greatest incursion in United States business history into the rights of shareholders. The Delaware Court allowed the directors of Time to redesign completely its proposed business combination with Warner, just to keep the decision away from the shareholders at incalculable cost.

This is the chronology: Time, Inc. and Warner Communications, Inc. originally negotiated a stock-for-stock merger in which the shareholders of Time would have the chance to vote whether to exchange their Time shares for new pieces of paper worth about $125 per share. Paramount entered the situation with a cash bid of $175 per Time share, later raised to $200. According to most commentators, Paramount was prepared to raise this sum still further, to $225 a share. Time and Warner, concerned that shareholders would not support their merger, revised their deal so that it would no longer require shareholder approval. When the contest reached the Delaware Supreme Court, the court examined the history of the Time Warner merger as initially proposed, and concluded that because it had been under discussion for more than two years, it was proper to proceed with it, even as radically revised in a very short time, and even in the face of a legitimate alternative.

This approach is consistent in process but not in substance with the factors that the Delaware courts consider in evaluating maneuvers that may be characterized as defensive. It is appropriate to consider the motives of directors to determine whether such actions are taken in good faith and therefore deserve the broad protection of the business judgment rule. However, it is not appropriate to give weight to an action just because it has been considered for a long time. First, it has nothing to do with an obligation to respond to the Paramount offer, which could not be predicted and creates a fiduciary obligation for an independent analysis. Second, it creates a very perverse incentive for boards to have their lawyers read aloud a list of every possible defensive action and every possible business combination at each board meeting, just to make sure that it is on the record as having considered it, but leaving entirely open the question of whether that consideration has been at all meaningful.

The *Time v. Paramount* case presents a clear question. The court put it this way: “Did Time’s board, having developed a strategic plan of global expansion to be launched through a business combination with Warner, come under a fiduciary duty to jettison its plan and put the corporation’s future in the hands of its shareholders?” The Delaware courts answered, “No,” a result that must be viewed against an offering price of $200 in cash versus a price on August 23, 1990, little more than a year later, of $76 3/8. When one of the authors of this book wrote a letter objecting to the deal (reproduced in the subsection below), Michael Dingman, an outside director of Time, responded. Monks asked Dingman whether he didn’t think that there was a problem in giving managers such broad discretion in a deal where their own compensation played such an important role. Mike was characteristically direct: “To put it bluntly, I believe that the directors of Time did an extraordinary job of preventing the shareholders from getting screwed.” The issue is one of process and substance. If the board of Time was so certain they were right, why did they believe they could not persuade their shareholders?
In the litigation over the merger, a great deal of financial data was introduced to the court, with various extrapolations of projected long-term value. The Warner transaction valued Time stock at $125, compared with the Paramount offer of $200 per share. It is hard to imagine a way that a shareholder could not do better with $200 cash, which he would be free to invest in any venture of his choice, than with a $125 investment in Time Warner, even with the most competent management ever known. How could any fact-finder ignore the simple fact that starting with 60 percent more capital is virtually certain to make more money? What this suggests is that the case is not about money, but that the Delaware courts have devised a language to resolve disputes that does not include a vocabulary for maximizing owners’ value.

What are owners left with after Time? Michael Klein, who argued as special counsel for the Bass brothers in this case, put it: “When the marketplace has put a 25 percent or 30 percent premium on one answer as opposed to another, why should the legal system be constructed so as to deny institutional and other shareholders the opportunity to accept that premium? What’s heinous about this case is the manipulation of the corporate machinery by the directors of Time to accomplish an avoidance of the shareholder franchise.” In this case, as in Moran v. Household International, management deliberately structured the transaction to avoid having to seek shareholder approval. The issue here was not merely the difference between anti-takeover provisions; it was the very essence of the transaction. Time conceived of the deal as providing a capital base that would give it the capacity to be an aggressive worldwide competitor. As the Supreme Court of Delaware found:

“The Time representatives lauded the lack of debt to the United States Senate and to the President of the United States. Public reaction to the announcement of the merger was positive. Time Warner would be a media colossus with international scope.”

Following Paramount’s initial $175 a share offer, however, debt did not seem so bad:

“[C]ertain Time directors expressed their concern that Time stockholders would not comprehend the long-term benefits of the Warner merger. Large quantities of Time shares were held by institutional investors. The board feared that even though there appeared to be wide support of the Warner transaction, Paramount’s cash premium would be a tempting prospect to these investors. In mid-June, Time sought permission from the New York Stock Exchange to alter its rules and allow the Time Warner merger to proceed without shareholder approval. Time did so at Warner’s insistence. The New York Stock Exchange rejected Time’s request....”

Thereafter, “Time’s board decided to recast its consolidation with Warner into an outright cash and securities acquisition . . . [t]o provide the funds required for its outright acquisition of Warner, Time would assume 7–10 billion dollars’ worth of debt, thus eliminating one of the principal transaction-related benefits of the original merger agreement.” The decision to alter utterly the capital structure of the surviving company to heavy leverage was made in a matter of days and appeared to undercut the purported rationale of the entire transaction.
Furthermore, Time’s commitment to the merger with Warner was less than its commitment to making sure Mr. Ross had a fixed retirement date. Negotiations were broken off for several months, until Mr. Ross was induced “to re-evaluate his position and to agree upon a date when he would step down as co-CEO.” The agreement reached was that Ross would retire five years after the merger and that Nicholas would then become the sole CEO of Time Warner. (So much for the role of shareholders and boards in selecting management.) The decision finds that “other aspects of the agreement came easily.” Despite the evidence about the importance of compensation and succession (these parts of the deal remained as the rest of it was completely restructured), somehow Chancellor Allen found that “there is insufficient basis to suppose at this juncture that such concerns have caused the directors to sacrifice or ignore their duty to seek to maximize in the long run financial returns to the corporation and its stockholders.” The concerns he referred to as “corporate culture” seemed to be focused only on compensation.

An enterprise and its equity securities are a function of two components – their businesses and their capitalization. There is an enormous difference between an equity-funded worldwide communications colossus and a debt-ridden venture. That the courts would base a decision on the long-standing plan respecting the businesses and ignore the quickly cobbled-together complete change with respect to capitalization suggests that Delaware courts will endorse any action of management, even if self-interested. “Finally, we note that although Time was required, as a result of Paramount’s hostile offer, to incur a heavy debt to finance its acquisition of Warner, that fact alone does not render the board’s decision unreasonable so long as the directors could reasonably perceive the debt load not to be so injurious to the corporation as to jeopardize its well being.” Rarely has the irrelevance of shareholder significance been so clearly articulated. Why pretend that there is such a thing as shareholder rights?

In the lower court decision, the Chancellor stated his position with a double negative: “I am not persuaded that there may not be an instance in which the law might recognize as valid a perceived threat to a ‘corporate culture’ that is shown to be palpable (for lack of a better word), distinctive and advantageous.” Of course there is an instance in which the law recognizes the validity of a “corporate culture.” The instance is in the value that corporate culture provides to shareholders. Time shareholders want the company to be able to reap the benefits of its culture, whether alone or in a productive synergy with another company. It is difficult for Time to claim that its culture and editorial independence could not have been preserved with Paramount, since they did not even meet with Paramount to discuss it.

Chancellor Allen was correct in saying that “Directors may operate on the theory that the stock market valuation is ‘wrong’ in some sense without breaching faith with shareholders.” However, they may only operate on that theory if they base it on fact. Let them demonstrate to the shareholders that they can do better. Without that, we abandon any pretense of a market test, in favor of “expert opinion,” paid for by management, usually with a contingent “success factor.” Even Chancellor Allen was appalled at the company’s estimated valuation of $208–$402 for Time Warner stock in 1993, calling it “a range that a Texan might feel at home on.”

In 2001 Time Warner merged with AOL, a company that barely existed at the time of the Time Warner–Paramount battle. Whatever the synergies created by the merger of two old-economy companies, the shareholder value they created was dwarfed by that created by an online newcomer.

*Are there any limits, short of explicit fraud or corruption, to the deference that the court will give to management’s determination of value? Is there any level to justify, even require, judicial intervention?*
The obvious reluctance of courts to involve themselves in second-guessing management of enterprises is understandable, even justifiable. However, the result denied owners both the right to vote on the merger of Time with Warner and the right to sell their shares to a willing buyer at a mutually agreeable price.

The Time board did not fulfill in an objective, independent manner its critical role coordinating the restructuring for the benefit of those to whom it owes the most scrupulous fiduciary duty, the shareholders. The court did not object. As Michael Klein pointed out, the Time Warner decision theoretically allows companies to “create a high threshold of risk, and then do everything deliberately to deprive shareholders of any alternative. The Time Warner directors did not even need to confront, evaluate, or compare alternatives.” The “Revlon mode” (requiring directors to preside over an auction) should be triggered whenever a conflict of interests between shareholders and management arises, because that is the key issue, not some formal notion of whether the company is “for sale.” At that point, the board must step back and preside over an orderly evaluation of all alternatives, to decide which will provide the best long-term return for the shareholders.

Within three years, Paramount switched sides, and again found itself losing in the Delaware courts. This time it was Paramount, headed by Martin S. Davis, that wanted to preserve a business combination, over the objections of another would-be bidder. Paramount, a producer and distributor of entertainment, including movies, records, television programs, and books, agreed to a merger with Viacom, an entertainment and communications company whose core businesses include cable networks like MTV and Nickelodeon. Viacom is controlled by Sumner M. Redstone. QVC, a retailer that operates a home-shopping cable channel, run by Barry Diller, sought to acquire Paramount instead.

In announcing the merger, Redstone and Davis made it clear that Paramount was for sale only to Viacom, and other bids were not welcome. Redstone called Diller and John Malone, a large block holder in QVC, to discourage them from making a bid. The agreement with Viacom had several provisions specifically designed to discourage other bidders. One was a $100 million “termination fee” to be paid to Viacom if for some reason the deal would not go through. Another was a stock option agreement that gave Viacom the right to buy 19.9 percent of Paramount’s stock for $1 a share in cash and seven-year subordinated notes for the remainder (about $1.6 billion). If triggered, both of these provisions would have a significant adverse impact on Paramount’s value.

Nevertheless, Diller wrote to Davis, proposing that QVC acquire Paramount. Both potential acquirers escalated their offers. The board continued to support the Viacom deal, and QVC and a shareholder group brought the issue to court.

The Delaware Chancery court granted QVC’s motion for a preliminary injunction, and sent the issue back to the board. The Delaware Supreme Court agreed. Both found significant differences making it impossible to give the board the broad deference to “business judgment” they granted in the Time Warner case. It is important to remember that the Delaware courts apply different levels of scrutiny to board decisions, based on what is at stake. The most significant factor in the courts’ decision to apply a stricter level of review was the fact that the Paramount–Viacom deal was a change of control, not from Paramount management to Viacom management, but from the outside shareholders to inside management. When a group loses control, it is entitled to a control premium. While the Viacom deal had such a premium, it was less than that offered by QVC.

Paramount tried to argue, as Time did successfully in blocking its bid, that the Viacom merger would carry out a pre-existing strategy, afford higher value to long-term holders, and be in the corporation’s best long-run interests; therefore, they were not obligated to forego these returns for short-term profit. The Chancery court said, “What is at risk here is the adequacy of the protection of
the property interest of shareholders who are involuntarily being made dependent upon the directors to protect that interest. In such circumstances fairness and our law require that the directors’ conduct be made subject to the enhanced judicial scrutiny...."

When that scrutiny was applied, the court found it was clear the directors had not had sufficient information. The court said the directors had to make their decision based on “a body of reliable evidence.” It did not have to be an auction or a market canvass, but it had to be as reliable as those options. The court noted, “Even if the board did not intend to deter bidding [with the lock up and stock option provisions], it had no informed basis upon which to grant an option with these Draconian features....”

CORRESPONDENCE BETWEEN ROBERT A. G. MONKS AND TIME DIRECTOR, MIKE DINGMAN

July 21, 1989
Dear (Shareholders):
Delaware’s Chancellor William Allen, in his decision to permit the merger of Time and Warner, has not just missed the forest for the trees; he has missed the forest for the bark.

As the Delaware Supreme Court prepares to hear oral argument in the challenge to the Time decision he issued last Friday, we wanted to let you know how we see the issues. We believe that Chancellor Allen missed the central issue, which is this: Can we justify a transaction that presents directors with a conflict of interest, by protecting their employment and compensation, but denies shareholders the opportunity to express their views?

As you know, Time and Warner negotiated a stock-for-stock merger in which the shareholders of Time would end up with new pieces of paper worth approximately $125 per share. Paramount entered the situation with a cash bid of $175 per Time share, later raised to $200. Time and Warner, concerned that shareholders would not support their merger, revised their deal so that it would no longer require shareholder approval. The revision also meant that the new company – and its shareholders – would have an enormous debt burden, at least $7 billion of new debt and possibly more than $10 billion. Reported earning will be essentially eliminated, because $9 billion of goodwill will have to be amortized. The equity deal was based on both industrial and financial logic. The debt was justified by the same industrial logic, but there was no longer any financial justification for the deal.

What this means is that Time’s management (1) devised and began to put into place a plan that was at least $50–75 per share under the market’s evaluation of the stock, (2) refused to meet with Paramount to discuss its offer, and (3) completely restructured the deal, along lines considered and rejected in favor of the original merger, to prevent shareholder involvement. Their utter disregard for the rights of shareholders was demonstrated even further by the line of succession they locked in for directing the company. This is one of the most important rights reserved to shareholders. All of this was permitted by Chancellor Allen’s decision.
He also concluded that because the merger had been under discussion for more than two years, it was proper to proceed with it. But the deal he allowed to go forward was not the one they designed during that period of deliberation; it was one they rejected and then put together quickly to obstruct Paramount. Furthermore, the original deal was developed without reference to Paramount’s offer. At the very least, that offer should have forced the board to determine why it was so much higher than the share value realized in their merger. Chancellor Allen said, in one of a series of double negatives, “I am not persuaded that there may not be instances in which the law might recognize as valid a perceived threat to a ‘corporate culture’ that is shown to be palpable (for a lack of a better word), distinctive, and advantageous.” The facts suggest that it was not the “corporate culture” that Time management was planning to preserve but the extremely favorable employment and compensation schemes they had negotiated with Warner. Chancellor Allen notes that the “Time culture” issue was of concern in setting the compensation for Time executives, but that this was resolved by paying them at a higher level, though still on the same basis, rather than revising it along the formula used at Warner.

The Time board has not fulfilled its critical role in coordinating the restructuring in an objective, independent manner, for the benefit of those to whom it owes the most scrupulous fiduciary duty, the shareholders. The court has not objected. The issue is the same one as that presented by management buyouts, a question of conflict of interests. The “Revlon mode” should be triggered whenever such a conflict arises, because that is the key issue, not some formal notion of whether the company is “for sale.” At that point, the board must step back and preside over an orderly evaluation of all alternatives to decide which will provide the best long-term return for the shareholders.

When directors, due to the impact various alternatives will have on their compensation and employment, have a conflict of interest that prevents their fulfilling their obligation as fiduciaries to protect the interests of the shareholders, then the decision should be made by the shareholders. That is the critical issue ignored by the court. We hope that the Supreme Court will reverse this decision. If not, shareholders have the choice of seeking legislative change, either in Delaware or at the federal level, or using their ownership rights to reincorporate the companies they hold in states with more respect for the interests of shareholders.

We will continue to keep you posted. In the meantime, if you have any comments or questions, please do not hesitate to call.

Sincerely,

R.A.G. Monks

August 15, 1989

Dear Bob,

Your letter of July 21st has been brought to my attention.

As you know, when it comes to shareholder value, I’ve believed, espoused, and supported many of the same things as you. In fact, in cases like Santa Fe, I’ve earned a reputation as an opponent of poison pills and entrenched management. But with the Time Warner merger, we part company. In the main, I find your opinions to be ill-informed and off target.

Paramount’s highly conditional offer of $175 or $200 per share was not only ludicrously low but transparently cynical. In making it, Mr. Davis (Chairman and CEO of Paramount Communications Inc.) had two motives. The first was tactical. He wanted
to sabotage Time Inc.’s carefully considered merger with Warner and thereby destroy or weaken a competitor that would dwarf his own newly created media/entertainment company. The second was opportunistic. If his public relations campaign succeeded, Mr. Davis saw a chance to panic the board into letting him pick up Time Inc. for a song.

He wasn’t that lucky. Unlike the role played by Paramount’s board in ratifying the tender offer to Time Inc., we weren’t about to rubber-stamp a managerial fait accompli. That’s not the way the Time board works. We had been looking at the merger with Warner for over two years and had considered the long-range payoff for shareholders, as well as the strategic and financial implications.

In the media coverage surrounding Paramount’s tender offer, it was the universal consensus that the Time board was composed of eight outside directors with reputations as hard-nosed individualists, men and women equally unwilling to do the bidding of either Time Inc.’s management or Mr. Davis. In this, at least, the media were on the money.

As a participant in the board’s deliberations, I was a witness to the demanding independence of the other seven outside directors. They lived up to their reputations as mavericks, asking all the tough questions and looking without sentiment or illusion at the offers on the table. In the end, all of us, without a single dissent, voted to proceed with the Time Warner deal.

I have no regrets about that decision. None. We’ve created the strongest and potentially most profitable media/entertainment company in the world. And if Mr. Davis succeeded in changing the terms of the original deal, nothing he said or did changed its rationale. It remains an extraordinary opportunity to improve dramatically the value of Time Inc. stock.

Frankly, I find it more ridiculous than insulting for you to accuse me and the other outside directors of a “conflict of interest.” No one—not even Paramount’s lawyers—raised this as an issue. In fact, if you really think I’m worried about my “employment” [sic] as a Time director or depend in any way on the compensation it entails, then you are probably beyond the reach of rational argument.

The ultimate outcome of the Time Warner situation will be decided in the near future as the managements come together to build what they set out to. Despite whatever speculative losses some investors may have incurred in betting on Paramount’s bid, I do hope you and others try to make an honest appraisal of the values represented by this new company.

There’s no question in my mind that the eventual outcome will resemble what happened at Disney after Saul Steinberg was paid his greenmail of $19.25 per share. Michael Eisner and his management team left the employ of Martin Davis and Paramount and brought a whole new energy and direction to Disney. At some point you may wish to examine for yourself why Eisner and other creative managers left Paramount, but this much is already certain: they have revived the company’s fortunes. Disney stock is now selling at $120 per share.

Dick Munro, Steve Ross, and Nick Nicholas have proven records of attracting and holding the best talent in the media/entertainment business. They have shown that they can create substantial value for shareholders, and now that the fight with Paramount is over, they will make an immense success out of their new venture.

I don’t mean to oversimplify all the issues that surrounded the Time Warner deal. It was a complex transaction that required some very tough judgments. And, in my opinion, the press did such a miserable job of covering the facts and issues involved that I can’t really blame you and your colleagues—never mind the ordinary shareholder—for being confused.

To put it bluntly, I believe the directors of Time did an extraordinary job of preventing the shareholders from getting screwed. And except for a few major shareholders like
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Capital Research — who understood the real values at stake and stood by their beliefs — they did it alone.

I look forward to seeing you in the future and discussing this at greater length. In the meantime, I felt it necessary to express my personal opinion concerning your previous letters.

Sincerely,

Mike Dingman

August 23, 1989
Dear Mike,
I very much appreciate your thoughtful response of August 15, to my letter about the Time/Warner decision issued by Chancellor Allen, and since then upheld by the Delaware Supreme Court. Although you described my “opinions to be ill-informed and off target,” I think we agree more than we disagree. I can support many of the points you made, and still think that the courts (and the board of Time) were wrong to disregard the rights of the shareholders. And I suspect that both of our positions lead to the same ultimate diagnosis, even the same solution.

I agree with you that the directors of corporations should have the power to consummate mergers; however, this must be done in a way that recognizes the clear conflicts of interest that exist for top management in such situations. Even though it imposes an additional burden on the “outside” director, I see no alternative to their taking over the merger process, much in the same way and for the same reason that they have been required by this same Delaware court to take over the “auction” process, as in RJR and McMillan. The chief advantage of outside directors is that they can bring some objectivity and discipline to the process. (I agree with your characterization of the Time Board. Indeed, I have frequently cited your involvement as conclusive evidence that the problem is systemic and not personal.)

Here is where I think we disagree. To my way of thinking there is a world of difference between “outside” and “inside” directors. The Time Board apparently chose to conduct the merger (acquisition) negotiations without limiting the participation of the “inside” directors. That the “outside” acquiesced in and supported direction of the transactions by “insiders” — and not that I am “beyond the reach of rational argument” — is why I refer to a conflict of interest by the Board.

Corporate reorganizations ultimately devolve into a question of who gets how much. There is no objective standard — no Mosaic Decalogue — that proscribes how much shareholders, how much management and how much of the total consideration should be allocated to other corporate constituencies. When, as I am sure you will agree was the case with Time, the consideration to be paid the principal executives is not immaterial, isn’t it better practice to limit their role in leading the negotiations? Should anybody be in the position of being the ultimate arbiter of their own entitlement? Should those with the largest personal stake continue to select and direct the professional advisers and thus the information reaching the Board? I think of the transaction as one where the top management took the top dollar for themselves, whether or not it was in the long-term best interest of the company and the shareholders as parties whose interest is far more genuinely long term than that of the people who put this transaction together.
Let's look at the transaction for a moment. It is ironic that the original proposal required shareholder approval, under the rules of the New York Stock Exchange, while the revised plan, far worse from the shareholders' perspective because of the debt burden, did not. Time was easily able to take the choice away from the shareholders, by redesigning the deal to make it much worse for them, and the shareholders did not have any way to get it back.

The court gave great deference to the fact that the merger with Warner was negotiated over a period of two years. However, the business combination that was actually executed was put together in days, in response to the Paramount offer, on terms that were explicitly considered and rejected during that two-year period of deliberation, terms that left the company with a gigantic burden of debt. The fact that the record showed compensation and succession of the top management to be the most contentious issues (apparently the only contentious issues) did not suggest to the court that perhaps self-interest might have been the primary factor in setting the terms of the merger. It does suggest it to me.

You could very well be right that the merger between Time and Warner makes more sense than a merger between Time and Paramount. The question is, who makes that decision. You suggest that it should not be shareholders, because they are uninformed and only look to the short term. I suggest that it should not be top management, acting without meaningful accountability, because they have a fundamental conflict of interest. I have the same problem with MBOs. There simply cannot be a level playing field when one party has all of the resources and all of the information. In this case, Time's management also had all of the power.

I do not think that institutional shareholders are irretrievably short term in their orientation. If they take short-term gains, they then have to find another place to invest them, and that is a real problem. Furthermore, most institutions have highly diversified portfolios, with major investments in thousands of companies. Many of our clients were investors not only in Time, but also in Warner and Paramount, not only in stocks, but also in bonds. They must look to the net impact of any proposed transaction, as fiduciaries and as prudent investors. This militates against a short-term orientation.

I agree that the institutional shareholders have a way to go before they can persuade those, like you, who are convinced that they look no further than the quarterly returns. In this regard, it is important to note the escalating portion of institutional investments that today are de facto or de jure indexed. Over the last few years, the index funds have performed better than the managed funds, which makes them hard for any “prudent and diligent” asset manager to ignore. I am enclosing testimony that I gave earlier in the year before the Markey subcommittee, where I recommended that indexed investments be deemed per se prudent under ERISA. It is essential to take some step to encourage (possibly, even, to ensure) that the largest class of institutional investor—one for whom liquidity serves no private or public objective—to be a genuine “long-term” holder and source of “patient capital,” and, therefore, begin to function as a permanent shareholder. I recognize that a gap exists today between my desired world of a solid core of long-term institutional shareholders and the arbitrageur-driven world of contemporary takeovers.

If the arbs were the only institutions, I would find it difficult to argue that a governance system be organized for their benefit; on the other hand, I see no reason to disqualify ownership as the fundamental object of governance just because arbs are involved. No one has suggested that newly elected CEOs have any less authority because of the brevity of their tenure, nor are directors required to serve an apprenticeship period.
I suggest that to the extent that the institutions have a short-term orientation, it is in large part attributable to the failure of the governance system. If you were an investment manager with a large holding in Time, your alternatives would be quite limited, even under the terms of the original deal with Warner. But if you had a real voice, a real relationship with management based on real accountability, to give you confidence in the long term, there would be no incentive to go for a short-term gain.

Under the current system, managers and boards and shareholders face real impediments to making the best long-term decisions on these issues. But the obstacles to shareholders can be removed, while the essential conflicts presented to managers and boards will always be there. As Professor Roberta Romano has noted, “We focus on enhancing shareholder value because, when looking at a corporation, it is difficult to conceive of who else’s interests would be appropriate for determining the efficient allocation of resources in the economy.” That is why it makes more sense to entrust these decisions to shareholders than to the people whose employment and income is at stake.

I am not at all convinced that the Delaware courts consider these issues fairly. (You and I have been in agreement on this point in times past!) I am certain that the “Delaware interest” factor played an important role in the Time decision, as it did in Polaroid and many others. Delaware risks losing its title as champion of the race to the bottom. The Pillsbury and McMillan decisions led to Marty Lipton’s call to reincorporate elsewhere, and the Supreme Court’s CTS decision gave the domicile states’ authority a boost. Pennsylvania and other states are moving quickly to pass laws even more accommodating than Delaware’s, with the “stakeholder” laws the latest fad. I testified before the Delaware state legislature, arguing against adoption of the anti-takeover law, along with every other shareholder representative. When the parade of CEOs came in, saying that they sure would hate to have to reincorporate elsewhere, it was no contest.

In order to protect Delaware’s economic interest in accommodating the Fortune 500, the courts have created a special language of takeovers that has no base in law or economics, and they make that language go through all kinds of acrobatics to make precedent appear to apply. This gives us the “Revlon” and “Unocal” modes. And it gives us the contortions that Chancellor Allen went through to keep Time out of those modes.

Another element of Delaware’s special language is the “business judgment” rule. Certainly, managements need and deserve the widest indulgence of courts in deferring to their “business judgment.” No one thinks that they should second-guess these decisions. But the courts should be there to make sure there is a process in place that promotes fair treatment — or at least one that does not impede it. Shareholders deserve a level playing field, too. The original Time/Warner proposed transaction can and should be supported. This represents a determination by management that ownership values can be maximized within the framework of a merger company, virtually debt free, that can be the aggressive competitor in a multinational world. The Time management has made three judgments for its owners: (i) the business of Time can best be carried out in tandem with Warner; (ii) the merged businesses can best be conducted with a solid equity base, permitting capital investment and acquisitions on a global basis; and (iii) that this merger is the best way to bridge the “value gap” for Time shareholders. At this point, the Paramount offer gave some public indication of the exact size of the “value gap.”
Paramount offered $200 per share and was willing to offer more; Time management dismissed this as inadequate notwithstanding that the market valued common stock in its proposed merger at $120 per share. Time then decided to buy Warner. While this preserved the face of the “business logic” of the merger, clearly a debt-encumbered survivor is not going to be able to pursue the course of multinational aggressive dominance that was the apparent keystone of the original merger. Management thus has turned 180 degrees from an equity-heavy company to one drowning in debt.

Should there not be some commonsense limit to the extent of deference paid to “business judgment” when deference is paid to a business strategy based on all equity and then it is paid again to a strategy based on all debt? Conceivably, one of these is correct. Both cannot be, and yet deference is paid to both. And, can the courts ignore arithmetic? How many years, and at what implicit rate of return, does a holder of Time common have to wait until his stock will achieve the levels that Paramount offered in 1989 in cash? Should there be any limit to this, or should deference extend indefinitely? Chancellor Allen conjures up only the most unsatisfactory “red herring” of limits based on fraud.

What is to be done? The Time/Warner decision represents a real failure of the system of governance. America cannot simply give over the assets and power of the private corporate system to managers who are not meaningfully accountable to anyone. I personally have little appetite for the federalization of corporate law, and yet I recognize that “Delaware interest” decisions like Time/Warner will tend to make federal preemption more appealing.

What I have been interested in for the past several years is fortuity of large fiduciary ownership. What seems to me to be a beginning point is to require that institutional owners act as such; that those with long-term interests be required to be long-term investors; that we stop regulating institutional fiduciaries in the interest of service providers and that we elevate the interests of the beneficiaries, who constitute an adequate proxy for the national interest.

Of one thing do I feel certain, had Michael Dingman been a large shareholder of Time, the transaction would not have been consummated without the meaningful involvement of owners.

I look forward very much to the opportunity to spend a few hours together to talk of this and so many other things of mutual interest.

With respect,
Your Friend,
R.A.G. Monks

August 31, 1989

Dear Bob,

Thank you for your letter of August 23, 1989. If we keep this up, we’ll be able to publish a book – The Monks–Dingman Correspondence!

You’re right. We agree on more than we disagree. But not on everything. For example, you believe that once a corporate merger comes under consideration, management and the inside directors should at some point turn the process over to the outside directors. (In your words, “Even though it imposes an additional burden on the ‘outside’ director,
I see no alternative to their taking over the merger process....”) Then, at some later point – again unspecified – the outside directors should step aside and let the shareholders decide.

I believe this would turn corporate governance into a muddle. More to the point, it has little bearing on the case of the Time Warner merger. The outside directors were in charge. Every step was reviewed and approved by us, and we weren’t the empty vessels you seem to believe we were, filled with whatever ideas and information management cared to pour in our ears. We challenged management every step of the way. We asked the kind of questions that we would ask of our own employees, and we didn’t settle for stock answers. In the end, we agreed that the merger was a magnificent opportunity that should be pursued.

You use the word “acquiesce,” i.e. “to accept quietly or passively.” We did a lot of things in the unfolding of the merger. Argued. Probed. Questioned. Inquired. Cross-examined. It went on and on until we were satisfied. But we never acquiesced.

One final thing. The central issue in the Time Warner deal was neither debt, nor compensation. Paramount would have loaded on more debt than Time’s acquisition of Warner, and provided a far less significant cash flow with which to service it. And Michael Eisner and Frank Wells were offered an extraordinary package by Disney, and they’ve proved themselves worth every dime. If Steve Ross can deliver the same return to Time Warner that he has for Warner, a company he built from scratch, his compensation will be more than justified.

The board wanted to build Time Inc. so it could provide the very best return for shareholders. I think we did.

You raise a number of interesting points in your letter and, if I had the time, I’d like to look at them all. But I don’t. The reality of creating shareholder value doesn’t leave much space for dwelling on theories. Sometime in the future, when we can manage it, I look forward to sitting down and discussing the whole matter of Time Warner, as well as its wider implications. I hope that we’ll both learn something.

There is one thing I am absolutely against and that is the federalization of corporations and/or the establishment of more government rules concerning how businesses, managements, shareholders, et al. interact. I hope we agree on this point as well, and please stay away from Mr. Metzenbaum.

Again, thank you for your thoughtful response to my letter.

Sincerely,
Mike

NOTES

4. Ibid., p. 1148.
5. Ibid., p. 1148.
7. Ibid., pp. 93, 269.
10. Interview with Michael Klein, July 6, 1990.
11. This is a standard to which one cannot be held accountable. He who is responsible to many, is responsible to none.
Sears, Roebuck & Co.

Sears, Roebuck & Company is one of the great success stories in American commerce. The company had its roots in 1886 when Richard Sears started selling watches in rural areas. Later, he developed the idea of selling goods by mail order, taking a host of new products to populations cut off from big city stores. The famous Sears catalog became a byword for Sears' reliability and quality. In the 1920s, the company began opening stores to back up the catalog business. The stores proved every bit as successful.

By the 1950s, you could buy a prefabricated house from Sears, not to mention clothes for your family and a kitchen table for them to eat at. Single-handedly, the company set out to raise the standard of living of the great American middle class.

By the 1970s, Sears accounted for a whole 1 percent of the gross national product. Two in three Americans shopped at Sears within any three months of 1972. Almost 900 stores covered the American continent.1

DIVERSIFICATION STRATEGY: THE FATE OF RETAIL

In the early 1980s, Sears built on the success of its insurance subsidiary, Allstate, by adding real estate and brokerage services as well – Coldwell Banker and Dean Witter, both purchased in 1981. This diversification was the brainchild of CEO Ed Telling and was initially successful. From 1984 to 1990 the earnings of the financial side improved 55 percent, but nobody was minding the store. The vast chain of over 850 outlets, the flagship division of the Sears, Roebuck empire, were failing fast. In the seven years up to 1990 the retail group’s earnings declined at an annual rate of 7.7 percent. By the late 1980s, Sears was set to lose its century-old position as the largest American retailer. The decline was reflected in the stock, which, between January 1984 and November 1990, offered investors a total average return of as little as 0.1 percent.2

This lethargy was in part a function of the corporate culture at Sears. Its style was inward looking and change resistant; in many ways, that had been Sears’s strength. Consumers liked the consistency and reliability of its products and employees liked the commitment to promotion from the inside. Sears’s rock-steady reputation allowed the company the ability to weather most economic downturns. Sears had always been a shopping-chain that people could trust – a place selling quality goods at reasonable prices, all under one roof. It became more than just a store. It was a venerable American institution, and Sears rightly traded on that reputation.

Sears’s venerability became a liability when it failed to respond to changing times. Retail changed dramatically, and the ancient lumbering Sears was last in the race for the new markets. Trendy national chains like The Gap or The Limited captured a vast market of people wanting reasonably priced clothes that look stylish. Wal-Mart and K-Mart attracted people who liked their clothes cheap. Specialty stores undercut Sears on almost every other front. People who wanted a hi-fi ten years earlier might have gone to Sears, knowing that they would find one of good quality...
at a reasonable price; now they would probably go to Circuit City, knowing they could find the same model cheaper.

Sears has a dated image. Joe Cappo described a New York store in *Crain's Chicago Business*: “It was like being time-warped 30–40 years back into history. This wasn’t a store. It was the Metropolitan Museum of Outdated Kitsch. Remember the ugly lamp your grandmother had in her parlor? Sears still has that lamp.”3 Another shopper said: “I still think of it as a place where you go to buy a ladies’ Size 18.” USA Today asked: “Will anyone believe Sears stands for fashion as well as bowling balls?”4 Lean and efficient discounters like Wal-Mart and K-Mart were catching up and were soon to overtake Sears’ sales volume. Sears was stuck with locations and properties that were selected years before; newer competition could create stores for today’s market. Sears had always boasted that it was the place where America shopped, the definition of solid middle-class values, the purveyor of the American dream. According to *Crain's Chicago Business*: “If Sears is ever to turn the tide of the last decade, it will need new thinking and new people. This doesn’t mean Sears is a bad company. In fact, it is a very good, solid 1950s company. And it will need something better than 1950s thinking to move it into the 1990s.”5 However, with the money from the financial divisions coming in, it was easy to ignore the tumbling profits and shrinking markets of the core business.

Edward Brennan, the corporation’s chairman, CEO, and chief executive of the retail division was an undeniably capable man. He had led the retail division in the early 1980s and made a brilliant job of it. He was the man behind the “Store of the Future” that made a successful early attack against Sears’s competitors. He became CEO in 1984, but it was under his tenure that, somehow, the Store of the Future had become the Store of the Past in the minds of so many Americans. Brennan was a “Searsman” to his marrow. He had worked in retail all his life, and at Sears since he was 26. His father, mother, brother, and uncle all worked at Sears. Brennan was dressed only in Sears clothes for the first ten years of his life. He had never owned a pair of jeans because his father was a dress-slacks buyer. According to Donald R. Katz in *The Big Store*, “No one in Ed Brennan’s family ever managed to leave Sears…. the Brennans ranked among those special families so bred to the romance of the place that it was hard to tell company and family apart. Even by Sears, Roebuck’s unusually emotional standards, Eddie Brennan took it all quite personally.”6 Carol Farmer, a retail consultant from Chicago said: “The trouble with Ed Brennan is that he’s in love with Sears the institution. And it's the institution that needs to be debunked.”7

The problem was obvious – the cure, less so. In November 1988, CEO Ed Brennan launched a new strategic plan to revive the ailing merchandise division. The plan was the product of “an intensive strategic examination of our corporation” that would usher in “a period of unprecedented growth.” Sears committed itself to “everyday low prices” in an effort to compete with thriving discount stores, and launched “power formats” to sell brand-names alongside Sears’s traditional house labels. The board also voted to spend $1.6 billion buying back Sears stock and resolved to sell the Sears Tower, the tallest building in the world, much touted as a symbol of pre-eminence, but considered by critics to be just the company’s largest white elephant.

Wall Street was disappointed by this strategy. Many observers had hoped for much more. Sears’s stock had risen on the back of a hope that a major restructuring was in the pipeline. Analysts predicted that Sears, Roebuck stock could possibly double in value if the successful financial divisions were spun off and management’s resources and energy were devoted to making the retail operation efficient. Analysts thought it was misguided to use the money raised from selling valuable assets to buy back shares rather than build up business. “From the point of view of gaining long-term strategic advantage,” said Louis W. Stern of Kellogg Business School, “it’s madness.”8 One analyst
CASE STUDIES: CORPORATIONS IN CRISIS

predicted that the changes would not satisfy the increasingly hostile shareholders: “Institutional investors will be disappointed by today’s announcement,” said Robert Raiff, the Sears analyst at C.J. Lawrence & Co. “They were expecting more and I hope they get more.” Others were dismayed by the failure of merger talks with Montgomery Ward, run by Brennan’s brother.

Despite the criticism, the corporation went ahead with its restructuring. However, in two years, this strategy failed to stimulate business. The competitive pricing policy failed to halt the sweeping invasion of Sears’s retail markets by discounters and the “power formats” campaign had resulted in only Brand Central being rolled out to all stores. Meanwhile, the cash generated by the financial divisions of the company – Dean Witter, Allstate, and Coldwell Banker – was used to buttress the corporation’s flagging fortunes. The retail division continued to wilt; Wal-Mart and K-Mart continued to catch up.

From 1984 to 1990, Sears had a total annual return, including dividends, of a mere 0.7 percent. For ten years in a row, the company promised a 15 percent return on equity, and for ten years in a row it failed to deliver. Things were looking worse: 1990 was a disastrous year for the company with earnings and stock prices at 1983 levels, a return on equity of 6.8 percent, and a loss in the first nine months of $119 million.

WHERE WAS THE BOARD?

What about the board of directors? A board, after all, is responsible for overseeing the overall strategic direction of the company. If Brennan’s program continued to fail in its bid to raise sales; if Wall Street continued to advise more fundamental treatment for the problem; if Sears’s stock continued to sag at somewhere under half its intrinsic value; if the financial services continued to have their profits swamped by retail’s losses; if Sears’s reputation continued to sink under the weight of accusations that it was out of date – shouldn’t the board do something? In theory, of course, the answer is “yes.” At Sears, in practice, the answer was silence. Like management, the board of Sears had grown up as an inward-looking, self-perpetuating dynasty.

Another extract from The Big Store details how board meetings worked a decade earlier under Telling. The view expressed is that of Charlie Bacon, a senior manager in the Merchant division:

“Charlie believed that the board of directors under Telling had become one of the least animated decision-making bodies imaginable. He knew that reports to the board were all checked over by [chief financial officer] Dick Jones, and scripts were so rigidly followed that no deviation from approved texts was tolerated.... The outsiders on the Sears board were, by and large, people who owned few shares of Sears stock and who collected $40,000 a year for attending occasional meetings. What they knew of the company came largely from the company.”

SHAREHOLDER UNREST

In July 1990, the first rumblings of the coming shareholder storm were heard. At a breakfast meeting with Sears, Roebuck’s largest 12 investors, Ed Brennan and retail chief Michael Bozic gave an upbeat assessment of the corporation’s plans. Investors exploded. They cited a grim share
performance – value had dropped 15 points since 1989 – and gave Brennan one year to achieve marked improvement in retail or to look for another job. Russell Thompson, a money manager with Waddell & Reed, who was present at the meeting, said: “We told them ‘somebody could raise $25 billion and easily take you guys out tomorrow.’” Or, in the words of one board member, Albert Casey: “It was time to fish or cut bait.”

Brennan’s first step was to take control. Michael Bozic lost his job as head of the retail division and was replaced by Brennan himself. The CEO then committed himself to an acceleration of the “power-formats” campaign, and to a savage, across-the-board cost-cutting program. Brennan announced that 21,000 jobs would be pared within the year and numerous stores were closed or re-modeled. In interviews with the press, Brennan got tough; no part of the Sears empire was safe. “If it doesn’t pay its way, it goes,” he said, raising the possibility that the century-old catalog business could come under the knife.

However, like the 1988 announcements, Brennan found that few people were convinced. In early December, the California Public Employees’ Retirement System, holder of 2.2 million shares, voiced its concern about Sears’s performance, citing depressed stock and the failure of retailing strategies. The message, said CalPERS then-chief Dale Hanson, was simple: “From 1984 on, Sears went to hell in a handbag.” In an open letter to Brennan, Hanson proposed the creation of a shareholders’ advisory group. Such a group would give the board nonbinding advice on matters such as major restructurings, acquisitions, mergers, and executive compensation. Hanson hinted that he favored a major restructuring, thus joining the growing school of thought that argued that Sears’s value could only be realized when the successful financial divisions were spun off from the plunging retail division.

In February 1991, some four months after launching the idea of a shareholder advisory group, CalPERS agreed not to press for its creation at the May annual meeting on condition that Sears executives meet with CalPERS at least twice a year. But performance continued to decline and investors continued to seethe. Fourth-quarter earnings, revealed in early February, showed a 37 percent decline in earnings, before a $155 million charge for the retail division restructure. Including the charge, earnings declined 74 percent.

Public confidence in Sears hit a new low. Business leaders surveyed by Fortune magazine rated Sears at 487th out of 500 companies for the reputation of its management. Wall Street analysts said that Sears required $1 billion in cuts to make it competitive, substantially more than the $600 million that Brennan said the cost-cutting program would achieve. Standard & Poor’s reduced its credit rating on Sears to single A. Asset Analysis Focus commented that: “Sears, Roebuck & Co. has one of the greatest price to intrinsic value disparities of any large publicly traded company.” In February 1991, Sears traded at between $25 and $30 a share, while analysts speculated it had a breakup value of up to $90 a share.

George Regan of the Teacher Retirement Fund of Texas said: “Obviously whatever management is doing isn’t working. Either you can change the management or you can change the system. And sometimes the only choice is to change the management.” Business Week speculated that “a power shift may be in the works” and that P.J. Purcell, chief of Dean Witter, might be poised to take over.

In May of 1991, Robert A.G. Monks (co-author of this book) stepped in. He engaged in a proxy contest for one seat on the board of a public company, something no one had ever done before at any company. His target was Sears.

Monks had submitted his name to the board the previous fall, along with the names and numbers of six CEOs on whose boards he had served, as references. The directors did not
discuss his candidacy at the November meeting, they said, because they did not have enough information, though at no time did they contact the references provided. They did discuss his candidacy at the February meeting. It wasn’t that they used the extra time to gather more information; they didn’t. They explained later that they decided that additional information was not necessary since Monks’s record, already well known to them, clearly qualified him for the job.

The board turned him down. However, Sears’s own bylaws provide that a shareholder may nominate a candidate for the board. Apparently, the corporate leaders think this is a fine system, as long as no one tries to use it. Monks was nominated by an old friend, also a Sears shareholder, and he sought election as a dissident candidate.

Monks had been looking for a company that would allow him to raise some of his general concerns about corporate governance and corporate performance. Sears met all of his criteria. First, the issues were suitable for shareholder involvement: they concerned the overall structure and direction of the company. Second, the obstacles to realizing shareholder value were those that could be addressed by shareholder activism. Third, success was achievable: the level of institutional ownership, the vacancy on the board due to the retirement of a director, and the cumulative voting in director elections made it possible to be elected with only 16 percent of the vote, with five seats up for election. Monks wrote about their response to his decision:

> It threw Sears into such a tizzy that they hired [renowned takeover lawyer] Marty Lipton, brought a lawsuit to stop me, and budgeted $5.5 million dollars over and above Sears’ usual solicitation expenses, just to defeat me [as Crain’s Chicago Business pointed out, one out of every seven dollars made by the retail operation last year]. Sears also assigned 30 of its employees to spend their time working to defeat my candidacy.

> The real outrage was that they got rid of three of their own directors, just to prevent me from winning one seat, what I refer to as “Honey, I Shrunk the Board.” With cumulative voting and five directors up for election, I could get a seat with only 16 percent of the vote, not impossible for someone with strong connections to large institutional holders. But Sears shrank its board by eliminating three director seats, which meant that I needed 21 percent of the vote to win a seat – virtually impossible to obtain, because 25 percent of the vote was held by Sears employees (and voted by Sears trustees) and the rest was held by individuals that it was impossible for me to solicit, without spending millions of dollars. The myth is that the officers of the company report to the board. The reality is that the board reports to the CEO, at least at Sears. When the CEO (who is also Chairman of the Board and head of the Board’s nominating committee) tells three directors they are off, they are off, especially, as in this case, when they are inside directors, full-time employees of the corporation.

Jay Lorsch, Harvard Business School professor and expert on boards of directors, wrote in the New York Times: “This bothers me. I like to see American managers take boards seriously and use them as a check and balance against the abuse of management. When you play with boards in this way, you undermine their legitimacy.”

Crain’s Chicago Business cited Sears’s “abysmal performance” and criticized Brennan for having “led the company’s flagship retail division down one strategic dead end after another.”
newspaper fully praised Monks’s attempt to let some fresh air into the Sears boardroom: “Sears is scared and with good reason. For years, its shareholders have been lapdogs. Now they’re showing some teeth.... Why doesn’t Mr. Brennan let his record speak for itself? Then again, maybe that’s what he’s afraid of.” Pension and Investments ran an article criticizing both Chrysler (that shrank its board to get rid of a genuinely independent outsider) and Sears for shrinking its board to keep out Monks: “The moves were virtually admissions by the two companies that they prefer to maintain tame boards that will go along with whims and wishes of strong chief executives. Given the poor performance of both companies, the desire for tame boards is understandable. And nothing so demonstrates the need for more independent voices on each board as their board’s acquiescence of these moves.” Monks wrote:

> There was never any question about who had more money. Sears spent half of what it budgeted, and still outspent me 10 to 1. Sears brought suit against me to prevent me from getting a shareholder list, claiming I wanted it for an ‘improper purpose.’ The ‘improper purpose’ they alleged was promoting my new book. I would have to be Kitty Kelley to make enough money on a book to pay for a proxy contest, but I would have to be Sears in order to finance both a proxy contest and a lawsuit to make that point. So the lawsuit effectively stopped me from communicating with smaller shareholders. Even if it had not, though, the expense would probably have been prohibitive.

Following approval and mailing of their proxy statement, Sears was free to have press conferences and to comment to the press on my candidacy, including mischaracterizations of my positions, but I was not permitted to respond. The weird world of SEC regulation prevented me from making any public statement for two crucial weeks, because of the risk that some shareholder might see my remarks before the SEC had approved my solicitation materials. [Note: this rule was later changed, partly as the result of Monks’s situation.] This problem persisted right up to the annual meeting, as I could not afford the roughly $1.5 million necessary to send the approved material to every shareholder.

It was not my intention to displace anyone. One of the reasons I picked Sears was that there was an opening on the board, with the retirement of former CEO Edward Telling. Therefore, I wanted to put the Sears candidates on my proxy card, so that a shareholder who did not want to cumulate votes could vote for me and for two of the incumbent directors. SEC rules do not allow that. [Note: this rule was also later changed, as a result of Monks’s situation.] If there had not been cumulative voting, this would have been an even more devastating blow, as a fiduciary voting proxies would have to throw away two votes to give me one.

It was on this basis alone that Monks lost substantial votes. One of the other candidates, a black woman university professor, had a good deal of support from investors who were unwilling to throw away two of their votes to give one to Monks. Monks also lost votes from institutional investors who had (or hoped to have) commercial relationships with the company and felt pressured to vote with management. He also lost the votes of at least one long-time supporter in the institutional investor community because a proxy contest for one board seat was not covered by
But perhaps the biggest frustration was that I could not reach the largest group of shareholders, Sears’ own employees. Sears offered to mail my materials to them, if I would pay $300,000 in costs (more than my entire budget for the solicitation). But more serious was that the trustees (four out of five of whom were past and present members of the Sears board) would have voted the stock without even considering my candidacy, if not for the intervention of the Labor Department. That resulted in a pro forma meeting with the trustees, who proceeded to vote for their board colleagues. Many Sears employees called me to say that they were unable to get any information about my candidacy, or that they wanted their stock voted for me, but could not direct it. Sears refused my request for confidential voting, which would at least have allowed employees who held stock in their own names to vote for me without fear of reprisal.

In theory, of course, the directors are there to represent the shareholders, evaluate the performance of the chief executive officer (CEO), and oversee the overall direction of the company. If they have one obligation, it seems to me, it is to ask hard questions. But the current rules not only fail to ensure that directors ask questions, they prevent others from asking them as well.

Let’s look at Sears. Edward Brennan holds four different jobs. He is CEO of the company as a whole, chairman of the board, and head of the company’s flagship division, the retail operation. Part of the job description for those jobs is that the people in them are supposed to communicate with each other, measure each other, ask questions of each other. One person simply can’t do them all. On top of that, Brennan is head of the board’s nominating committee. He gets to pick his own bosses, and, as my experience shows, when he is faced with someone he didn’t pick, he brought all of the corporate resources to bear to stop me.

Where was the board in all of this? The answer lies in another question – Who are the directors? ‘Independent director’ is something of an oxymoron in today’s companies. The directors are selected by the CEO. The candidates run unopposed, and management counts the votes. In the rare case of an opposing slate, management gets to use the shareholders’ money to pay for their side of the contest, without regard for the interests of shareholders, while the dissidents must use their own. The CEO determines the directors’ pay, and the directors set the CEO’s pay. It’s a very cozy relationship, and one that has been most profitable for both parties, as CEO pay and director pay have skyrocketed over the past decade, at many times the rate of increase in pay for employees. This system does not promote accountability, or even the questions that are a necessary predicate for a climate of accountability.

At the annual meeting, after the votes were cast, I said that Sears had changed, as a result of my contest. Brennan said, ‘Baloney.’ Time will tell. But I can think of three important changes already. First, my arguments about the ability of Sears’ investment banker to give an objective opinion about the value of remaining a conglomerate led to the disclosure that Goldman Sachs had indeed advised them that they could realize more value – as much as three times more – by spinning off the other entities. This may not have changed Sears – yet – but it certainly changed the perception of Sears in the investor
Monks was right, but it took another year. While he was not elected to the board, Monks received more votes than any other director from the shareholders who received his proxy card. Sears responded to this strong indicator of shareholder concern by making some changes, including reducing Brennan’s jobs to three (and later to two when a new CEO was found for the retail division). Brennan was removed from the board’s nominating committee, and independent trustees (not directors) were appointed for the employee stock plan.

In 1992, Sears “shrunk the board” again, again making it virtually impossible for Monks to get enough votes to be elected. Instead, Monks devoted his resources to supporting five shareholder proposals submitted by others. This included an SEC-cleared mailing (note that this approval would no longer be required under the revised rules) and a full-page ad in the *Wall Street Journal* calling the Sears board “non-performing assets” (see figure 7.1).

The five resolutions came from a wide variety of sponsors, almost a “who’s who” of shareholder activism: a public pension fund, a Sears employee, a member of the United Shareholders Association, an individual investor, and one of the Gilbert brothers, who started the whole shareholder crusade more than 50 years earlier. They proposed: restore annual election of all directors (as was the practice for more than 100 years, until staggered elections were adopted as an anti-takeover move in 1988); to separate the positions of CEO and chairman of the board; to allow confidential voting by shareholders (to prevent pressure on shareholders who vote against management); to study the benefits of divesting one or more of the financial services divisions; and to impose minimum stock ownership requirements for directors.

The annual meeting, held in Atlanta on May 14, was a catalog of protest. The *Chicago Tribune* wrote: “For more than two hours... Brennan was forced to stand by as speaker after speaker told him his company’s performance had been poor in the last year.” USA Today agreed, describing the mood of shareholders as “rebellious.” Hazard Bentley, the Allstate employee who sponsored the divestment resolution, said, “There are grave problems in the company to which I have dedicated my working life,” and Cari Christian of the United Shareholders Association asked, “How can the board effectively serve shareholders as the overseer of management when it is led and dominated by the company’s senior manager?” Other shareholders were even more blunt: “Your retail stores are lousy,” said a 70-year-old veteran Sears customer.

At the meeting, Monks made a statement that concluded:

“We are the owners of Sears, Roebuck and Company and we are asking for the most basic elements of accountability. We are asking for the most basic and the most essential attribute of ownership: true confidential voting; the right to express opinion free of the possibility of coercion or reprisal. This is the right guaranteed to all citizens of the United States in the exercise of political rights; it is accorded to the shareholders of Exxon, IBM, General Motors, and other leading corporations in...
The Directors of Sears, Roebuck and Co.

NON-PERFORMING ASSETS

Two years ago, Sears was the nation's largest retailer. Its stock price today is less than it was in 1988. In my opinion, the reputation of the Sears Board of Directors has also fallen, due largely to its lack of energy and interest in making management accountable to shareholders. Make no mistake, a board's value translates into stock price.

The most recent and clear example, of course, is General Motors. The Wall Street Journal reported on management, GM stock gained 11.25 cents while the Dow Jones Industrial Average fell 62 points. Two weeks later, GM was suddenly reorganized to launch the largest equity offering in history.

PROTECTING THE OWNERS—THE AG PRIORITY

The GM Board acted to protect its owners. We ask the Sears Board to give shareholders and the investment community a sign that it, too, understands its priorities. We ask the Board to take a modest step toward independence by reconsidering its blanket opposition to the shareholder proposals:

- Make Shareholder Votes Confidential
  The Board's current practice is to deny shareholders complete confidentiality in voting, a right American express. Why would a board oppose giving the secret ballot to the very shareholders it is supposed to represent?
- Separate Chairman Position from CEO/President
  This proposal offered by the 320 billion New York City Employer Retirement System seeks to establish a truly independent chairman. Mr. Edward Browne is Sears' chairman, President and CEO, as well as operating head of the seriously troubled retail group. How can a chairman objectively oversee management when the chairman is management? Would a board be any more available to owners let an executive hold not just one but all of the most crucial jobs in the company?
- Sandy December
  In each of the last ten years, Sears management's goal of a 3% return on equity has been met. Yet, in 1990, a news article states that Sears employees were fired. As a director, how would I ensure that Sears' non-merchandising businesses were spin-offs, shareholders would have a better chance of achieving that return. An employee proposal calls for an independent entity to determine the value of a dividend Sears. Would a board committed to shareholder value impose such a reasonable request?

- End Staggered Board Nominations

A staggered board is a device by which entrenched management controls. The Sears Board repeatedly has allowed manipulation of board size to protect current management. Would an accountable board allow itself to be used to protect management interests?

- Require Directors to Own Minimum Shares

Thanks to management, last year each Board member received an average of $25000 in cash and a gift of 100 shares. The provision of directors should not be a perquisite. To assure accountability, shouldn't Board members have an investment of their own money in a company?

- Activist Boards and Shareholders

- Increase Stock Values

Scholars and experts, looking at the concept of the "governance divide" are documenting how owner activism and board performance increase stock value.

- Ex-post shareholders depress value. A 1997 study of 300 major companies by Princeton John Pound of Harvard and Lili A. Gordon of the Gordon Group (whose permission has been obtained to use their study in this advertisement) showed that companies with poor governance profiles did worse over the long term than their peers with better governance profiles.

Pound and Gordon documented "significant and systematic differences...for return on assets, operating margins, and market valuation relative to cash flow..." Shareholder initiatives increase value. A 1992 study by Wharton Associates found that shareholder proposals submitted to the California Public Employee Retirement System resulted in a $37 million net gain, even when the proposals did not get a majority vote.

There can be no assurance that a "governance dividend" will result from the adoption of Sears shareholders' proposals. But, by withdrawing its opposition to these proposals and demonstrating independent thinking, the Sears Board could give Sears owners a governance dividend of their own.

- VOTE FOR SHAREHOLDER PROPOSALS

We urge all Sears shareholders to endorse the need for Board accountability and vote for fellow shareholders' proxy proposals. Even if you've voted, you can still change your vote. Send in your proxy card or contact George & Co., Wall Street Plaza, New York, NY 10005, 1-800-223-2204.

Figure 7.1 The Wall Street Journal advertisement.
the exercise of their shareholder rights. I have looked shareholders in the eye as they told me they could not vote with me due to fear of coercion. As the former chairman of a major fiduciary bank, I have felt it myself. Even the most conscientious and courageous shareholder cannot risk the commercial suicide of opposing a substantial potential customer. No vote can be meaningful as long as the company can retaliate.

Why won’t Sears give its shareholders the dignity and full protection of true confidentiality? A more difficult question is why our management would advertise that it has adopted a policy of confidentiality, when the fine print says that it doesn’t apply in a proxy contest, the one situation where it makes a difference?

What does it mean when management announces an objective and then fails to achieve it for every one of ten years? In the interest of honesty, should the objectives be lowered? Should there be some consequences for this failure to meet their own goals, some increased accountability? Two of the shareholder proposals, the proposal to separate the Chairman and the CEO and the proposal for annual election of all directors, will make a difference. These are changes that make questions more likely.

Should there be a change in the corporate strategy? What does it mean when the board opposes an independent study, by a firm of their own choosing? To me, it demonstrates yet again that they just don’t want to respond to any questions.

Who are the directors? Won’t it make a difference in their attitude toward shareholders if they have some minimal shareholding themselves, not the 100 shares a year they are given, but shares purchased with their own money? That is the purpose of the last of the resolutions.

Sears has a slogan: ‘You can count on us.’ We want to hear the board say that to the shareholders. We want to see the board earn that trust. The resolutions currently presented by five different and diverse shareholders and groups demonstrate a high level of concern, even dissatisfaction. We want better. We are tired of waiting. And until we see some change, we will keep reminding you – you can count on us.

Two of the resolutions (confidential voting and annual election of directors) got votes of over 40 percent. The proposal to separate the CEO and chairman positions captured 27 percent. The proposal for a study of the benefits of divestment received a 23 percent vote and nearly 6 percent of the shareholders withheld approval of the candidates for the board of directors, then a record vote of no confidence for a public company board.

Things continued to worsen for Sears. The Sears auto repair facilities were charged with fraud by the Attorneys General of California and New Jersey, who complained about the “company culture.” A lawsuit was filed in connection with Martinez’s appointment as CEO of the merchandise group. Dean Witter partnerships had “roll up” problems. Allstate fared worse than its competitors in the liabilities incurred by Hurricane Andrew.

The company announced the appointment of two new outside directors, Michael Miles, chairman of Phillip Morris, and William LaMothe, former CEO of Kellogg.

On September 29, 1992, Sears announced a massive divestment plan. Sears would no longer offer its “socks and stocks” policy, and would focus more directly on the retail division. Coldwell Banker would be sold in its entirety. Twenty percent of Dean Witter would be sold and the rest spun off to shareholders. Sears would also put 20 percent of Allstate on the block.
The reaction of the market was positive. In a single day the stock rose 3 7/8 in a market that slid nine points. Over $1 billion was added to Sears’s market value in that day alone. One year later, it was clear that the restructuring helped Sears turn itself around. For stockholders, the shakeup proved bountiful. A year after the restructuring, the stock traded at around $56, down from a 52-week high of $57.75. On the day Sears announced its restructuring, the stock opened at $41. Thus, shareholders saw each of their shares appreciate about $15 in a single year. This increased Sears’s market value by over $5 billion.

Sears shareholders garnered other values as well, via the spinoff of Dean Witter, Sears’s brokerage arm. Twenty percent of Dean Witter was sold in March 1993, ahead of schedule. The remaining 80 percent was spun off to shareholders. Sears holders received a special stock dividend of four-tenths of a share of Dean Witter for each Sears share they owned.

The Sears example demonstrates the role that focus by active shareholders can and should play in under-performing companies. What is more, it shows the crucial link between activism and value. As a result of shareholder involvement, Sears became a better run, more open, more accountable, and more valuable company.

SEARS: A POSTSCRIPT

It was Fortune magazine that first identified Sears, Roebuck as a “dinosaur” but, in recent years, the famous retailer shrugged off its carapace and evolved into something that can survive and thrive.

Looking at Sears four years later, Fortune commented that “the ‘dinosaur’ … turned into a cash cow.”

The company took a fresh approach, and was finally able to rid itself of itsusty, outmoded image. In 1997, Sears was voted Fortune’s most innovative general merchandise retailer, and the company gained market share in almost all categories of merchandise.

What was the key to the turnaround? Fortune identified a change in culture, a change that required Sears to free itself of its glorious past and concentrate instead on the future: “the main reason Martinez has been able to change Sears is that he changed the people…. ‘We used to be so inbred, it’s a wonder we didn’t have one eye in the middle of our foreheads,’ says executive vice president Bill Salter, a 32 year old Sears veteran.” In 2004, Sears was purchased by Edward S. Lampert following his acquisition of former rival Kmart. He did very well for a few years, but in 2007, after a drop in the stock price, onetime shareholder activist Lampert found himself the target of an activist campaign by hedge fund manager William Ackman.

NOTES

5. Cappo, “Big Stores Masters Art of the Big Store.”
12. Ibid.
13. Ibid.
17. Silver with Zinn and Finotta, “Are the Lights Dimming for Ed Brennan?”
18. Ibid.
19. While Sears asserted that the primary purpose was to raise the proportion of outside directors (all three shifted directors were employees), they also admitted that the step was taken as a mechanism to keep Monks off the board. One Sears executive, insisting on anonymity, said: “That’s the real motivation of today’s announcement – to keep Monks out.”
Armand Hammer and Occidental Petroleum

In 1989, the proxy statement of the Occidental Petroleum Company informed shareholders that the company intended to spend tens of millions of corporate dollars to build a museum to house the art collection of Occidental’s founder, CEO, and chairman, Dr. Armand Hammer. Furthermore, a substantial sum would be spent to underwrite the costs of a book detailing two years in the life of Armand Hammer. The story provides an excellent study of boardroom neglect in the face of a powerful and domineering chief executive.

Occidental’s proxy revealed that the company had undertaken to finance the cost of a biography of Hammer, detailing his life from 1987 to 1989. The proxy stated that costs had run to $255,000 already, with another $120,000 committed for further expenses. Occidental would have its costs reimbursed from the proceeds of the book. The publication was expected to be successful since Hammer’s first volume of biography, published two years before, had been a bestseller. Any remaining profits from the book would be donated to the Armand Hammer United World College of the American West, in Montezuma, New Mexico.

The volume of Hammerography was a small endeavor compared with the second project described in the proxy. Occidental pledged to finance the Armand Hammer Museum of Art and Cultural Center, to be located in a building next to Occidental’s Los Angeles headquarters. The proxy stated that, “Occidental’s board of directors believes that the financial support of the Museum will promote the continuation of goodwill which has inured to Occidental from its longstanding past association with and support of the [Armand Hammer’s] collections.” Occidental would bear the cost of constructing the new museum and renovating four floors of the Occidental HQ building for use by the museum under a 30-year rent-free lease. These construction costs were estimated at $50 million.

Occidental was the subject of several shareholder suits charging that the museum represented improper use of corporate assets. During discovery, more facts emerged that further illustrated the careless use of shareholder money that the board had allowed. For instance, in 1980, Hammer had purchased a Leonardo da Vinci notebook, called the *Leicester Codex*, for $5.3 million. Hammer renamed it the *Codex Hammer*. It later transpired that the notebook had been bought with Occidental’s funds. In other words, Hammer had spent the Occidental shareholders’ money on a work of art that he named after himself. More outrageously, the board let him do it; they retroactively ratified the purchase.

Further, Occidental would contribute funds to the museum for 30 years at a cost of $24 million. At the end of the 30-year lease, the museum would have the option to buy the museum building and the Occidental HQ building from Occidental for $55 million, its “currently estimated fair market value at that time.” Occidental would then lease its HQ building back from the museum at a fair market rent.

The issue here is not whether corporate charitable giving is of benefit to shareholders. Some level of charity by corporations is not only acceptable, it should be encouraged. Companies
CASE STUDIES: CORPORATIONS IN CRISIS

should recognize their obligations to the community through charitable contributions, and these contributions provide important benefits to long-term shareholders, both directly and indirectly. Directly, shareholders benefit from the favorable tax treatment of charitable contributions. Indirectly, they benefit from the goodwill, support, and name recognition they inspire. However, did the museum and book projects constitute corporate charity or were they gifts to Armand Hammer?

Consider the biography. Unarguably, Hammer has led a fascinating life, and his first volume of biography had sold superbly, appearing for 18 weeks on the New York Times bestseller list. However, the very success of the first book should have made it possible for Dr. Hammer to negotiate a contract for a sequel with a commercial publisher. Instead, Hammer borrowed the money from Occidental’s till and gave it to someone to follow him round the world for two years. If the book made money, Occidental would be reimbursed, but why should the shareholders bear that risk? Why should a publicly held company be in the business of making interest-free loans to the CEO? Especially given the fact that the CEO was a billionaire and could easily afford to bear the risk of publication himself.

Of course, the book’s cost represented a fraction of the costs of the museum, which soon leapt way above the $86 million mentioned in the proxy. One shareholder court filing in October 1990 alleged the total cost to be closer to $157 million. What was Occidental paying for?

The company argued that it “expects to receive appropriate public acknowledgment of its role in forming the Museum.” This was a highly tendentious claim. Hammer had originally promised his collection to the Los Angeles County Museum of Art (LACMA), but reneged on his promise when the museum refused certain of Hammer’s demands. Among these demands was that his collection must be housed only in rooms bearing his name (and his name only), and should be housed together, separate from other works. Further, he insisted that the entry way to his collection contain a life-size portrait of not just Hammer but also his wife. Lastly, he demanded that the collection have its own curator, answerable to the Armand Hammer Foundation rather than LACMA. Hammer was insulted by LACMA’s failure to accede promptly to his demands and promised that he would house his collection in his own museum. Los Angelenos felt betrayed by this abrupt U-turn.

Occidental’s claim that it would gain recognition via its association with the museum failed on a second count. Art critics and historians believed that Hammer’s collection was not sufficiently good to merit its own museum. As the New York Times put it, for each of the good works, “there are a dozen Victorian pot-boilers, saccharine nudes and other losers.”1 Time magazine was harsher: “Most of it [the collection] is junk: a mishmash of second- or third-rate work by famous names.”2 In other words, Occidental’s shareholders weren’t merely stumping up $95 million for a private museum, they were doing so for a second-rate museum.

Should shareholders bear the cost of a museum memorializing the company’s founder? Especially when various works of art in the museum don’t belong to him anyway? Should shareholders pay for Hammer to acquire a reputation as an art-lover, charitable donor, and philanthropist? Should Occidental’s shareholders pay tens of millions of dollars to divert the collection from a superior facility at LACMA in order to assuage Hammer’s bruised ego?

It was also dubious whether the museum counted as legitimate charitable giving. Under Delaware law (Occidental was incorporated in Delaware) charitable contributions in excess of the amount
deductible for Internal Revenue Code purposes may be considered unreasonable. Occidental’s taxable revenue in 1988 was $111 million, and charitable giving was deductible only up to 10 percent of that sum. However, Occidental was planning to spend $86 million on the museum, rather more than the $11 million that could be deemed “reasonable.”

Where was the board in all of this? Let’s begin with the chairman of the board, the legendary Dr. Armand Hammer himself. His career is the subject of hundreds of articles and several books. His career as an industrialist, philanthropist, and unofficial diplomat spanned the twentieth century. He was one of the first Westerners to do business with the Soviet Union and with many Third World countries. He was the friend of world leaders. He was also a convicted felon, due to his violation of federal campaign contributions in 1976. (He was later pardoned by President George Bush.) At the sentencing proceeding, held in Los Angeles because Hammer was too weak to travel to Washington, he appeared in a wheelchair, his heart hooked up to monitoring machines checked by a team of cardiologists in the next room. His lawyer told the court that Hammer was “a sick old man [who] lives four blocks from the office, goes in late, goes home for lunch and takes a nap in the afternoon.”

Despite being too old and sick to work, Hammer was paid over $6 million in compensation from 1985 to 1988. Furthermore, his employment contract, which provided for nearly $2 million in annual pay (including a “guaranteed minimum bonus” of $420,000), was written to remunerate him for his services until February 1998, when Hammer (had he lived) would have been 99 years old. One feature of the contract was that it would be paid in full whether Hammer lived or not. Thus, following Hammer’s death, Occidental’s shareholders coughed up a further $18.3 million to the Armand Hammer Foundation. The Los Angeles Times labeled this compensation gimmick a “Golden Coffin.”

However old and sick Hammer was alleged to be, there was no doubt that he was an energetic and highly “hands-on” CEO who ran the company in many ways as though it was his own kingdom. Wall Street recognized his deep (and sometimes eccentric) involvement in every aspect of the company with sharp increases in the stock price every time he got sick. (Indeed, on the day Hammer died, Occidental’s stock appreciated by over $500 million.)

Hammer picked his board members carefully. More than half the directors were insiders, or outsiders with ties to the company. Louis Nizer was a partner and Arthur B. Krim was a counsel to a law firm that received $5 million from Occidental the year the board approved the museum. Another “outsider” was Rosemary Tomich, who was also a director of an Occidental subsidiary. Arthur Groman, also an Oxy director, was a partner in a law firm that received fees of $1.8 million from Occidental in 1987, and Groman performed legal fees for Hammer and was a paid consultant to Occidental. George O. Nolley was the founder of the Permian Corporation, which had been bought by Occidental.

There was a widespread rumor that Hammer had signed undated letters of resignation from each of his directors. Occidental’s board was ready to respond to every whim of the company’s domineering chairman.

Occidental had a staggered board, divided into three classes. The stated reason for the staggering was to ensure the “continuity” of board service. Such “continuity” seemed unlikely given the average age of Occidental’s directors. Hammer himself was 91 years of age, Nizer was 87, Gore was 82, and Krim 79. More than half of the board was over the age of 72. The “continuity” of this board was not something over which the company had much control.

It seems that Hammer went ahead with the museum plan even without full board approval. He had presented his proposal to the Executive Committee of the board, but the plan was not
approved by the Special Committee (made up of outside directors) until long after construction had actually begun on the site.

One shareholder suit charged that the Special Committee had lacked sufficient information to appraise the museum proposal thoroughly. For instance, the Committee received its legal advice from the firm of Dilworth Paxson – Hammer had chosen the firm to advise the Committee, despite the fact that Dilworth Paxson was at that time representing Hammer in a personal legal matter. The Committee was never advised of this conflict of interest. The Committee also accepted, without investigation, the $55 million option price – the price the museum would pay if it wished to buy the complex after 30 years – on the basis of a report by an appraiser selected by Hammer. They accepted this report despite its startling conclusion that a building that cost $50 million to build would be worth only $55 million 30 years later. (Rockefeller Plaza, for instance, is 60 years old and is still the most valuable commercial property in New York.)

When the Committee approved the museum proposal they did not know:

- that Hammer had promised the collection to LACMA, and caused public disapproval when he reneged on this promise;
- whether the museum building would be owned by Occidental or the museum itself;
- the value of the art to be contributed by Hammer and the Hammer Foundation;
- what portion of the art had been purchased with Occidental money;
- whether Hammer would provide any financial support for the museum;
- the cost to Occidental of the museum’s rent-free use of space in the company’s headquarters building;
- the tax aspects of the proposal – they didn’t even know if Occidental’s payment for construction of the museum complex would be tax deductible;
- not even where Occidental would get the funds to pay for the museum.

Senator Albert Gore Sr., at his deposition, showed that he understood few aspects of the museum proposal he had approved. The defendants suggested that Senator Gore, at 82 years of age, should not be expected to recollect corporate matters between board meetings. The obvious question is: what was he doing on the board at all? But that question can equally be asked of every Occidental board member.

A shareholder lawsuit challenging the museum was settled – over the objections of the large institutional investors – because the court found it likely that the contribution would be protected by the business judgment rule.

Who then is in the best position to establish accountability here? How?

NOTES

In the spring of 1988, Shamrock Holdings, an investment group headed by Roy Disney, bought a position of roughly 5 percent in Polaroid Corp. The stock of the imaging company was then trading at $30–$35 a share.

This trading range was low, considering Polaroid’s distinguished history. Since its formation in 1937, the company can rightly claim to be one of America’s most innovative. Under the leadership of Edwin Land – who had more patents to his name than any other American inventor save Thomas Edison – Polaroid developed many leading-edge technological products, most notably its signature instant camera.

However, such stellar achievements did not guarantee commercial success. Though Polaroid is credited with developing and advancing instant-imaging technology, the company suffered heavy competition from increasingly cheap, high-quality, 35 mm cameras and film. By the late 1980s, Polaroid was seen as a ripe candidate for takeover, for the following reasons:

- The company’s profits were relatively low.
- It carried a small amount of debt.
- It owned a potentially enormous, though unliquidated, asset in the form of a patent infringement suit against Eastman Kodak. It was anticipated that Polaroid would obtain a very substantial damage award against Kodak, possibly up to $6 billion.

Polaroid already had significant anti-takeover defenses in its charter, including:

- a shareholder rights plan, or “poison pill”;
- a prohibition on shareholder action by written consent;
- a prohibition on shareholders’ ability to call special meetings;
- authorized issue of “blank check” preferred stock.

Shamrock was known as a potential acquirer. There was no question but that it intended to use its 5 percent stake as a springboard for a Polaroid bid. On June 16, Roy Disney and Stanley Gold of Shamrock Holdings tried to reach Polaroid CEO I. MacAllister Booth by phone to request a meeting. Booth, then out of town, instructed his secretary to tell Shamrock that he would be unavailable for a meeting in the near future. Booth, however, cut short his trip and returned to Boston the next day to meet with representatives of Shearson Lehman Brothers, Polaroid’s investment bank.

Disney, unable to reach Booth by phone, wrote a letter on June 17, reiterating his interest in a meeting. The letter stated that the purpose of such a meeting would be “to establish the ground work for a good relationship with the company.” Though Shamrock gave no indication that it intended a hostile bid – indeed, Booth later testified that the letter “had no threatening aspect to it” – there could be no doubt that Shamrock was determined to take Polaroid over. Shamrock was a takeover vehicle; Polaroid was a prime target.
Polaroid management finally agreed to meet with Shamrock and set a date for July 13. Polaroid insisted on certain conditions, including a demand that Shamrock not exceed a 5 percent holding by the time of the meeting. Shamrock agreed, and reversed some commitments it had made to continue buying the stock. Shamrock later charged that it cost $500,000 to reverse these commitments and stay below a 5 percent holding. In return, Shamrock sought assurance that Polaroid was not merely trying to buy time to erect anti-takeover barriers. In later court testimony, representatives of both sides directly disagreed. A Shamrock associate said that he received an assurance from Polaroid that the company had no plans to alter the status quo. A Polaroid representative, by contrast, said that the company merely promised not to sell itself to a third party before the July 13 meeting.3

The meeting between Booth and Shamrock never took place. On July 12, one day before the scheduled meeting, a special meeting of the Polaroid board was convened to approve a “comprehensive plan” for the reorganization and redirection of the company. Included in the scheme was a proposal for an employee stock ownership plan (ESOP) that would account for 14 percent of Polaroid’s shares. Other details of the “comprehensive plan” included a commitment to enter the worldwide market for 35-mm film, and various streamlining and cost-cutting measures.

The board approved the strategy and issued a press release announcing the formation of the 14 percent ESOP. At the same time, Shamrock was informed that the meeting scheduled for the next day was canceled.

Under Delaware law, a hostile acquirer must gain 85 percent of a company’s shares to consummate a merger within three years. If the ESOP shares remained beholden to incumbent management, this would all but destroy Shamrock’s chances of taking Polaroid over.

Shamrock bitterly protested the decision of Polaroid’s board. Gold wrote to Booth, saying, “Contrary to your assertion that the so-called ‘comprehensive plan’ will improve shareholder value . . . I believe some of the actions planned will have a significant adverse impact on such value.” At the same time, Shamrock announced that it would seek to have the ESOP invalidated in the Delaware courts, on the grounds that the Polaroid directors had breached their fiduciary duty in hastily adopting the ESOP in the face of a presumed threat.

Before the case reached the hallowed chambers of Wilmington, however, Shamrock launched its long-expected bid for the company. In September 1988, Shamrock bid $42 in cash for all of Polaroid’s shares, conditional upon 90 percent of outstanding shares being tendered and the ESOP being declared invalid in court. Later, Shamrock raised its bid to $45, and declared it would raise it to $47 if the ESOP were struck down. Polaroid’s board of directors ruled that the Shamrock bid was “inadequate” and announced its opposition, citing:

- an insufficient price;
- the highly conditional financing of the Shamrock bid;
- the extent of Polaroid’s leverage if Shamrock succeeded;
- Polaroid’s bright future prospects;
- the prospect that a takeover by Shamrock might jeopardize the expected return from the Kodak litigation. On this last point, directors claimed that Shamrock would be forced to settle early for less than the possible award or that Shamrock would not be viewed as the “victim” of the patent infringement and would therefore receive a lesser reward.

In a September 20 press release confirming the rejection of the offer, MacAllister Booth said, “The board also considered several factors including Polaroid’s excellent initial progress in
implementing its comprehensive strategic plan, announced July 12.” Shamrock’s interest in Polaroid had now become a fully fledged takeover battle. Shamrock had to persuade Polaroid shareholders to tender their shares despite the strong recommendation from Polaroid management that they not do so. Of course, Shamrock’s bid depended wholly on the ESOP. If the Delaware court ruled the ESOP invalid, Shamrock had a far better chance of succeeding in its bid. If the ESOP was upheld, Shamrock’s chances were next to nonexistent.

The case was heard before Vice-Chancellor Carolyn Berger in December and January 1988–9. The case went into great detail about the timing of the ESOP and the effects it was intended to have. The following questions were raised:

• When directors approved the 14 percent ESOP, were they fully informed about the terms of the plan? For instance, did the board consider the effect the ESOP would have on productivity or on the independence of the company? Did the board know how the company’s employees felt about the plan?
• Did the board have a fiduciary duty to study such issues?
• Did Polaroid adopt the ESOP primarily as a device to thwart Shamrock or did the plan serve a fundamental business purpose?

On January 6, 1989, Judge Berger delivered her opinion, upholding the Polaroid ESOP. Before we weigh the merits of the opinion, let us consider the facts.

POLAROID’S ESOP: DELAWARE SITS IN JUDGMENT

An ESOP of sorts had been under consideration at Polaroid since 1985. In that year, management floated a proposal that would allocate 4 million shares over ten years. At the time, management noted that one of the benefits of such a scheme, aside from the intrinsic merits, was that it would help deter a hostile acquirer.

In 1987, the company approached the issue in greater depth. Management decided that the ESOP would have to be funded by the employees, who would exchange various benefits in exchange for their shares in the plan. Various meetings were held with employee representatives to see what employee benefits could be exchanged to pay for the plan and the size of plan that could be created from such exchanges.

At a meeting in March 1988, Polaroid’s corporate benefits committee debated and approved an ESOP of “up to 5 percent” of the company’s stock. Their proposal was put to Polaroid’s board of directors four days later on March 29, 1988. The board approved in principle, though the size of such a plan was not discussed. Minutes of the meeting noted, “[T]he plan should also serve to introduce a note of stability at this time of increased corporate takeover activity.” The board approved the idea of an ESOP, but stipulated that it would be funded by an exchange of employee benefits, and that the shares would be purchased in the open market to avoid a dilutive effect on shareholders.

At the presentation to the board, chief financial officer Harvey Thayer showed that the costs of the employee 401(k) plan and the profit-sharing retirement contributions could be exchanged for an ESOP somewhat less than 5 percent. Several directors recommended an ESOP of larger than 5 percent as long as the plan remained shareholder neutral.
Polaroid issued a press release after the meeting, announcing the formation of a smaller ESOP. The release said, “The ESOP as currently envisioned will own somewhat less than 5 percent of the outstanding shares in the company.” Defending this plan later before Judge Berger, Polaroid’s chairman and former CEO William J. McCune testified that he had no recollection of an ESOP in excess of 5 percent being discussed during this period.

Judge Berger concluded, “In short, I am satisfied that the press release was accurate – the board approved, in principle, an ESOP of approximately 5 percent of the outstanding stock.” Such was the situation when Shamrock principals confirmed in a letter to Polaroid that they were substantial holders of Polaroid’s stock and interested in a meeting with management. Booth would later testify that the letter was “a jolt of reality.” Norwood said that it was received like a “cold shower.”

On June 26, nine days after receiving the “good relationship” letter from Shamrock, the management executive committee (MEC), consisting of Polaroid’s senior managers, met in a special Sunday morning meeting to discuss their response to Shamrock’s overture. Judge Berger wrote, “As Booth explained, there was ‘no question’ but that everyone wanted to put together the ESOP quickly because of the Shamrock letter.”

However, there also seemed to be no question that an ESOP accounting for 5 percent of the stock was inadequate. In Judge Berger’s words:

> Booth announced that he wanted a larger ESOP funded in part by the five year seniority increase (this was an automatic 5 percent pay raise granted to all employees after they had served five years). Booth apparently was surprised that the MEC (which in April had been unable to agree upon even a 2 percent pay cut to fund the ESOP) was aggressively pushing a larger ESOP. Booth even got to the point where he had to play ‘devil’s advocate’ and point out to his senior people that the pay cuts would not be an easy thing to sell to the employees . . . . During the course of the discussion, the committee members were advised that an ESOP greater than 18.5 percent would require stockholder approval. Although the committee members were pushing for an ESOP of 20 percent or larger at this meeting, when they learned of this additional requirement, they agreed that 18.5 percent would be the cap on the ESOP.

On June 29, Booth met with two employee representatives. He told them he had decided on funding a $300 million ESOP with an across-the-board 5 percent pay cut, the 401(k) matching funds, a delayed pay-scale change, and the profit-sharing retirement contribution. The employees did not cheer the news, as the Berger court later noted: “The two employee representatives argued against the 5 percent pay cut and pointed out the severe financial impact that [it] would have on employees.”

Having decided on the enlarged ESOP and the means of funding, Booth wished to implement the plan before the next scheduled board meeting on July 26. His motive, he testified, was that the last two weeks of July coincided with Polaroid’s annual “summer shutdown,” and he didn’t want employees to read of the new ESOP and pay cuts (if approved by the board) in their holiday newspaper. Booth therefore called a special meeting of the board for the earliest convenient date, which was July 12 – one day before the scheduled meeting with Shamrock. Due to the short notice of the special meeting, three directors were unable to attend and a fourth had to leave before any votes were taken.
At least one Polaroid executive managed to attend in spirit, however. Judge Berger commented, “The minutes are not a model of accuracy . . . [they] refer to two proposals made by [vice president of corporate personnel, John] Harlot, who did not even attend the meeting.”

At the meeting, Booth explained the “comprehensive plan” to the board and sought approval of the enlarged ESOP.

The ESOP was discussed for two hours. Berger wrote, “Although the directors had approved the concept of an ESOP on March 29 . . . they had never considered an ESOP as large as $300 million and they had never considered funding an ESOP (regardless of size) with employee pay cuts . . . . The directors did not question the ESOP size chosen by management and they did not ask about or discuss alternative funding sources.”

Directors also failed to discuss two other important points. Judge Berger noted:

1. that employee representative groups strongly opposed the use of a pay cut and had proposed alternative funding sources;
2. that a 14 percent ESOP would make a hostile takeover of Polaroid almost impossible.

One of the chief issues before the Berger court was whether Polaroid directors would be protected by the business judgment rule.

Under Delaware law, directors are “charged with an unyielding fiduciary duty to the corporation and its shareholders” (Smith v. Van Gorkom). Normally, their decisions will be protected by the business judgment rule, “a presumption that in making a business decision the directors . . . acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company” (Aronson v. Lewis). The protection of the business judgment rule will not be afforded to directors who fail “to inform themselves, prior to making a business decision, of all material information reasonably available to them” (Aronson v. Lewis).

The business judgment rule is available to directors even when they are facing a takeover threat. In such circumstances, however, there is “an omnipresent specter that a board may be acting primarily in its own interests” (Unocal v. Mesa Petroleum). Thus, the Delaware courts have established a more burdensome business judgment standard for takeover situations. Directors must show that they had “reasonable grounds for believing that a danger to corporate policy and effectiveness existed” and that the measures taken to oppose takeover were “reasonable in relation to the threat posed” (Unocal v. Mesa Petroleum). The board must make such a determination, referred to as a “Unocal analysis,” if they are to be afforded the protection of the business judgment rule when faced with a takeover threat.

Shamrock’s argument was simple. The decision of Polaroid’s board could not be protected by the business judgment rule because, in approving the ESOP, the directors had breached their fiduciary duties.

The directors, charged Shamrock, were both uninformed and misinformed. They had not fulfilled their duty to consider “all material information reasonably available to them” (Aronson v. Lewis). In particular, the board approved a massive alteration of Polaroid’s capital structure without questioning management’s conclusion that the ESOP would enhance productivity. The board simply accepted this argument as valid, without subjecting it to any independent or expert examination. Also, the board was uninformed— or, rather, misinformed by Booth— with regard to the opposition of the employees to the pay cut. Shamrock, in its pre-trial memorandum, wrote, “We believe that the directors’ virtually unquestioning reliance on management’s conclusory recommendation to triple the size of the ESOP reflects a self-interested motivation to protect the
corporate ‘fiefdom’ they have shared with management for many years.’” Shamrock also argued that the board had approved the ESOP as a defensive measure yet failed to apply a Unocal analysis. Shamrock asserted, “Polaroid’s board cannot establish, as it must, (i) that the defensively oriented Lock-up ESOP was the product of a reasonable investigation into any perceived threat and (ii) that the Lock-up ESOP was itself a reasonable response to any such threat.” Polaroid’s actions, concluded Shamrock, “were certainly an unwarranted and unreasonable response to a request by a substantial shareholder to meet with management – a request conceded by Booth to be non-threatening and which in any event could not reasonably be perceived by anyone as any sort of threat at all.”

For these reasons, argued Shamrock, the decision to approve the ESOP could not be protected by the business judgment rule. The directors had breached their fiduciary duties in reaching their decision, so the ESOP should be invalidated by the court.

Polaroid argued, in Judge Berger’s words, that “The ESOP can withstand even the highest level of judicial scrutiny. That being so, it becomes irrelevant whether the ‘process’ was tainted, since the result is a plan that is entirely fair.” In other words, Polaroid asserted that the court should not worry about the means, given that the end result was a workable, effective ESOP.

**JUDGE BERGER’S RULING**

The judge first considered the question of the business judgment rule. Were the directors informed of “all material information”? Judge Berger concluded that the board did indeed act hastily, deciding to implement the ESOP after only two hours’ discussion in a meeting called at short notice, with no materials distributed beforehand, and at which three directors were absent: “There is no question but that the directors did not know all of the relevant facts.”

Judge Berger, however, sided here with the defendants, agreeing with them that “a board’s failure to become fully informed does not take its decision outside of the protection of the business judgment rule unless its lack of information was so extreme as to reflect gross negligence on the part of the directors.” Polaroid admitted that the directors were unaware of the opposition of the employee groups to the pay cuts, but said this was not crucial to the decision to enlarge the ESOP. The directors, after all, were hardly to assume that the employees would welcome a pay cut. Thus, the failure of the board to become informed on this point did not render them “grossly negligent.”

Next, Judge Berger considered whether Polaroid had responded inappropriately to the takeover threat, if indeed Shamrock’s advance constituted such a threat. Her opinion discussed some of the previous cases that had come to Delaware in which would-be acquirers had charged their targets with unfair defenses. She wrote: “However, none of those cases address the issue, arguably presented here, of whether a board, largely composed of disinterested directors, should be deemed to be acting from the same motives as the members of management who proposed the transaction.” In other words, what if management had enlarged the ESOP as an anti-takeover device, but the board had approved it for very different reasons, such as to enhance productivity?

In the end, Judge Berger decided that all these questions were irrelevant. “Neither a board’s failure to become adequately informed nor its failure to apply a Unocal analysis, where such an approach is required, will automatically invalidate the corporate transaction. Under either circumstance, the business judgment rule will not be applied and the transaction at issue will be scrutinized to determine whether it is entirely fair.” Thus Berger put aside the issue of whether the board’s decision-making process was tainted. She deemed that question secondary to that of
whether the approved ESOP was one that would benefit the company and its shareholders. The judge addressed this latter question along three lines:

1. Would the ESOP impair productivity?
2. Would it unduly discourage takeovers?
3. Would it unfairly dilute share value?

She answered “no” to all three questions. On the first question, Berger concluded that even if the 14 percent ESOP was not very popular with employees, it would be unlikely to impair productivity. Moreover, the costs of the ESOP would not be damaging to the company’s ability to operate.

As to the second question, the judge agreed that ESOP shares were more likely to be voted for incumbent management, but she pointed out that employees retained the right to vote their ESOP shares confidentially, and so were open to solicitation by an acquirer. She observed:

“I find that the anti-takeover aspect of the ESOP does not make it less than fair. Given its confidentiality provisions, it cannot be said that management controls the [ESOP share block, or] that the leg up it gives management in any way harms the company or its public stockholders. The ESOP may mean that a potential acquirer will have to gain the employees’ confidence and support in order to be successful in its takeover effort. However, there has been no showing that such support is or would be impossible to obtain.”

Lastly, she found dilution but dismissed its unfairness. Because the ESOP shares were issued by the company and not purchased on the open market, the interests of public stockholders were diluted. However, that, in her view, did not render the ESOP unfair. Berger decided that there was no hard evidence that the dilution would adversely affect Polaroid’s nonemployee shareholders. Indeed, she added that if the ESOP resulted (as hoped) in increased productivity, such dilution would be more than made up for by improved earnings.

Judge Berger wrapped up her opinion as follows:

“After considering all of the evidence, including the timing of the ESOP’s establishment, its structure and operation, its purposes and likely impact (both as a motivational device and an anti-takeover device), I am satisfied that the Polaroid ESOP is fundamentally fair. It is essentially stockholder neutral although it does have some dilutive effect. It is structurally fair in its voting and tendering provisions and I do not find either the timing of its implementation or its possible anti-takeover effect objectionable under the facts of this case....”
Shamrock did not abandon its bid. Rather, it appealed Berger’s decision. Let us look at Judge Berger’s decision in a broader context. What does this case tell us about the interrelationship of managers, the board of directors, shareholders, and employees? Who is entrusted with what, on behalf of whom?

It is universally accepted that the shareholders entrust the board to oversee management. Directors are entrusted with seeing that the corporation is managed in its own long-term interests.

*Did Judge Berger lose sight of this principle?*

The court accepted that the board was uninformed. Judge Berger wrote, “There is no question but that the directors did not know all of the relevant facts.”

*As a shareholder, would you expect the board that you elected to consider the reallocation of 14 percent of a company’s capital in a two-hour meeting, at which four directors were not present?*

*When Polaroid’s stockholders bought their shares, did they trust the company’s board to have a more thorough oversight of management than that?*

Judge Berger even concluded that the board accepted management’s recommendation for a 14 percent ESOP while approaching the question with a different set of assumptions. The judge wrote: “The evidence establishes that management was responding to a takeover threat. It is not as clear that the outside directors were operating in a defensive mode.”23 In other words, Judge Berger validated the board’s decision to approve the ESOP, even though that approval was granted without a full understanding of management’s motives for recommending the ESOP in the first place.

*Given the admitted failure of the board to inform itself of all the facts, or to inform themselves as to management’s motives, would you, as a Polaroid shareholder, continue to entrust those directors with the oversight of the company?*

Judge Berger decided that these questions did not need to be answered. Though she accepted that the board was uninformed, she did not believe that its lack of information was so extensive as to constitute gross negligence. Berger said that the information withheld from the board was relatively unimportant, and, while the board’s decision making was hasty, they had ended up, by hook or by crook, in approving a plan that was fundamentally fair.

Let us look a little more closely at the judge’s reasoning. On the one hand, the courts had to ensure that managers were accountable to shareholders and, on the other, they did not wish to chill management’s incentives for risk taking and innovation. The result was the business judgment rule’s emphasis on *process*. As long as directors made informed decisions with care and attention, the *results* would not be second-guessed.

In this case, however, Berger completely reversed this accepted principle. She judged that although the process was suspect, the end result was fair. In other words, if the process is fair,
but the end result is not, directors have the protection of the business judgment rule. Thus, if the process is not fair, but the end result is, the courts won’t oppose that decision making either.

*Who can lose, apart from the shareholders?*

There can be no doubt that Polaroid management and the board of directors faced a conflict of interest. A successful Shamrock bid, after all, would mean unemployment for the incumbents. As the judge in *Unocal* stated, there is the “omnipresent specter” that management and the board will act in their own interests when facing a possible takeover. According to many of the depositions in the case, at least one of the motives for the ESOP was to render the company less susceptible to takeover. It may not have been the leading motive (indeed, if it had been, the court would have no choice but to invalidate the ESOP, since Delaware directors aren’t allowed to issue new stock for defense purposes), but both Polaroid executives and directors admit that protection was among their motives for creating and enlarging the ESOP.

Given this fact, shouldn’t we subject their decision making to closer examination? Shouldn’t we require that the directors be even more rigorous in their analysis of the ESOP? Or should we agree with Judge Berger that it really doesn’t matter whether the board’s approval of the ESOP was hasty and uninformed, as long as the end result is fair?

This line of questioning leads to another: *Who gets the ultimate say over what constitutes fairness?* Shareholders own the corporation and they hire managers to run it for them. However, because shareholders are numerous and diverse, they elect a board of directors to oversee management on their behalf. The question is: who should protect the shareholders if the board is derelict in its duty? In this instance, Judge Berger decided she should. She argued that the directors had failed to exercise “business judgment” and thus “the transaction at issue will be scrutinized to determine whether it is entirely fair.” Judge Berger did such scrutinizing herself and decided to approve the transaction on behalf of the shareholders. *Could the shareholders decide that for themselves?* It would be a simple matter to explain the 14 percent ESOP in the proxy statement and put it to a vote at the annual meeting. We already know that one issue management discussed when they enlarged the ESOP was avoiding the 18.5 percent threshold that would need shareholder approval.

*Why was management afraid of seeking such approval? Can shareholders be trusted to act in their own best interests? Should crucial decisions relating to a company’s capital structure be left to a judge?*

What do you believe was the motivation behind the formation of the 14 percent employee stock ownership plan? Do you believe the decision to move from a 5 percent ESOP to a 14 percent ESOP was the result of Shamrock’s interest in the company? Do you believe the ESOP was created primarily in the employees’ interests, or to fend off a possible hostile bid?

Before the case reached the Delaware court of appeal, Polaroid pulled more tricks from out of the corporate sleeve. On January 29, the company announced a sweeping recapitalization. Polaroid said that it would spend up to $1.1 billion to buy back up to 22 percent of its stock at $50 a share and that a special issue of preferred stock would be issued to Corporate Partners, an investment concern run by the Wall Street firm Lazard Freres. The issue, for which Corporate Partners would pay $300 million, would be convertible into 10 percent of the common stock.
Polaroid argued that the recapitalization plan represented a better means of realizing shareholder value than the Shamrock offer. Shearson issued an opinion to this effect, based on an estimated $1.2 billion recovery in the Kodak litigation and on management’s financial projections, which assumed growth of about 10 percent over historical results. If such sales growth was achieved, Polaroid would be close to the top of the Fortune 500 list.

In a press release, Booth described the recapitalization as “a program designed to deliver directly to shareholders a portion of the company’s current value while enhancing Polaroid’s prospects for future growth in shareholder value.”

Shamrock put a rather different spin on the announcement. Gold described the recapitalization as “irresponsible and another indication of management entrenchment at any cost . . . . [The moves serve] no discernible business purpose.” Gold continued:

> The placement of preferred stock, together with the proposed stock buy-back program, is clearly a defensive action designed to park even more Polaroid shares in ‘friendly hands’ at the expense of Polaroid’s public shareholders . . . . Polaroid’s thinly veiled effort to ‘stuff’ the ballot box in anticipation of its annual meeting vividly demonstrates that Polaroid management is more interested in preserving its position than allowing Polaroid shareholders an opportunity to receive at least $45 per share in cash for all their shares, pursuant to Shamrock’s offer.

In a reprise of the ongoing legal battle over the ESOP, Shamrock announced that it would sue Polaroid and Corporate Partners in the Delaware courts, asserting that the recapitalization plan was adopted to thwart Shamrock’s takeover, and not with any valid business purpose in mind. This case has come to be known as “Polaroid II” – the sequel to the case decided by Judge Berger discussed above.

Days later, Shamrock announced that it would seek control of the company via a proxy fight. That is, Shamrock would nominate its own slate of directors and seek to have them elected in the place of management’s slate at the annual meeting. Even this looked like a vain bid by the California-based acquirer. The effect of the ESOP, the buyback, and the Corporate Partners deal was to put about 30 percent of Polaroid’s stock in management-friendly hands – almost overwhelming opposition.

The viability of Shamrock’s bid now rested with the Delaware Supreme Court, which was reviewing Berger’s judgment on appeal. On March 23, the court upheld Berger and let Polaroid’s ESOP stand. Four days later, Shamrock announced that it was abandoning its nearly year-long interest in Polaroid and was calling off its proxy fight. “We are disappointed and frustrated by the Delaware courts,” said Gold.24 In a settlement deal between Shamrock and Polaroid, the photographic company agreed to repay Shamrock’s expenses to the tune of $20 million, as well as buy $5 million in advertising time on Shamrock’s radio and TV stations. In return, Shamrock agreed not to seek control of the company for a period of ten years. In 2001, Polaroid filed for bankruptcy. Top executives received large bonuses but employees and shareholders were left with nothing. Was this the result of management entrenchment that included the defense against Shamrock?

**NOTES**

1. All the information for this case study has, unless cited otherwise, been drawn from relevant court documents. See *Shamrock Holdings v. Polaroid Corp.*, Del. Ch., Civil Action Nos. 10,075
and 10,079, Berger, V.C. (Jan. 6, 1989). Also see “Polaroid II,” a complaint by Shamrock and a purported class of Polaroid stockholders against Polaroid, its directors and Corporate Partners, L.P.

2. See Plaintiff’s pretrial memorandum, p. 35.


4. Ibid., p. 11.

5. Ibid., p. 13.

6. Plaintiff’s pretrial memorandum, p. 35.

7. Ibid., p. 20.

8. Ibid.


10. Ibid., p. 24.


12. Ibid., p. 96.

13. Ibid.


16. Ibid., p. 33.

17. Ibid.

18. Ibid., p. 35.

19. Ibid., p. 36.

20. Ibid., p. 44.


22. Ibid., p. 49.

23. Ibid., p. 35.

Carter Hawley Hale

In 1984, Carter Hawley Hale stores (CHH) was the largest retailing chain on the West coast and sixth largest in the country. Based in Los Angeles, its nationwide empire stretched from trendy LA bargain basements to tiny Fifth Avenue boutiques, with a bookstore chain in between. Operating under the CHH flag were Bergdorf-Goodman, The Broadway, Contempo Casuals, Emporium-Capwell, Hole Renfrew, Neiman-Marcus, Thalimers, Walden Books, John Wanamaker, and Weinstock’s.

The chief executive of this diverse conglomerate since 1973 was Philip M. Hawley. He had led the company on an ambitious acquisition drive, increasing revenue threefold.

Despite the strength of the company’s franchise, however, there was a widespread belief that weak management was dragging down the company’s earnings, reflected in Wall Street’s favorite saying about the company: “God gave them Southern California and they blew it.” Hawley’s acquisition program had resulted in enormous growth in sales, but not in profits. The company’s net earnings had barely grown in the ten years of Hawley’s stewardship.

Not all was wrong in the Hawley empire. The specialty stores division, especially its Contempo Casuals, was performing superbly. The big department stores, however, including The Broadway and Emporium-Capwell, continued to show marginal returns.

The company’s sluggish growth was reflected in its stock price. CHH did not keep pace with the explosive growth of the rest of the market during the early 1980s and hovered around $20–$25 a share. However, the stock carried a healthy dividend of $1.22, prompting Barron’s writer Benjamin J. Stein to comment: “Some investors viewed CHH common as a sort of bond with no redemption date and carrying no say in the affairs of the company.”

HOSTILE TAKEOVER

On April 3, 1984, CHH’s management received an unsolicited bid to take over the company. The would-be buyer was The Limited, Inc., an aggressive Ohio-based retailer led by billionaire Leslie Wexner. The Limited offered $30 a share (a premium of nearly 50 percent over the pre-bid price) for 56 percent of CHH’s shares, and then a package of Limited shares worth about $30 per CHH share for the remainder.

CHH responded with vigorous defiance. Management wasn’t giving up without a fight.

The first step taken by CHH was a rapid repurchase of its own stock. The admitted aim was to buy up sufficient shares to prevent The Limited from acquiring a dominant position. CHH’s stock climbed higher and higher as the company repurchased nearly 18 million shares within a week.

The second part of the strategy was to bring in a so-called “white knight.” By persuading a friendly third party to buy a large position, CHH could keep stock out of The Limited’s hands. General Cinema, one of CHH’s largest shareholders and headed by Richard A. Smith, agreed to buy a special issue of preferred stock for $300 million. The shares carried preferential voting rights,
giving Smith 37 percent of the voting power for a much smaller fraction of the stock. The stock paid a guaranteed dividend of 13 percent, at a post-tax cost to CHH of about $39 million a year. Lastly, Smith was offered an option to buy Walden Books (probably CHH’s most profitable asset) at a discount. In exchange for this deal, Smith agreed to vote his stock in line with the recommendations of a majority of the CHH board of directors.

The Limited responded to CHH’s defensive measures by raising its offer to $35 a share, roughly a 75 percent increase on CHH’s pre-bid trading price.

The General Cinema deal did not guarantee CHH its independence, however. The crucial chunk of stock – which could decide the takeover battle one way or the other – was in the hands of the employees.

For some years, CHH had run an employees’ profit-sharing plan, structured as a 401(k). While most 401(k) plans allow employees to choose between a variety of investment options, the CHH plan purchased only the company’s stock. On retirement, employees could claim the stock they had collected over the years or the cash equivalent. Thus, employees who saved under the plan relied entirely on the good performance of the company’s stock for the growth of their savings. The plan involved over 20 percent of the company’s 56,000 employees and some 6.5 million CHH shares. Prior to The Limited’s bid, these shares accounted for 18 percent of CHH’s outstanding shares. Following the repurchase effort, this figure rose to 39 percent of the total, though the plan’s shares represented only 23 percent of the voting power owing to the issue of the preferred stock to General Cinema. The size of the plan gave it a virtually decisive say in the takeover battle. If The Limited could persuade CHH employees to vote against incumbent management, its bid would almost certainly succeed.

This left a possible divergence of interests between the members of the plan and the senior managers of the company. Employees stood to make an instant 75 percent gain on their 401(k) savings if they tendered their shares to The Limited and the bid succeeded. From the executives’ point of view, however, a successful Limited bid meant losing their jobs – Wexner would certainly replace top management if he won control of the company. Thus, while it might be in the employees’ interests to tender their shares, it was in the interests of CHH executives to see that they didn’t.

THE ROLE OF BANK OF AMERICA

The duty of resolving this dichotomy was left to the trustee of the profit-sharing plan, Bank of America. Under the Employee Retirement Income Security Act (ERISA), the trustees of such a plan must see that the plan’s assets are managed “solely in the interest of the participants and beneficiaries” and with “complete and undivided loyalty” to them.

To this end, a trustee must not have any conflict of interest in administering the plan or act in any transaction involving a conflict of interest.

*Did Bank of America have a conflict of interest in dealing with the stock of the profit-sharing plan?*

- The Bank agreed to be the lead lender to the CHH takeover defense. It arranged a $900 million line of credit to CHH, pledging the largest single share of $90 million. Much of this money was used to repurchase CHH shares. For this service, Bank of America received an initial fee of $500,000.
Before The Limited announced that CHH was the target of its tender offer, Bank of America had agreed to commit $75 million to The Limited for use in an unspecified acquisition. When it became known that CHH was the target, it withdrew from this arrangement.

Hawley sat on the Bank of America’s board of directors, was a member of the executive committee, and chairman of the compensation committee. He had held those positions for nearly a decade.

For years, the bank had been CHH’s most important lender. At the time of The Limited’s bid, it had loans outstanding of over $57 million and lines of credit of $15 million.

Following the announcement of The Limited’s bid, the Bank of America revised these loan agreements so that if a majority of CHH’s board of directors was replaced, the loans would automatically be in default. Were The Limited’s bid to succeed, the Bank could, at least theoretically, step in and instantly repossess CHH assets.

Stein wrote in Barron’s: “Bank of America was supposed to administer the plan according to the sole interests of the stockholder-employees. But it was simultaneously in the active, highly paid service of CHH management with a life or death interest in seeing that the shares of the plan were voted against the tender offer.”

Do you agree with this comment?

The possibility of a conflict of interest between the company’s management and the plan’s trustees at the bank had been addressed when the CHH profit-sharing plan was first created. The trust agreement, signed in 1971, included a “pass-through” provision that would come into effect if CHH were ever subject to an unsolicited takeover bid. In that situation, Bank of America would inform the plan participants of the terms of the offer and allow them to vote their shares in confidence.

Despite the terms of the pass-through, the bank still had two responsibilities under ERISA. First, it had to explain fully to employees the terms of the offer, to ensure that they made an informed choice. Second, it had a duty to ensure that employees made an independent choice, free from any coercion from management to vote their way.

The pass-through was designed to achieve both these ends in a hostile bid situation. Under the terms of the provision, the bank would inform employees of the terms of the bid and individuals would then instruct the bank how to vote the shares in their accounts. If employees representing more than 50 percent of the plan’s stock instructed the bank to sell the stock in their accounts, then it was to tender all the stock held by the plan. Otherwise, none of the stock was to be tendered.

The pass-through received its first test when The Limited made its bid. No sooner had the offer been made, however, than the terms of the provision were radically changed. Under the new terms, CHH’s employee-shareholders were given four choices:

1. to tender all the shares in their account but only if plan participants representing a majority of the plan’s shares chose to tender;
2. not to tender their shares unless the majority voted to tender;
3. not to tender their shares, the votes of the majority notwithstanding; and
4. to tender their shares, the votes of the majority notwithstanding.

Letters were sent to employees explaining these choices. The letter stated that if plan participants chose either of the last two options, the bank would be unable to preserve the confidentiality
of that vote. In other words, if a CHH employee voted to tender to The Limited (essentially a vote against management), CHH management would know that he or she had done so. This was because the plan participants’ account records were maintained by CHH, not by the bank.

The bank’s instructions added that, under the new provisions, any shares for which no voting instructions were received would automatically be voted according to the second option – not to tender unless a majority did so.

All of the plan’s assets were ultimately distributed to individual accounts maintained for participants. At any given time, however, the plan owned a big chunk of unallocated stock because shares acquired during the course of a year were not distributed to individual accounts until the year’s end. At the time of The Limited’s bid, there were 800,000 such shares, or 11.4 percent of the total plan. The bank announced that these shares would be voted in line with the voting instructions received from a majority of the plan’s shares.

*Did the bank act in the interests of CHH senior management or the plan participants? Did the bank fulfill its ERISA requirement to act with “complete and undivided loyalty” to the beneficiaries? Did the fact that management knew how an employee voted constitute coercion?*

**THE DEPARTMENT OF LABOR TAKES NOTE**

These were some of the questions raised by the federal agency charged with overseeing ERISA funds, the Pension and Welfare Benefits Administration (PWBA), a branch of the Department of Labor (DOL). The PWBA was then headed by one of the authors of this book, Robert A.G. Monks. On April 30, 1984, Monks wrote to the law firm representing Bank of America to inform them of PWBA’s interest in the case. The letter strongly suggested that if Bank of America did not alter some of the terms of the pass-through (such as the provision to vote all unallocated shares against the tender if a majority so voted), then the Bank would be in violation of its fiduciary duties under ERISA.

The DOL’s warning was just one of several regulatory and legal challenges filed against CHH and Bank of America.

- A single employee of CHH launched a suit against Bank of America, charging misadministration of the profit plan.
- The SEC sued CHH, on the basis that the giant buyback of stock constituted an illegal tender offer.
- The New York Stock Exchange (NYSE) threatened CHH with delisting because the issue of preferred stock to General Cinema, and the massive dilution that resulted, had been consummated without shareholder approval.

The DOL concluded that the amended pass-through was insufficient in protecting employees’ independence and prepared a suit charging violations of ERISA. The *New York Times* commented: “Analysts yesterday said they found it remarkable that Carter Hawley had managed to run afoul of the SEC, the stock exchange and possibly the Labor Department, considering the caliber of its legal and investment advisers.” CHH had hired the New York firm Skadden, Arps, Meagher and Flom as counsel and Morgan Stanley as investment adviser.
One by one, CHH dodged the bullets. The NYSE reached an agreement with the company under which CHH shareholders would get their chance to vote on the General Cinema issue in the summer. Soon after that settlement, a Los Angeles court ruled that the SEC’s case was without merit. Less than a week later, a second LA court dismissed the employee’s suit. The judge agreed with Bank of America’s argument that there was no connection between the bank’s trust department that administered the plan and the commercial department that arranged loans to CHH for its takeover defense.

The DOL, however, broke ranks. In a draft complaint prepared by PWBA, the DOL charged that, under ERISA, “participants must be given a free choice, monitored by an entirely neutral trustee.” The complaint argued that Bank of America had broken this guideline in two respects:

1. The pass-through provision, as amended, did not leave employees with an uncoerced, free choice.
2. Bank of America had a conflict of interest in connection with the outcome of the tender offer that precluded it from acting as an impartial plan trustee.

In connection with the second argument, the DOL demanded that the court appoint an independent fiduciary to oversee the tendering process of the plan’s stock.

Several aspects of the new pass-through worried the DOL. First, DOL officials decried the fact that nonresponses, and the 18,000 unallocated shares, would be treated as votes not to tender, unless a majority voted in favor of tendering. Second, they objected to the option that allowed employees’ votes to be reversed depending on the choice of the majority. Third, they noted with concern that Bank of America had not guaranteed the confidentiality of employees’ votes.

ERISA imposes rigorous fiduciary duties on plan trustees, who must manage the plan’s assets with “care, skill, prudence, and diligence.” This includes voting the plan’s shares. Where Bank of America had received no direction from individuals as to how to vote the shares — whether because the shares were unallocated or because the individual concerned had not responded — the bank, argued the DOL, had a fiduciary duty to make a reasoned, independent decision about how to vote. The bank could not simply abrogate this fiduciary duty by lumping all the shares together under a decision not to tender. The complaint argued, “The trustee must reach an independent fiduciary decision as to whether to tender shares for which proper directions are not received.”

The complaint also contended that there was an ERISA violation in the option that allowed employees to vote a certain way, depending on the decision of the majority. Under ERISA, there were only two groups that could lawfully make investment decisions about the shares in the CHH profit sharing plan — Bank of America, as the plan trustee with a fiduciary responsibility to the participants, and the participants themselves, as the “named fiduciary.” However, two of the options on the voting card allowed for the possibility of an employee’s vote being reversed if his/her choice was in the minority. Thus, the responsibility for the outcome of the vote lay with “the majority” of the employee shareholders, a group with no fiduciary responsibility to either the plan or its participants.

The DOL’s brief also challenged the lack of confidentiality in the voting procedure, particularly the fact that an employee who wished to tender his shares could not do so without management knowing: “A trustee could not be considered to have fully discharged its responsibility to make sure that participants’ directions are proper unless it takes all available steps to preserve the confidentiality of their choices and makes reasonable efforts to assure that the directions are not the result of pressure or coercion.”
The DOL's case included a broader criticism. Given that the pass-through, in the DOL's opinion, was insufficiently protective of employees' independence, the fiduciary responsibility for the CHH plan remained with Bank of America. As the plan trustee, the bank was ultimately responsible for seeing that the administration of the plan conformed with ERISA. The DOL alleged that the bank, due to multiple conflicts of interest, was incapable of fulfilling this role. The bank could not possibly act with complete objectivity to the tender offer, given its intimate connections with one of the parties concerned: "Rather than serving as a fiduciary protector of the participants, the Bank here has already aligned itself with CHH as the lead lender to the CHH takeover defense, thus presenting not only a conflict of interest in fact and law, but a necessary perception in the minds of the participants that the trustee is acting in league with their employer."

The DOL argued that there were numerous legal precedents for a plan trustee to step aside. The complaint referred to one Supreme Court opinion that said the chief purpose of ERISA's fiduciary provisions is "to prevent a trustee from being put in a position where he has dual loyalties, and, therefore ... cannot act exclusively for the benefit of a plan's participants and beneficiaries." The DOL's complaint cited a case argued before the US Court of Appeals in which the court stated: "As a practical matter we view favorably the suggestion ... that the preferred course of action for a fiduciary of a plan holding or acquiring stock of a target, who is also an officer, director or employee of a party-in-interest seeking to acquire or retain control, is to resign and clear the way for the appointment of a genuinely neutral trustee to manage the assets involved in the control contest."

The DOL complaint never got beyond its draft stage. The DOL was instructed by the Department of Justice (DOJ) to drop its suit. It was government policy that any suit brought by any part of the federal government had to be approved by the DOJ – and the DOJ put an end to this one.

Why was the DOJ so concerned? In a statement to Stein, Michael Horowitz, general counsel at the department, said the matter was purely one of government intervention: "We were concerned that a part of the government seemed to be expanding its role through litigation and we did not want any part of the government making policy through litigation. Our feeling was in no way related to the personalities involved or even the dollars involved."

Stein questioned whether the decision was a little more political than that. The US attorney-general at this time was William French Smith, a California lawyer and a long-time friend of Phil Hawley. Smith had served on various corporate and nonprofit boards alongside Hawley. Stein also noted that Smith's office, along with the White House and Federal Trade Commission, had been lobbied hard by the Californian congressional delegation. Over three-fifths of California's representatives had gathered at a press conference, pledging their support for an independent CHH. They were joined by Tom Bradley, mayor of Los Angeles, and many other Californian public officials. Stein verified that Bradley, among other CHH supporters, had received contributions from the CHH political action committee.

The DOL dropped its suit, as ordered. Each of the three legal suits, as well as NYSE's threatened delisting, had now collapsed. Within days of the May 1984 dismissal of the employee's suit, The Limited dropped its tender offer. Wexner stated that he would seek other ways to gain control of CHH.

The CHH stock, which had been run up into the $30 range by arbitrageurs and speculators, quickly dropped back to the low twenties.

1984 was not a great year for CHH. Depressed by the cost of defending itself against The Limited, earnings fell to half their 1983 figure. CHH struggled to pay the guaranteed 13 percent dividend to General Cinema for its preferred stock, while finding enough left over to pay dividends
on the common. Despite slightly better performance in 1985, Standard & Poor’s placed CHH on credit watch in March 1986.

THE LIMITED ATTACKS AGAIN

In November 1986, The Limited formed a special acquiring group called Retail Partners with real-estate developer Edward J. DeBartolo. Together, they made a second bid for CHH, offering $55 a share. The pre-bid trading price of CHH was $35–$40. Stein notes that The Limited had doubled in size since its 1984 bid and reported earnings were about four times those of CHH on 40 percent less sales.14

CHH faced up to the second battle in much the same shape as it had fought the first. General Cinema held more stock than it had before, but its voting rights were limited to 39 percent. The employee profit-sharing plan owned about 20 percent of CHH. Again, these would be the two crucial elements of CHH’s defense.

Richard Smith, head of General Cinema, announced that he was not adamantly against the idea of tendering his shares to The Limited, but that he considered $55 too low. Believing that Smith could be persuaded to tender at a higher price, Retail Partners raised their offer to $60 a share.

Meanwhile, Bank of America had put new procedures in place in the event of a tender offer.

- Employees could request information about the tender and, if they wished to vote, could apply for their share certificates and vote the shares themselves, rather than issuing instructions for the trustee to vote for them.
- If an employee didn’t request his or her certificates, however, the shares would automatically be voted against the tender.

The new procedures were hardly a step in the direction of confidentiality, since the only reason an employee would apply for his share certificates would be to vote for the tender. The records of employee shareholding were still at CHH headquarters, so management would know exactly which employees had requested their shares and might be considering a vote for Wexner.

Not only were the new Bank of America voting procedures transparent, they were moot. Even if an employee decided to tender his shares, it was impossible to do so. Employees were informed that it would take six to eight weeks for their certificates to arrive, if requested. Retail Partners’ offer expired in five weeks.

On December 8, 1986, CHH announced that it was rejecting the $60 bid in the light of a widespread restructuring of the company. Morgan Stanley issued a fairness opinion saying that the restructuring was a much better choice for shareholders than the inadequate Limited offer. It was later asserted that such a restructuring had been under consideration since October 1986, just before The Limited’s second bid.

The restructuring, if approved, would split CHH into two new companies. Each would carry a separate stock. One company, still called Carter Hawley Hale, would consist of department store operations, including Broadway, Thalimers, and Weinstock’s. The second company, called The Neiman-Marcus Group Inc., would consist of the specialty stores: Contempo Casuals, Neiman-Marcus, and Bergdorf Goodman.

Stockholders, including employee-shareholders, would receive the following for every share of CHH they owned:
• one share of the department store company;
• one share of The Neiman-Marcus Group;
• a one-time payout of $17, which could be converted into further shares of CHH and Neiman-Marcus.

Under the restructuring, General Cinema would end up with a huge interest in The Neiman-Marcus Group, while CHH would be owned by its employees. Top management would convert its $17 a share payout and its outstanding stock options into a 22 percent holding of the department store company—a massive holding compared with the less than 1 percent that management owned of the unstructured CHH. The employee plan would own a further 23 percent.

The net effect was to insulate CHH from any hostile takeover attempt and to give the employees a huge stake in the company. In Phil Hawley’s words to Women’s Wear Daily: “The big story, and you can forget all this other stuff—the big story is that we are the first major retailer owned by the people who work for it.… All of a sudden we have 12,000 entrepreneurs.”15 The restructuring was announced to shareholders in the form of a 400-page proxy statement and prospectus. The proxy stated that the board had unanimously approved the restructuring and asked shareholders to ratify it. The restructuring contained some amendments to CHH’s certificate of incorporation. These included:

• the division of the CHH board into three classes;
• elimination of directors’ liability in future damages if claimed as a result of any breach of their fiduciary duty of care;
• elimination of the ability of stockholders to call a special meeting of stockholders or to take any action by less than unanimous written consent;
• a shareholder rights plan, or “poison pill,” that would kick into effect if any person acquired 20 percent of the company’s shares.

The proxy admitted, “Certain of the amendments to the Company’s certificate of incorporation … may make more difficult or discourage the removal of company management … and may make more difficult, if not impossible, certain mergers, tender offers or other future takeover attempts.”

The proxy warned that the restructuring would “include an immediate change in the Department Store Company’s capitalization to one that is highly leveraged,” since the department store half of CHH would assume the debt burden of the entire company. The proxy disclosed the fact that shareholders faced “the prospect that no dividends will be paid to holders of the Department Shares for the foreseeable future.” Finally, the proxy said that paying for the $17-per-share distribution, and financing the restructuring, would cost over $1 billion.

The proxy predicted a bright financial future for the department store company. Sales were expected to rise from $2.7 billion in 1988 to $3.2 billion in 1991. Earnings per share were expected to rise from $1.41 in 1988, to $3.2 in 1990, and to $4.51 in 1991. As Stein comments, “These projections were provided, with the straight face that only a financial document can offer, as ‘in line with recent results’… results had never shown such dramatic improvement, except over periods of less than three quarters.”16 Stein also pointed out the fantastic fees that would be paid to Morgan Stanley for their part in the restructuring. The investment banking firm received a basic fee of $24.375 million, though its involvement in the placement of the securities associated with the restructuring would take the overall fee to over $43 million.17 This figure is substantially greater than CHH’s own estimate of its 1988 earnings of $32 million.
Shortly after the announcement of the restructuring, The Limited and Edward DeBartolo withdrew their offer. The ownership structures of the two companies under the restructuring made a takeover impossible without the cooperation of either management or the board of CHH. It was clear to Retail Partners that neither would be forthcoming.

**AFTER THE RESTRUCTURING**

How did Hawley’s “12,000 entrepreneurs” fare as a result of this shake-up? At first, the employee-shareholders appeared to have made out like bandits. CHH stock reached a peak of nearly $80 during the period following The Limited’s bid and continued to trade at roughly the $60 price Wexner had offered. Stein, in his May 1987 article, concluded: “Considering the current share prices, the CHH story could have come out a lot worse than it did.”

*Baron’s* later admitted it was wrong — as far as the shareholders were concerned, the CHH story came out just about as badly as it possibly could have. In the months following their approval of the restructuring, CHH’s shareholders witnessed the freefall of their shares. By the end of 1987, CHH’s stock had plunged to around $10.

Moreover, over the next four years the company manifestly failed to live up to the projections provided in the 1987 restructuring prospectus. That prospectus had predicted that net earnings would reach $85 million for the year ended July 31, 1990. Instead, the company reported a $26 million loss in that year. In other words, the company lost $1.03 a share, compared with its 1987 prediction that it would earn $3.25 per share in 1990. Meanwhile, the stock continued on its downward spiral, reaching a low of less than $5 a share in late 1990. The company filed for Chapter 11 bankruptcy protection on February 11, 1991.

Employee-shareholders went down with the ship. Because the CHH plan was a profit-sharing plan, not an employees’ retirement fund, the plan trustee was not obliged by ERISA to diversify employee holdings. That is, Bank of America was merely charged with acquiring CHH stock on behalf of the plan, not ensuring that they had a diversified, less risky portfolio. The result was that Bank of America had continued to buy CHH stock on behalf of the plan, even up to a week before the Chapter 11 filing.

Employee-shareholders experienced a devastating reduction in the value of their plan accounts. *Baron’s* described one employee, Bill Fiore, who had contributed $8,000 to the plan over 13 years. His contribution was now worth less than $2,000.

*The Wall Street Journal* interviewed Shirley J. Miner, an employee of 26 years standing, who had expected her contributions to have grown to $80,000. On retirement, she found that her account was worth just $15,000.

What did the 12,000 employee-shareholders now own?

- One CHH share, trading at about $2 in the months following the Chapter 11 filing.
- One Neiman-Marcus share, received at the time of the restructuring. Following the spin-off, Neiman-Marcus stock traded at highs of up to $45. By the time of CHH’s bankruptcy filing, it had dropped to around $17.
- The $17-a-share special payout.

So the shares in the plan, for which Wexner had offered $60 in 1986, were worth about $36 four years later.
This loss in value did not go unnoticed in the press. Rising to his company’s defense, Hawley told the *Journal* that the plan accounts were not “retirement savings.” 22 Strictly speaking, this was true – CHH’s 401(k) scheme merely allowed employees to share in the company’s profits. As such, employees could decide whether to contribute up to 12 percent of salary for the purchase of CHH stock or keep the extra cash and make their own investment decisions. CHH employees, however, charged that the choice was not that simple. Employees told the press that they were pressured into contributing a full 12 percent to the plan, for fear of seeming uncommitted to the welfare of the company. Bill Fiore told *Barron’s*, “It was common knowledge that if you were thinking of going into management, you’d better have your 12 percent in or you weren’t going anywhere.” 23 Ms. Miner told the *Journal* that she felt she had “no choice” but to convert her $17-per-share payout at the time of the restructuring (worth $23,000) into further CHH and Neiman-Marcus shares: “I feared being labeled as disloyal.” 24 Employees must have wondered why they hadn’t realized an instant 75 percent gain on their shares by tendering to Wexner in 1984 or accepted $60 dollars a share in 1986. Of course, if either of those bids had been successful, Hawley and his management team would have lost their jobs.

**Whom did the profit-sharing plan serve?**

**To what lengths should incumbent managers be allowed to go to protect their company from takeover? Did Phil Hawley go too far?**

**Does this case study present a “free market” for corporate control? Should takeovers be encouraged or discouraged? Would your answer change if you knew that The Limited also suffered from years of poor performance following its attempted takeover of CHH?**

**Were the employee-shareholders of CHH genuine shareholders? Were they genuine stakeholders? How might their interests be protected?**

**Is employee ownership in the best interests of good corporate performance?**

**What role did Bank of America play in fending off The Limited? What role should it have played?**

**NOTES**

2. Ibid.
7. Ibid., p. 4.
10. Stein, “A Saga of Shareholder Neglect.”
11. Ibid.
12. Ibid.
13. Ibid.
14. Ibid.
17. Ibid.
18. Ibid.
20. Ibid.
22. Ibid.
Eastman Kodak

The following report is a study prepared by Lens Inc., an investment management firm in which both authors of this book were principals. This study shows how informed and involved shareholders may add value to their target companies.

JULY 1992 (STOCK PRICE, 7/1/92: $40.50)

Eastman Kodak was first selected as a Lens “focus” company. Kodak was unnecessarily diversified into non-value-adding businesses, with a record of long-term under-performance. Kodak’s problems included:

- **Debt.** Kodak’s balance sheet has deteriorated seriously over the last ten years. As of late 1992, Kodak’s total debt stood at $10.3 billion, having doubled since 1988. The ratio of debt to total capital was nearly 60 percent.
- **Unrelated diversification.** The $5.1 billion acquisition of Sterling Drug in 1988 has never produced the anticipated returns. Analysts speculated that the money-losing copier division could also be sold.
- **Long-term under-performance in its core businesses.** According to *Business Week*, “The company angered Wall Street by assuming that the slowdown in its core photographic market in the 1980s was only temporary. Its cost structure was predicated on a return to growth that never materialized.” Contrary to analysts’ predictions, Kodak assumed growth in its core photo business of 6–8 percent. Actual growth was nearer 2–4 percent.
- **Poor long-term strategy.** Since 1982, Eastman Kodak has undertaken four separate restructurings, including billions of dollars in write-offs. Yet (according to a PaineWebber market analyst) the company has under-performed the S&P 500 index by 200 percent since 1982. During the last decade, sales growth has been at an annual rate of 6.7 percent, but earnings, which in former times were running around $3.00 per share, had dropped to virtually break-even in 1991. Over the last four years Kodak has spent $5.2 billion on R&D and has made $8.2 billion of capital expenditures. Long-term debt increased $5.2 billion, total debt $6.1 billion, and shareholders’ equity rose by less than $100 million. Management has not been able to convert massive expenditures into additional value for shareholders, despite the several restructurings.

AUGUST 1992 (STOCK PRICE, 8/3/92: $43.37)

Lens principal Robert A.G. Monks wrote to Kodak’s CEO, Kay R. Whitmore, identifying Kodak as a company where the involvement of credible shareholders could add value. Monks wrote:

> In *Eastman Kodak’s 1991 Annual Report* you [Mr. Whitmore] describe the company’s underlying precepts: ‘We will not participate in a market or enter into a business simply
because we possess the technical competence to do so. Our goal is the number one or number two positions in markets where rates of return consistently exceed the cost of capital. It is not apparent that Eastman Kodak’s position in chemicals, drugs, or copying is at the top of their respective industries; nor is there indication of progress towards that goal in the performance of recent years; it is clear however that the rates of return achieved are not among the leaders . . . Kodak still has the dominant position in photographic markets throughout the world, but competition is growing. Is it better able to confront its formidable competitors in that field as a diversified conglomerate or through the focused creation of a competitive corporate culture?

NOVEMBER 1992 (STOCK PRICE, 11/2/92: $41.37)

Three Lens Principals met with CEO Kay Whitmore and other senior managers to discuss Kodak’s competitive position. Both sides agreed that the meeting was frank and constructive. In a letter following the meeting, Lens outlined its specific concerns with the company’s strategic direction:

“"The financial results of Eastman Kodak in recent years could objectively indicate to an outsider that management has:

- followed a policy of building an empire measured only by gross size;
- thrown larger and larger amounts of money at Kodak’s core problem — competition for market share — seemingly without a strategy;
- invested heavily in diversification in an attempt to sustain corporate growth and restore shrinking margins; and
- allowed the development of a vast bureaucracy.

Kodak’s diversification efforts have been generally unsuccessful to date. Cost of acquisitions, and of the huge research programs and capital budgets, have been financed by a nearly five-fold increase in debt, while shareholders’ equity has remained flat. Growth has remained slow, and margins have fallen drastically, Management has taken six special write-offs, totaling $4.7 billion, in less than eight years, with little or no improvement in margins.

The letter was accompanied by a detailed financial plan (available on request) outlining a six-point plan for improved shareholder value:

1. increasing the realization on assets and sales;
2. resuming earnings growth;
3. shifting the usage of cash flow to reduce debt and allow dividend increases as soon as prudently possible;
4. restoring the company’s financial strength by reducing debt;
5. focusing the attention and energies of the board and the management on Kodak’s core business; and
6. distributing unrelated assets to Kodak shareholders.

The plan also recommended some “governance reforms” to create a constructive relationship between the managers and owners of Eastman Kodak. The recommendations were to:

- introduce confidential voting;
- end the system of staggered board elections to provide for the annual election of all directors;
- improve the ratio of insiders to outsiders to provide for a genuinely independent board; and
- separate the positions of chairman and CEO.

Finally, the letter said that Lens would be filing a shareholder resolution at the Eastman Kodak 1993 Annual Meeting. The resolution proposed a bylaw amendment to create an advisory committee of the company’s largest, long-term shareholders.

**JANUARY 1993 (STOCK PRICE, 12/31/92: $40.50)**

Kodak’s management took a series of steps that demonstrated a new commitment to the company’s owners. *Business Week* wrote: “Insiders say Kodak Chairman Kay R. Whitmore has concluded that only radical surgery can rescue the company . . . ‘Shareholders have been the most underserved of our constituents’ he confesses.” The new measures included:

- *The appointment of a new chief financial officer, Christopher J. Steffen.* Steffen came to Kodak in January 1993, having helped create successful turnarounds at Chrysler and Honeywell. Significantly, Kodak broke its traditional rule of promoting insiders, Steffen being the highest ranking outsider appointed since 1912. His recruitment was greeted enthusiastically – Kodak’s stock improved 17 percent in a matter of days. *Business Week* dubbed Steffen the “$2 billion man” for his contribution to the company’s market value.

- *An overhaul of the core imaging business.* In a letter to Monks, Whitmore described the strategy as “an aggressive action plan . . . which is quite consistent with much of what we discussed when you visited with us last November here in Rochester.” The strategy was based on an admission that growth in imaging would be a sluggish 2–4 percent and that cash flow would have to be increased in other ways. To this end, Kodak announced it was cutting R&D spending, revamping overseas operations, and paring some 2,000 employees from its Rochester headquarters. These measures were expected to lower net costs by over $200 million a year. The plan received widespread approval: “It’s a belated recognition that Kodak is no longer growing its core business,” said Eugene Glazer of Dean Witter. “This is a business strategy that really fits with reality,” said PaineWebber’s Kimberly Retrievi.¹

- *A new compensation plan for senior executives.* The plan requires 40 top managers to buy stock in the company equal to 1–4 times their current salary. Whitmore personally pledged himself to achieving holdings of four times his current salary, or $3.8 million, within five years. The plan was applauded by investors across the board. “There’s nothing that gets management thinking like a shareholder like being a shareholder,” said Lens principal Nell Minow.²

- *A new Corporate Directions Committee.* The committee will consist solely of outside directors and has a straightforward charter: “to assess Kodak’s competitive position and develop plans to increase shareowner value.”
A new long-term strategy. Two weeks after his appointment as CFO, Steffen said that he expected to have a business plan ready in about six months. He intends to cut the debt:capital ratio from its current 59 percent to around 30–40 percent, and said he would not rule out asset sales to achieve that goal. The stock jumped a further $2.63 on the news.

The response of the investment community to Kodak’s measures was very positive. By the end of January 1993, the company’s stock had risen to $49.88.

FEBRUARY 1993 (STOCK PRICE, 2/26/93: $53.62)

As a result of the giant steps Kodak’s management took to gear the company to improved performance, coupled with the company’s genuine desire to address shareholder concerns, Lens agreed on February 26 to withdraw its shareholder proposal calling for a shareholder advisory committee.

Kodak was not long out of the news, however. On April 28, just 11 weeks after his arrival in Rochester, Chris Steffen resigned as Kodak’s CFO. Mr. Steffen found that his ideas were perceived as too “revolutionary” when others wanted a more “evolutionary” approach. When Steffen abruptly resigned (causing Kodak’s stock to lose over $5 per share in a single day), Kodak shareholders questioned the company’s commitment to change.

During the two-week period between Steffen’s departure and the company’s annual meeting, investors demanded that Kodak explain why Steffen had resigned and why they should trust incumbent management to lead the company to success. Ultimately, many institutional holders recognized that CEO Whitmore had not sought Steffen’s departure and that his commitment to change had not weakened. At the annual meeting, Whitmore spoke to shareholders about the “constructive” and “helpful” role Lens and other investors had played over the previous year. He said, “It provides us an external point of view that we have to listen to with care.”

Ultimately, the independent directors at Kodak were not convinced that Mr. Whitmore would be able to fulfill the commitment made to shareholders to improve Kodak’s performance significantly. On August 6, 1993, the independent directors announced that Mr. Whitmore would step down upon the naming of a successor, and on October 27, 1993, they announced the appointment of Motorola CEO George Fisher as Kodak’s new CEO. On the day of the announcement, Kodak’s stock rose $4.87 to $63.62.

NOTES

Waste Management was a star stock of the 1970s and early 1980s. Its founders, Dean Buntrock and Wayne Huizenga (who went on to launch the worldwide Blockbuster video rental chain), understood that domestic trash collection could be a national business. Until then, garbage collection was the preserve of thousands of small, regional companies dealing only with a local area. Waste Management saw that vast economies of scale could be achieved if these companies could be folded into a single company with nationwide reach.

Waste Management moved aggressively and its growth was phenomenal. Founded in 1971, it grew by acquisition (at one point it was performing 200 mergers and acquisitions a year) to become the largest waste haulage company in the country. In doing so, it acquired more than 2,000 companies. The result was a fiendishly complex corporate organization. At the peak of Waste’s expansion, the company featured about 250 local divisions, 40 regional offices, and nine area offices, not to mention headquarters.

Initially, the market did not mind these convolutions. Adjusted for splits, the stock rose from $1.84 in 1980 to the mid-$40s in the early 1990s. However, growth at this speed could not last. As the company grew, so it had to acquire even more companies to maintain that growth. Its size impeded its continued acceleration. Furthermore, the market settled down. Other companies followed Waste’s lead and consolidated their own regions. Over a period of 15–20 years, the domestic trash hauling business matured.

Waste was not finished. Its managers continued to insist it was a growth company. The company diversified into international waste hauling, recycling, environmental cleanup, hazardous waste disposal, and home services. By 1990, WMX had become a complex conglomerate that owned or part-owned companies ranging from a UK water utility to lawncare contracting. Some idea of the sprawl that was WMX is provided by the company’s 1996 10-K filing with the SEC. The company listed more than 700 direct subsidiaries, which in turn owned a further 600 sub-subsidiaries. The Wall Street Journal argued that Buntrock “saw the company as a kind of mutual fund of environmental business, setting up as many as four publicly traded units.”

WMX Technologies consisted of Waste Management, which concentrated on North American residential and industrial solid waste disposal, a publicly traded subsidiary (until 1995), Chemical Waste Management, which dealt with hazardous waste, and a 60 percent owned subsidiary, Advanced Environmental Technical Services, which provided hazardous waste services. A further wholly owned subsidiary, Chem-Nuclear Systems, dealt with radioactive waste management.

The company’s international operations were provided through Waste Management International, which was owned 56 percent by WMX and 12 percent each by the company’s Rust International and Wheelabrator Technologies subsidiaries. Waste Management International offered services in ten countries in Europe as well as Australia, South America, Asia, and the Middle East. It also owned 20 percent of Wessex Water, a publicly traded water utility in the UK.

Wheelabrator Technologies (58 percent owned by the company) was a public company primarily providing clean air and water to municipalities and industry. Rust International, also a public company until WMX bought back its stock in 1995, was part owned by WMX and Wheelabrator.
It offered environmental and infrastructure engineering and consulting ranging from hazardous waste cleanup to scaffolding provision. Rust had international operations in 35 countries.

Rust owned 41 percent of NSC Corp., a publicly traded provider of asbestos abatement, and a 37 percent interest in OHM Corp., a publicly traded provider of environmental remediation services. Finally, Rust owned a 19 percent interest in ServiceMaster, a provider of management services including management of healthcare, education, and commercial facilities, lawn care, pest control, and other consumer services.

In 1993, Waste Management renamed itself WMX to reflect its modern, all-encompassing presence. Buntrock boasted that WMX had become “one of the most important companies in the world.” The trouble was that, almost without exception, they lost money in these noncore areas. For example, in the 1980s, there was a sudden fear that the US was running out of landfills. Waste Management spent wildly to develop more landfill facilities only to suffer from vast over-capacity. Meanwhile, Americans produced less waste as producers emphasized “source reduction,” creating less packaging to be thrown away.

At the same time, a vast market was projected for recycling. Waste Management, like others, moved to attack this market, only to find that the expected development never happened. The market for treating hazardous chemical waste proved similarly elusive.

One of the authors, Nell Minow, told the press: “They were successful for so long that they didn’t realize that they stopped being successful . . . . They were successful in their core business and made the fatal mistake of trying to go beyond that.” Whose job is it to ensure this doesn’t happen?

GOLD INTO GARBAGE

By the mid-1990s, WMX’s star had tarnished. The Washington Post commented: “In the 1980s, when investors looked at the company named Waste Management Inc., they saw gold. But in recent years, the company now known as WMX Technologies has looked more like garbage.” In 1994, the picture darkened considerably – profits fell by 50 percent and the company failed to meet earnings projections. Meanwhile, the stock headed south – ticking at over $46 in February 1992, it slipped to less than $23 in April 1994.

If one looks back at the company’s ten-year performance from 1996, it is apparent that the company had experienced a sharp downturn in its fortunes. If you had invested $100 in WMX in 1986, it would have been worth $318 in 1991. The same sum invested in the S&P 500 index and the Smith Barney Solid Waste index would have returned $204 and $222 respectively. In other words, from 1986 to 1991 WMX was outperforming both the market and its sector.

By 1996, the story is less sunny. That same $100 invested in 1986 would now be worth $269, about one-sixth less than five years previously. The same sum invested in the S&P 500 would be worth $415 and an investment in the index was worth $215. So WMX was still doing a bit better than its competitors, but the company was failing to keep up with the bull market, and, worse, the return over five years was actually negative.

In fact, WMX continued to report profits, but these were all but wiped out by year after year of special charges. Such special charges are meant to be exactly that – special. They reflect extraordinary one-time losses. Unfortunately, at Waste, they became all too familiar.
From 1990, these charges read as follows:

- **1991**: $260 million pre-tax charge to boost reserves for cleaning up old dumps.
- **1992**: $159.7 million pre-tax charge to write down value of medical waste business and incinerators; $23.4 million after-tax charge to write down value of asbestos-cleaning business.
- **1993**: $550 million pre-tax charge to write down value of hazardous waste business.
- **1994**: $9.2 million pre-tax charge to get out of marine construction and dredging.
- **1995**: $140.6 million pre-tax charge, mostly a further write down of value of hazardous waste business; $194.6 million pre-tax charge to write down value of international waste business.
- $88 million after-tax charge on sale of Wessex stake.

In a 1996 meeting with the authors, Dean Buntrock said: “The trouble is, no one believes our numbers.”

What warning bells does this ring?

What do the special charges tell you about the company’s attempts to diversify?

The company appeared unfazed by the charges or the stock’s downward trajectory and continued to pour capital into projects. The *Wall Street Journal* quoted Steve Binder, analyst at Bear Stearns, who said: “They continue to allocate resources as if they were still participating in a growth industry.”

Indeed, Buntrock told the 1994 annual meeting: “We are a growth company.”

Was it? If not, whose job was it to find an alternative strategy?

**LENS AND SOROS**

In the mid-1990s, Lens Inc., an investment fund of which the two authors were principals, invested several million dollars in WMX.

Lens’s first concern was to call for fresh talent on the board. When the fund first invested, the board was made up as follows:

- **Jerry E. Dempsey**, 62, director since 1984. A former employee of the company, he served as senior vice-president from 1988 to 1993. Since retiring from Waste, he had acted as chairman and CEO of a glass, coatings, and chemicals company.
- **Dr. James B. Edwards**, 67, since 1995. Former United States Secretary of Energy, dentist, former governor of South Carolina, president of the Medical University of South Carolina. He held eight other nonexecutive director positions.
- **Alexander B. Troubridge**, 65, since 1995. Former Secretary of Commerce. He had served as consultant to the company since 1990, an arrangement that in 1995 was worth $30,000. He held nine nonexecutive director positions.
Dr. Pastora San Juan Cafferty, 54, since 1994. Professor at the University of Chicago School of Social Service Administration.

Donald F. Flynn, 55, since 1981. He had served as senior vice-president of the company from 1975 to 1991. He had been CFO from 1972 to 1989 and the treasurer from 1989 to 1996. He was also a director of two WMX subsidiaries. Until the end of 1994, Flynn was making $300,000 p.a. in consultancy fees. The consulting arrangement included a retirement benefit that was due to pay out for the rest of his life.


Phillip B. Rooney, 50, since 1981. He had been an employee of the company since 1969.

Dean L. Buntrock, 63, chairman and CEO since 1968.

Howard H. Baker, 69, since 1989. Lawyer, Reagan’s chief of staff, three terms as US Senator. He was a partner in a law firm retained by the company.

Peter H. Huizenga, 56, since 1968. Nephew of the founder, consultant to the company from 1989 to 1993. Served as vice-president and secretary of the company from 1975 and 1968, respectively, until he resigned from those positions in 1988.

Peer Pedersen, 70, since 1979. Lawyer and Dean Buntrock’s personal attorney. He was chairman of a law firm retained by the company.

It is noteworthy that nonexecutive directors also took part in a Phantom Stock Plan and stock option plans – they had a vested interest in the performance of the stock rather than the performance of the company. This was, as we shall see, highly significant.

Pedersen, an affiliated director, chaired the compensation committee. Baker, also connected, served on this committee. In 1995, the audit committee featured as many affiliated outside directors as independent ones. The five-member Nominations Committee contained four affiliated outsiders. Thus, of the 12-member board, two were full-time insiders, three were former employees, three were affiliated due to consultancy arrangements, and four were independent outsiders. As Nell Minow told the press: “Two-thirds of the board is on the payroll.”

The one, indeed the most important, area in which the board did demonstrate best practice was in stock ownership. James B. Edwards owned over 1,700 shares on joining the company. H. Jesse Arnelle owned over 9,000, and Trowbridge over 20,000. However, even these shareholdings, given the numerous other connections that tied the directors to the incumbent management, failed to create the right environment of tough-speaking independence.

There was one director with a considerable stake – Peter Huizenga, nephew of Waste’s co-founder Wayne Huizenga. He owned over eight million shares, but, like management, his stake in the company was intimately bound up in its past. Peter Huizenga showed little aptitude or appetite for the tough choices required in a turnaround.

**FIRST FEELERS**

Lens sought and was granted a meeting with management. The Lens principals came away with the view that the executives did not perceive a problem. They were confident that their strategy was the right one and that the magical growth of earlier years would return.

Lens concluded that the very success of the company’s early years – a success that the present managers had helped create – was inhibiting an honest view of the current situation. Having established a great company, the founding team could not view the company any other way.
Lens came away with three conclusions:

1. that Dean Buntrock was a dominant CEO who stifled debate;
2. that there was a need to clean up the numbers;
3. that the board required more aggressive outside talent.

Related to the need to clean up the numbers was a need for a new CFO. James E. Koenig, with the company since 1987 and CFO since 1989, was the incumbent and had hence overseen several years of the restructuring changes. If, as Dean Buntrock said, “no one believes our numbers,” the problem was clearly partly Koenig’s. It was an early demand of Lens and other investors that Koenig be replaced.

In May 1996, the company had a rude shock. George Soros, the tycoon speculator who became famous for making $1 billion betting against the Bank of England in the September 1992 sterling crisis, announced that he had acquired more than 5 percent of the company. His stake was worth $750 million.

The investment was made by a Soros affiliate, Duquesne Capital Management, and was a clear signal of intent. Soros was not a takeover predator in the traditional mode – he had no plans to launch an all-out hostile bid for the company. However, his investment gave notice that he expected change and soon.

**1996 ANNUAL MEETING**

Lens attended the annual meeting to speak directly to the board about its concerns over the company’s long-term under-performance. However, the company had a surprise of its own. After nearly 30 years as chairman and CEO, Dean Buntrock announced that he would be stepping down as CEO, although he would remain as chairman. Long-serving lieutenant Phillip Rooney, who had also been at Waste since its birth, would replace him.

Though Buntrock’s semi-retirement perhaps indicated a change in attitude by senior management, it was clear to Lens and others that there was much still to be done. Although Buntrock was taking a hand off the levers of power, he remained a significant presence as chairman, with longtime insider Rooney moving up a place. In terms of substance, management hadn’t changed a bit.

In 1996, there were two shareholder resolutions, both opposed by the company. The first, filed by the Central Pension Fund of the International Union of Operating Engineers and Participating Employers, called for a policy banning directors “from accepting consulting or other fees from the company.” The statement noted that “directors owe their fundamental allegiance to the shareholders of the corporation . . . and not to management.” The proposal claimed that consulting fees paid out to directors may have run to hundreds of thousands of dollars a year; “there is an appalling lack of precise information provided to shareholders on the extent of these financial arrangements.” The board said, “this rigid restriction is unnecessary and ill-advised.”

The second proposal was filed by the Teamsters Pension Plan, calling for annual election of all directors. The resolution argued that the move was necessary because “a number of concerns raise the possibility that WMX management may not be fully attuned” to shareholders’ interests. The Teamsters cited WMX’s poor record on executive compensation, noting that “[pay] expert Graef Crystal found WMX’s CEO scored fifth in rankings of his peers when measuring low performance and high pay.” The board said that the staggered system had received nearly an 80 percent shareholder vote in favor when it was proposed in 1985.
Both proposals were defeated, although the company made the surprise announcement that it would itself propose the same resolutions at the next year’s meeting.

AFTER THE ANNUAL MEETING

In a further meeting, in October 1996, Lens offered the view that the company had never successfully diversified beyond domestic trash. The division still represented half the company’s sales, and easily reported the most profit. Rooney countered that he intended to sell $1 billion of underperforming assets by 1998.

Filtering through to analysts, the news of this restructuring sent the stock from the mid-twenties to $34.

Lens continued to press for a revitalized board. In a meeting with Alexander Trowbridge, former Secretary of Commerce and head of the nominations committee, Lens noted that four directors were up for election in 1997. Lens argued that it was the perfect opportunity to bring in some tough new outsiders. In contrast to the incumbent board, Lens sought independent outsiders who could bring considerable business experience to the table in order to effect a turnaround. Lens offered four names to Trowbridge, of which the company eventually accepted one — Paul Montrone, who joined the board in January 1997. Mr. Montrone, 55, was the CEO of Fisher Scientific International. He had also been a director of Wheelabrator since 1989.

Despite the promise of streamlining and the improved share price, Lens felt the company was still moving too slowly. It was convinced that the only route to fundamental change lay with new talent at the top of the company. It was inconceivable, in Lens’s view, that the company could be restored when top management and the board were made up of long-term insiders.

Lens had a multipronged strategy to keep the pressure up. In December 1996, the fund retained Spencer Stuart, the blue-chip recruitment firm, to gather names for a proxy fight for four seats on the board. The involvement of Spencer Stuart was evidence that shareholder activists had achieved mainstream legitimacy. It demonstrated that the shareholders’ involvement was credible and concerned with long-term wealth creation to the benefit of the company and all its shareholders. Although Spencer Stuart was happy to be associated with Lens, individual director candidates were less happy about getting involved in what could be a high-profile proxy contest. Spencer Stuart identified several people who expressed an interest in serving on the board, but who were unwilling to do so without being asked by the company. Lens forwarded their names to Waste’s board.

At the same time, Lens filed a shareholder resolution calling for an independent investment bank to be hired to study the divestment of assets. The resolution was a means of maintaining pressure on the company.

Lens also prepared a full-page advertisement for the Wall Street Journal that identified the Waste board as “long-term liabilities.” The ad, similar to the one directed at Sears in 1992 (see figure 7.1), was another means of needling the Waste board into action. Waste was informed of the ad and told that dates had been booked for its publication.

Directors obey the Heisenberg uncertainty principle. Like subatomic particles, they behave differently when observed. Discuss.
THE SOROS EFFECT

George Soros’s group, with that $750 million stake behind them, continued to be active. In December 1996, Stanley F. Druckenmiller, Duquesne’s chief investment officer, told Crain’s Chicago Business that he wished to see an overhaul at the top of the company: “We have become convinced that the only way the inherent shareholder value in the company can be realized is with a change in the current top management.”

In the same month, the Soros group filed a statement with the SEC saying that the investors were “frustrated with lack of progress” at the company and questioned “the resolve of management about enhancing shareholder value.”

The company pressed ahead with its streamlining plans. It announced that it would sell its stake in the UK water supply utility, Wessex Water, and pledged to repurchase 25 million shares. However, the moves failed to ignite the stock, which continued to bob around in the high twenties to low thirties.

CREDIBILITY PROBLEM

The company was now under considerable pressure to reform and perform. Two events further undermined the incumbent management’s credibility.

First, the company was found guilty of cheating a partner in the development of a hazardous waste site. WMX had purchased the dump from the developers; part of the purchase agreement was that WMX would pay a percentage of the dump’s revenue over a period of years. However, WMX’s creative accounting led to greatly understated revenue and hence a lesser payment to the developers. The court found that the accounting fiddle amounted to $91.5 million. Though the episode did not concern the top executives, it was embarrassing because it seemed indicative of WMX’s approach to financial reporting. Analysts and investors instinctively seemed to distrust WMX’s numbers. Here, on a small scale, was evidence that they were right to do so.

Second, the company disclosed in filings to the SEC that senior management was cushioning itself for a possible change in control. The disclosures revealed that the executives had received large salary increases, hefty stock options, andgolden parachute arrangements. Sixteen members of senior management were awarded $13 million in restricted stock that would vest if the employee was terminated.

Rooney himself was blessed with a new five-year contract, a 25 percent increase in base salary, plus options on 350,000 shares – twice the grant he had received the year before. The company said the raise and the options were in recognition of the fact that Rooney had been elevated from COO to CEO.

In August 1996, the company initiated a new three-year rolling contract with James Koenig, the CFO, and Herbert A. Getz, the general counsel, that essentially insulated them from being terminated (except for cause). The contract agreed to pay three years’ salary plus annual bonus plus long-term bonus. The proxy estimated that, had the company been taken over on the last day of 1996, the new contract would be worth $1,889,300 to Koenig.

To Soros and Lens, these pay disclosures were evidence that management was further insulating itself from external discipline.
Analyze these compensation arrangements. Do they align the executive’s interests with those of shareholders? How might you design a compensation package for a turnaround situation such as this? If an executive is richly rewarded for failure, what incentive does he have to succeed?

RESTRICTURING

In the early, cold months of 1997, WMX pledged a full restructuring. The market eagerly anticipated what had been demanded for so long – a full-scale retrenchment and consolidation, and a re-focus on the core business.

The *Wall Street Journal* dubbed the day of the announcement as “WMX Tuesday” and described “euphoria” among analysts. The stock was bid up 11 percent in the month leading up to the day.

However, WMX Tuesday went less with a bang than a whimper. The restructuring consisted of a partial retreat back to its core business. Domestic waste would once again be the company’s main area of activity, with international operations curtailed (though not eliminated, as Lens had requested). Noncore assets to the tune of $1.5 billion would be disposed of, 3,000 jobs cut, and the share repurchase program expanded by 10 percent. Later in the year, the company simplified operations by taking Wheelabrator off the market. WMX spent about $900 million buying back the shares it did not own.

In a belated recognition that the company had it right first time, WMX announced that it would change its name back to Waste Management. The sexy-sounding “WMX Technologies” had lasted barely four years.

The company also answered one of Lens’s early demands – the departure of Koenig. WMX had repeatedly promised he would be removed, but he didn’t leave the CFO’s office until February 1997 when he was merely reassigned. He remained an executive vice-president.

Although the changes were considerable, it wasn’t sufficiently aggressive for the market. The price plunged 9 percent in a single day, down $3 to about $33. The fall indicated that nothing less than an absolute overhaul would satisfy investors who had waited too long for results.

A further question remained – who was to implement this plan? Lens and Soros continued to press for fresh blood on the board. In February 1997, Lens informed Waste that the fund would drop the proxy fight if the company immediately appointed two of Soros’s director nominees for the board. The Soros group asserted that both Buntrock and Rooney had to go.

In a February 11, 1997 filing with the SEC, Soros nominated four directors to run against the board’s nominees for the forthcoming annual meeting, and repeated their call for Rooney’s departure. The filing said the group was “even more frustrated with management’s lack of progress in enhancing value for shareholders and the apparent inability of management, and its recently announced restructuring plan, to address the issue.”

The looming battle was knocked off track by the announcement, on February 18, just one week after Soros’s demand for new leadership, that Phil Rooney was resigning from the company. He said he didn’t want the company “being distracted by the current public debate over the leadership of the company.” This announcement, coupled with the news that the company would replace two incumbent directors at the forthcoming annual meeting, persuaded investors that the company was serious about initiating change. The share price was bid up nearly $2 to $34.75.

Where did this leave the Soros proxy fight for board seats? The purpose of the contest was to find credible outside directors who, in turn, could select a tough CEO, but this purpose had now
been overtaken by events. Although Rooney’s departure meant that Buntrock was back in the hot seat as acting CEO, it also provided an opportunity to find a credible outsider. One analyst told Reuters that Rooney was a “sacrificial child to get Soros off their back.”

A Soros spokesman told the Chicago Tribune: “We would like to see the best possible CEO running the company on a day-to-day basis. We would also like to see that CEO reporting to the strongest possible board of directors.” On February 21, the Soros group announced that it was dropping its proxy fight. Soros said that running a proxy fight would only distract the company. The key, said a Soros spokesman, was bringing two new independent directors and the best available CEO. Gerald Kerner, managing director of Soros affiliate Duquesne Capital Management, explained the decision to pull out of the proxy fight: “We never wanted to drive the bus, and now we believe we are going to get the best driver possible.”

*It is not in shareholders’ interests to replace management. It is in shareholders’ interests to get the board to do it. Discuss.*

The news surprised the investor community, but most understood that the Soros retreat was a tactical maneuver rather than withdrawal. The Dow Jones Wire asked whether the move constituted “Detente or lasting peace?” One analyst, NatWest Securities’ Paul Knight, said: “They avoided a confrontation now, but if WMX doesn’t deploy its strategy with successful result to the stock price, there will be a battle later.” The New York Times quoted Leone Young of Smith Barney: “Soros dropped the proxy fight because it is convinced that the board will listen to its suggestions. And that is not the same as backing off.”

In other words, Waste had bought itself a breathing space. It now had the opportunity to find an outstanding CEO candidate from outside the industry alongside some new directors. If it failed to do so, the dissident shareholders would undoubtedly be back.

The key, as far as Lens was concerned, didn’t stop with the CEO. There was a need for personnel changes that went beyond the chief executive’s suite. One of this book’s authors, Nell Minow, speaking to Reuters, said that Buntrock should only remain at the company long enough to find a CEO: “Any successor worth his salt is not going to want the job if Buntrock is going to be too involved.”

The CEO hunt got underway, with the help of leading search firm Heidrick & Struggles. Howard H. Baker and Peter H. Huizenga had announced their decisions to retire at the annual meeting. In mid-March 1997, Waste announced two new nominees for the board, to be submitted for election at the May annual meeting.

The first was Robert S. Miller who had unwittingly become something of a crisis management professional. As an executive at Chrysler, he had been part of two major turnarounds under Lee Iacocca. Having retired, he agreed to serve as nonexecutive director at two troubled companies, Morrison Knudsen and Federal Mogul. At both companies, the incumbent leadership had abruptly resigned and he had taken over as acting CEO.

The second candidate was Steven G. Rothmeier, chairman and CEO of Great Northern Capital. He had also been chairman and CEO of Northwest Airlines, where he had overseen the airline’s rapid growth.

Both candidates met the criteria Lens were looking for – they were outsiders, of genuine ability, and had chief executive experience at big companies. There was little chance they would be yes-men.
ROONEY’S DEPARTURE: THE AFTERMATH

If the company seemed to be moving in the right direction, it still managed to upset investors. Waste’s proxy revealed that Phil Rooney would continue to be paid $2.5 million a year until 2002 – this after eight months’ work as CEO.

The Wall Street Journal questioned whether any payment should be made at all. Rooney’s contract called for the $2.5 million annual payment, but only following “termination by the company.” Like anyone else, Rooney wasn’t due a dime under his contract if he departed voluntarily, and Rooney had resigned; he had not been forced out. Furthermore, Rooney went straight to a senior job with ServiceMaster, a subsidiary of Waste’s sold only months before – at too low a price, according to many. Again, there was a disturbing perception that directors’ interests were being placed ahead of shareholders’.

Crain’s Chicago Business was in no doubt about the message that Rooney’s departure sent. They declared “outrage” at his payoff, which he was in line to receive for “doing basically nothing.” The editorial pointed out that Rooney had been well compensated during his time at WMX. “No parting gifts were necessary. He is out of a job because he wasn’t considered responsive to shareholders; now, WMX’s board has added insult to investor injury by rewarding him for his ineffectiveness.”

Refer back to chapter 4 and the section on executive compensation: what does the Rooney episode tell you about the state of executive pay in corporate America?

TOWARDS THE ANNUAL MEETING

Dean Buntrock told the Wall Street Journal in April 1997 that he was willing to give up a management role in order to bring the right CEO to the company. However, he continued to express a desire to remain on the board. This did not please investors who not only felt that it would be difficult to select a CEO with Buntrock still a presence in the background, but also continued to press for a more thorough board shake-up.

In advance of the 1997 annual meeting, the Teamsters sponsored a bylaw amendment to provide that the board consist of a majority of independent directors, according to the Council of Institutional Investors’ definition. The Teamsters’ proposal complained that Buntrock and Rooney were employees, Flynn, Dempsey, and Huizenga former employees, Baker and Pedersen associates of law firms that receive legal services for the company, and San Juan Cafferty and Edwards employees of universities that may receive grants from the company.

Lens brought its pressure to bear at the 1997 annual meeting. The fund invited some of WMX’s most sizable investors to attend. Representatives of Alliance Capital Management, Harvard Management, Bear Stearns, Capital Research, Lazard Freres, and Goldman Sachs were all present. This was highly unusual. Institutions of this kind are invariably absent at annual meetings, since they have regular access to management at analysts’ briefings and one-to-one meetings. The message Lens intended to send was that the company’s shareholders were standing together, a point we will return to below.

Lens principal, Robert Monks, took the opportunity of the annual meeting directly to address questions to the chairs of the board committees. He said:

“To the chairman of the audit committee, James Peterson. This company has had a history of eight consecutive years of special charges, with almost annual restructurings.”
What is the audit committee doing to make sure that the company’s numbers will be more reliable in future?

Other shareholders asked further searching questions. One asked the chairman of the search committee, Peer Pedersen, about the status of the CEO search. Another asked Trowbridge whether the nomination committee would again consider shareholder suggestions for board candidates.

Other questions included: “What are the independent directors doing to respond to the issues raised by the $91 million fraud judgment against the company? How often do the outside directors meet in executive session, and have they considered retaining their own counsel?”

Imagine you are a nonexecutive director of Waste. How might you respond to these questions?

A NEW CHIEF EXECUTIVE

Waste was marking time until the arrival of a new CEO. In July 1997, the company announced the appointment of Ronald LeMay, previously number two at phone provider Sprint.

The stock dropped slightly on the news, demonstrating that investors were anxious for quick results, impatient after a five-month search for the right candidate. The *Wall Street Journal* speculated that Buntrock’s continued presence helped depress the stock.?

While LeMay was a man of undoubted ability, there were aspects of his appointment that were troubling:

– he didn’t purchase any stock;
– he continued to serve on numerous other boards;
– he didn’t bring any outside personnel with him, so senior management at Waste remained the same;
– he continued to live at his home in Kansas, commuting to Waste’s headquarters near Chicago each week.

Investors were also worried by the wealthy nature of LeMay’s incentive package. He was granted a salary of $2.5 million, plus options on four million shares of stock. This represented plenty of upside potential but little downside risk. LeMay was not required to bet on himself to succeed.

Further, Waste agreed to buy out LeMay’s existing stock appreciation rights at Sprint, at a potential cost of $68 million. In the parlance of executive pay, Waste agreed that LeMay should be “made whole” before leaving Sprint. Again, this strips out any risk. LeMay was not forced to make a commitment to Waste. Indeed, he was not forced to make a choice between Sprint and Waste, since he stood to benefit enormously if either company did well.

The overall impression seemed to be, not that LeMay was eagerly accepting the challenge Waste offered but that he had to be dragged reluctantly from his former company.

*Shortly after Lee Iacocca joined Chrysler in 1978, he received an annual salary of one dollar a year, no bonus, but a large number of stock options that would only pay out if the share price improved. Ultimately, such was Chrysler’s performance, he cashed in option gains of about $43 million. Compare Iacocca’s compensation arrangement to LeMay’s.*
Early in October 1997, Waste announced that earnings would again be lower than expected. They added that the previous year’s third quarter income statement was overstated and that another charge might be added to the company’s long string of write-offs. The market downgraded the stock 10 percent on the news.

Days later, LeMay quit and returned to Sprint. He’d served as the CEO of Waste Management for little over three months. The market was stunned. LeMay said that he had joined Waste because it offered an interesting set of challenges but that “I have determined, however, that the needs of the company now present different kinds of challenges.”

The stock sank like a stone, off 20 percent on the day to $23.25.

On the same day that LeMay rode back to Kansas, the incumbent and former CFOs (James Koenig and his successor, John D. Sandford) also quit the company.

Rumors were rife. The Associated Press commented: “The company’s shares tumbled as much as 24 percent as Wall Street was abuzz with speculation that the departed executives had discovered major accounting irregularities that would impede implementation of an aggressive turnaround plan.” The New York Times said that “the abrupt turn of events…smacked of a story untold – and LeMay was not telling it.” LeMay later referred to Waste’s accounting as “spooky.”

Robert S. Miller was appointed acting chairman and CEO. He was the fourth CEO in less than a year.

It was now Wall Street’s worst-kept secret that Waste’s books contained some very bad news. Investors would continue to mark down the stock until they knew the truth.

Miller’s first job, then, was to convince investors that they had a clear, warts and all, picture of the company’s health. He said he knew of no irregularities but that a review of the company’s accounting policies was under way. He said: “we’ll probably adopt going forward with a substantially more conservative philosophy in the way that we record the earnings of the company.”

Miller confirmed yet another charge, involving “some pretty big numbers hitting the books,” but denied that there was “something terrifying under the covers.” “This is not a train wreck,” said Mr. Miller.

**MILLER’S TALE**

Miller moved aggressively to reconstitute the board. In November 1997, he announced the appointment of two new directors. One of them, Roderick M. Hills, was the former chairman of the SEC. This news intimated that the company was expecting to have to deal with some kind of SEC investigation – again, it seemed like trouble was waiting just around the corner.

The board committees were given a thorough shakeup to put the new outsiders in a dominant position. A new search committee was established to seek a fifth CEO in less than a year. It was made up solely of directors appointed since Lens and Soros had first invested. The audit committee was entirely replaced, now under the chairmanship of Hills.

The charter of the nominating committee expanded to include board practice and corporate governance issues, and the board’s executive committee was reconstituted under the chairmanship of Miller, replacing Buntrock. Dean Buntrock no longer served on a single board committee of the company he had helped to found.

Days later, Miller flew to New York to meet a dozen or so of his largest investors. He traveled alone, accompanied by just an investor relations officer. Miller emphasized that “there’s a new board in charge” and told his investors, “you’re the owners. I work for you. I want your views.”
Contrast Miller’s style to that of Buntrock or Rooney.

FIFTH CEO

Speculation was rife as to who might take over the poisoned chalice of the CEO suite. A name frequently mentioned was that of Al Dunlap, christened “Chainsaw Al” for his aggressive cost-cutting methods. He had a career of being appointed to failing companies and ruthlessly turning them round. He pruned noncore divisions, eliminated thousands of workers, and often negotiated a merger for what remained. Though many criticized his style, there was no arguing with the results. Dunlap had already effected a successful turnaround at Scott Paper, one of Lens’s former investments.

Al Dunlap, speaking to a Bloomberg panel, was asked for his views on Waste. He said: “The shareholders would have been better off if they had gotten captured by terrorists…. There you’ve had a classic case of a sitting management and a board that’s allowed a situation year in and year out to go on without taking the proper corrective action – that’s to dramatically change the management.”

MORE MANAGEMENT

Part of Waste’s problem, according to Crain’s, was “too much wasted energy, not enough management.” Miller set about applying some management, first by simplifying the complex structure.

Waste’s growth had taken place by acquisition, which led to a remarkably convoluted structure. In November 1997, Miller announced that the number of regional headquarters would be cut from 250 to 32. Staff would be trimmed by 1,200, for annual savings of $100 million.

One of those staff members to be trimmed was Dean Buntrock. The company announced he would be gone by the end of the year. The Tribune commented: “Perhaps the best thing Dean L. Buntrock did for the company he helped found was simply to leave.”

The plan nudged the stock northwards on a day the rest of the market fell. However, the 25 cent rise “suggests investors still view the Oak Brook-based waste hauler with caution.”

RESTATED ACCOUNTS

At the end of January 1998, Waste finally fessed up. It opened the door on a closet simply stuffed with skeletons.

The company admitted that its misleading accounts went back to 1992, two years earlier than most had anticipated. The company announced a special charge to account for misstated earnings of $3.5 billion pre-tax. This was a whole billion dollars higher than the predicted worst case.

Under the restated earnings, Waste suddenly looked a less healthy company. For example, the company had reported net earnings in 1996 of $192.1 million. In the reviewed accounts, this became a loss of $39.3 million.

In retrospect, the company reported a 1996 loss of $39.3 million, down $231.4 million from the original accounts. The 1995 earnings had to be downgraded to the tune of $263.8 million.

In a press release, Robert Miller said: “The steps we are taking are the strong prescription we believe is needed to acknowledge past mistakes, clarify our financial reporting picture, and begin the process of restoring investor confidence in Waste Management and its ability to prosper in the future.”
The *Wall Street Journal* described the adjustments as “mammoth.” The *Chicago Tribune* said the results were “startling” and described shareholders as “shocked.”

The SEC immediately launched an investigation.

Amazingly, the stock budged just 20 cents on the news of this $3.5 billion problem. This indicated the extent to which investor confidence in Waste had evaporated. The market had such a dim view of the company that *nothing* the company could have announced would have been perceived as bad news.

*Fortune* magazine devoted an in-depth report to how Waste had managed this feat of accounting trickery: “Standard industry practice is to depreciate – or write down – the cost of trucks (about $150,000 apiece) over eight to ten years, with each year’s depreciation expense reducing the bottom line. However, in the early 1990s, at Rooney’s direction and with Buntrock’s assent, Waste began stretching the depreciation schedules by two to four years. This lowered the company’s annual depreciation charge, boosting earnings.”

That, as *Fortune* revealed, was just the beginning: “Waste also reduced by as much as $25,000, the starting depreciation amount on each truck, claiming that sum as ‘salvage value’ – an amount it would recover by selling the vehicles. Standard industry practice is to claim no salvage value. On a North American fleet of nearly 20,000 vehicles, this manipulation added up.”

It wasn’t just trucks that were dealt with in this way. Waste listed the work life of a dumpster as between 15 and 20 years, while the industry norm was 12. The same kind of shenanigans were carried out for recycling plants, hazardous waste treatment facilities, everything. Every Waste asset, from the dumpster to the engineering plant, had its working life stretched.

The same technique of making wildly optimistic assumptions was applied to Waste’s 137 landfills. Obviously if a landfill can expand, its useful life is longer and so depreciation and startup capital costs can be spread over a longer time. “So what did Waste Management do?” asked *Fortune*. “Naturally, it claimed that landfill expansions were likely – even when they weren’t.” At a site in Atlanta, the company’s books counted on a huge expansion even after the state had passed a law barring any expansion. The site’s value was inflated by over $30 million.

The sum effect of playing with all these figures was to boost earnings by $110 million a year.

Dean Buntrock told *Fortune*: “To my knowledge, there was proper accounting used on all our financial transactions.”

Rod Hills, chairman of the audit committee, pointed the finger at Arthur Andersen, Waste’s long-standing auditors. “The SEC is going to find they didn’t do their job,” he said. An Andersen spokesman sniffed back: “We take exception to pre-investigative inappropriate finger-pointing.”

### USA WASTE

Lens and the Soros group bit the bullet. The company, surely, had hit rock bottom, but there were new people in charge and things could only get better.

In March 1998, the Dow Jones wire reported that the feeling that Waste “is ripe for takeover is gaining momentum…. There is some talk that USA Waste will make an offer in the low 30s.” A critical energy in the merger talks was Ralph Whitworth, one-time boss of the United Shareholders Association and now principal of Relational Investors, a shareholder activism/turnaround fund.

USA Waste was the minnow in the trash collection pond. It ranked third in terms of size and was just one-third the size of Waste Management. It had stayed resolutely clear of expansion into
noncore businesses, remaining a trash collector, pure and simple, with a sizable presence in southern and western states but no presence in the north and east where Waste was strong.

Though Waste was the far larger of the two marriage partners, it was USA Waste that walked off with the keys to the new home. John E. Drury would take over as CEO of the combined enterprise and the headquarters of the merged company would be in Houston, USA’s hometown.

The merger was a humiliating end for Waste, once the most exciting of companies. In essence, Waste was being taken over by one of its junior competitors. The Wall Street Journal noted: “Though Waste Management’s name would live on, the deal would effectively mark the end of one of the great growth stories of the 1970s and 1980s.” Crain’s Chicago Business argued that “the merger represents the best, perhaps only, prospect for Waste’s management.”

Drury pledged that the new look Waste Management would go back to basics. He told Fortune: “It’s a simple business. We don’t know that we’re real good at a lot of things. But we’re damn good at picking up garbage.”

WHAT WENT WRONG?

Waste’s story is a sad one. It was a great company, of enormous energy, whose growth dazzled investors, but it ended being merged into a company one-third its size.

We have explained above the accounting trickery that laid Waste low, but it is important to understand that the dodgy accounting was the symptom, not the cause, of Waste’s decline. Waste’s failure was not one of accounting; it was one of management. Management failed because it concentrated too much on the appearance of the business and not on the business itself.

This problem started when management continued to insist that Waste was still a growth company despite a maturing market. The Wall Street Journal noted that, “it became a company as much in the growth business as the garbage business.” The paper cited one analyst who compared the company to the movie Speed – if it goes below 55 mph it blows up.

Fortune reported: “Waste Management did the things it did because it refused to concede that it was no longer a hot growth company. Its desire to retain its status as a Wall Street highflier drove Waste Management not just to inflate its numbers but also to make a whole host of wrong-headed decisions.”

The magazine asked: “By the early 1990s, Waste needed to deal with a new reality: it couldn’t be a growth company anymore. Or could it?”

Fortune lamented the short-term demands imposed by quarterly earnings and the fact that the stock is punished if predictions are not met. Given these pressures, “the temptation to boost earnings by using accounting gimmicks can be powerful.” Buntrock told the magazine: “For 20 years, we had double digit growth. The marketplace and shareholders and even your own employees expect you to continue that.”

Fortune argued that: “Since going public in 1971, Waste Management has been obsessed with its stock price … but then came the 1990s and that obsession became its curse.” Satisfying your shareholders is the result of building a successful business, not the route to it. As Robert Miller told the magazine: “The stock should be the product of how you do business, not the god you pay homage to every day.”

In an interview with Business Week, Miller outlined other roots of corporate failure. His conclusions were:
How might Waste’s history have been different if it had applied Miller’s rules from the beginning?

HOW WAS IT SOLVED?

The key to the Waste turnaround was shareholder communication – because without communication, shareholders cannot act collectively. In the language of Berle and Means (see the section on separation of ownership and control in chapter 2), “ownership” (the shareholders) without communication remains diffuse and powerless in the face of focused and tightly organized “control” (management).

At the beginning of the book, we described governance as a set of relationships between three groups – the management, the directors, and the shareholders. In this relationship, management has vastly more power than any other group. They control the company and, most importantly, they control the flow of information to the other groups. To a large degree, despite the best efforts of GAAP and other reporting requirements, it is up to management to decide whether the information they disclose is full and accurate – witness Waste’s reporting of the most basic issue: its performance. It is also up to management (largely) whether to have a tough, independent board that rigorously checks and balances management, or not.

In the face of such a stoutly defended corporate bastion, shareholders are powerless – unless they can organize. As owners of the company, they have the legal right to replace the board and the managers, but this right is more myth than reality unless they can act in concert.

Lens set up an “intranet,” a private website protected by password and accessed only by those with a genuine interest. The site was made available to nearly 20 of Waste’s largest institutional holders, including giants like Alliance Capital Management, Bear Stearns, Fidelity, Goldman Sachs, J.P. Morgan, and Lazard Freres, as well as the more “usual suspects” such as CalPERS, New York State Teachers, and CREF.

The website was a device for sharing information and disseminating it rapidly. Notes from meetings with management, thoughts about director candidates, and ideas about how to move the campaign forward could be fed out to investors representing 40 percent of Waste’s stock at the touch of a button.

Lens deployed this core group of investors in other ways. When Lens attended its first annual meeting in 1996, it had the air of a pep rally. Dominated by employees, the affair was nothing less than a celebration of the company’s success. (The fact that that success was tarnishing rapidly did not seem to be a matter for discussion.)

The following year, as described above, Lens coordinated a group of large investors to attend the annual meeting. This, again, was a remarkable departure from the norm. By attending the annual
meeting en bloc, Waste’s largest shareholders were demonstrating that they were acting together. It was a gesture of solidarity. It showed that the barriers impeding collective action by shareholders had been crossed.

The playing field had been leveled.

What does the Waste story tell you about the organization of a public company? Who has the power and how are they held accountable?

“Management controls the information.” Is this true? And if so, what can shareholders do about it?

Who was responsible for Waste’s astounding success? And who was responsible for its decline?

WASTE MANAGEMENT: A POSTSCRIPT

A happy ending? In corporate governance?

Waste Management’s future, folded into USA Waste, looked secure. After all, Waste’s problem was that it spent too much time expanding its empire and not enough time consolidating it. As one critic said, there was too little management. Now it was merged with the acknowledged management maestros of the trash sector, surely it could put its grim history of special charges behind it.

Apparently not.

By August 1999, the three members of the rescue team who remained on the board – Relational Investors’ Ralph Whitworth, Steve Miller, and Rod Hills – were back running the company full time. USA Waste’s reputation for probity and management excellence turned out to be, well, a load of trash.

There was a note of tragedy in this comedy of errors. In November 1998, John Drury was diagnosed with a brain tumor. He promised to be back at his desk within a week of surgery and doctors’ reports were encouraging. Besides, the company appeared to have a ready-groomed successor in COO Rodney Proto.

Drury’s remarkable recovery proved to be short lived. At a March 1999 board meeting, Ralph Whitworth noticed that Drury was “noticeably weaker” and not in full control of his faculties. However, Whitworth noticed something worse – arrogance. Drury and Proto belittled Miller, the chairman, behind his back. When Whitworth proposed that management prepare monthly updates on how the merger was proceeding, his suggestion was brusquely dismissed.

Steve Miller decided to step down early as chairman and planned to hand over to Drury at the May 1999 annual meeting. Many of the directors were not happy about that, given Drury’s health, although at the time of Miller’s decision, many board members had not seen Drury in two months.

Drury attended the annual meeting in a wheelchair. He had trouble standing to receive the chairman’s gavel from Miller. “That’s when we should’ve taken a more aggressive stance,” says Hills in retrospect.

Meanwhile, Hills was making himself unpopular with management. The merged company still had the painful hangover of Waste’s history to deal with – notably, several shareholder lawsuits
and an SEC investigation of Waste’s accountancy practice. Hills started to delve deeply into the financials of the combined operation, with the result, as one director told the *Wall Street Journal*, “he pissed everyone off.” Hills’ efforts led him to the conclusion that US Waste had badly overpaid for past acquisitions, both before and after the Waste Management merger. The company was not the spotless star it had appeared.

Out of the blue, in July 1999, the company announced that second-quarter results would fall short of expectations. The stock declined by more than a third. Worse, the company could offer no convincing explanation of the shortfall.

Traditionally, the first quarter is a weaker period, yet the company had come within a penny a share of those estimates. Why had performance dipped in the usually strong second quarter? “For the board, what had been a string of unrelated concerns and annoyances was fast coming together to shatter its trust in management,” said the *Wall Street Journal*.

The rescue team’s principal concern was that the first quarter’s earnings had been dressed up with some undisclosed one-time earnings. Their suspicions hardened when it was revealed that Proto and a dozen other managers had sold significant chunks of stock in the weeks before the profits warning. Proto himself had sold 300,000 shares for more than $16 million. Had they kept the share price pumped up in the first quarter, giving them time to offload stock, before the company’s true financial picture emerged? There is no proof that any of the directors acted so coldly, but for an already impatient board, it was a management failing.

The board named Whitworth interim chairman. He made it his task to extract the truth from the financial department, keeping at them until they conceded that the first-quarter earnings had included undisclosed one-time items and would have to be restated.

Drury and Proto were dismissed; Miller was appointed acting CEO, for the second time.

USA Waste, it transpired, had suffered the same disease as Waste Management – it was too fixated on the stock price to devote sufficient attention to the day-to-day operations of the company.

The *Journal* concludes: “Since the early 1970s, the formula at publicly traded garbage companies has been to use stock to buy up smaller, privately held haulers. Add profits. Boost the stock. Fund more deals. Actually integrating the operations and running the company efficiently became a secondary consideration. Industry consolidation pushed up acquisition prices, making it harder to boost profits without using some aggressive accounting. At some point, nearly all the big players stretched too far to do deals.”

Whitworth was determined to extract a warts-and-all picture of Waste Management’s financial position – a problem that all thought had been fixed. He was told that every operation had its own financial controller – 600 of them. How long would it take them to bring their books up to date? Some said 400 hours.

The company brought in 1,160 outside auditors from Arthur Andersen and Pricewaterhouse-Coopers, the firm’s auditor, at a cost of $3 million a day. The real numbers finally arrived – $211 million in uncollectable bills, $305 million in unrecorded expenses, $226 million miscellaneous.

In late 1999, Waste Management took a third-quarter charge of $1.76 billion. Would its history of special charges never end?

The board recruited a new CEO – Maurice Myers, CEO of trucking company Yellow Corp.

Rod Hills had an extra pile of litigation and a renewed SEC investigation. One of the shareholder lawsuits? From Dean Buntrock, who alleged that Hills and Miller had mismanaged the company, and owed him $12 million in pension benefits.
NOTES

13. Ibid.
16. This and all Fortune citations below are taken from the May 25, 1998, issue.
CASE STUDIES: CORPORATIONS IN CRISIS

Stone & Webster

STONE & WEBSTER: THE COMPANY THAT BUILT AMERICA

The work of Stone & Webster can be found in the very fabric of the United States of America. As an engineering and construction business, the company helped build the superstructure for the Manhattan project which developed the atom bomb in World War II, the New Jersey Turnpike, the Statue of Liberty restoration, and the Washington, DC, subway system.

In the 1970s, the company continued its success, constructing nuclear power plants for US utilities. The company has built more such plants in the US than any other company, except for one.

In its 1994 annual report, the company made much of its place in American corporate history: “Stone & Webster is a century–old group of integrated and interdependent engineering, construction and consulting businesses. We have, for more than 105 years, been providing technological vision and innovative solutions to the changing world of energy, petroleum, petrochemicals, environmental responsibility, and infrastructure.”

However, as we saw in the Sears and General Motors case studies, a glorious past is no indicator of future success. Indeed, a company accustomed to success may find its entrepreneurial spirit replaced by a sclerotic institutional culture. Past glory may even be an inhibitor of future performance.

Stone & Webster was known for being old and prestigious. It was also renowned for being secret and defensive.

The Boston Globe, writing in November 1994, tried to talk to some Wall Street engineering and construction analysts to give them insight into Stone & Webster. They found that no analyst tracked the company. The company’s policy, it seemed, was not to brief the market on the company’s prospects. Stone & Webster was also the only company in its industry that did not release backlog data, an indicator of future performance.

The Globe continued: “Its [the company’s] critics say Stone & Webster clung to the past, refusing to acknowledge that its once highly profitable nuclear business was dead,” and added: “It’s a culture, say those who have worked there, where the boss is always right.” The newspaper identified the cause of this corporate culture. One former executive told the Globe: “They had been very successful in the past, so there was no reason to change. The more money they made, the more conservative they got.”

Certainly in the case of Stone & Webster, the proud words of the 1994 annual report bore little relation to the facts. The company’s core engineering business had been losing money for several years, a fact reflected in several key areas. By the mid-1990s, for example, the company’s permanent staff had fallen to 6,000 from the 15,000 of less than a decade previously. Profits flattened and the stock price fell from the mid-forties to the high twenties at a time of consistently rising markets.
From 1989 to 1993, the stock of Stone & Webster fell 11.4 percent per annum, compared with a 7.1 percent per annum increase in the S&P 500 index and an annual advance of 7.5 percent in the S&P Engineering and Construction index.

These poor figures were caused by continued poor performance of the company’s central business. Stone & Webster had, in the early to mid-1980s, done considerable business building nuclear power plants. The business was conducted on a lucrative “cost plus” basis, and the company’s profits boomed.

The “cost plus” system, under which the company is paid the cost of the project plus a percentage, may indeed have damaged the company’s ability to compete. This system does not require a company to keep costs down. It does not create an incentive to find quicker, cheaper, or innovative ways of completing a project. Indeed, since the company’s fee is based on a percentage of the cost, there is an incentive to drive up costs as high as possible. The system positively promoted ill-discipline.

The nuclear power market collapsed, however. Following the incident at Three Mile Island in 1979, followed by the Chernobyl disaster seven years later, US utilities lost interest in nuclear power. The last two nuclear power plants in the US were ordered in 1978 but later canceled.

The fact that Stone & Webster was slow to react to the decline of its central business is perhaps part explained by the diverse nature of the company’s operations. In addition to central heavy engineering, the company also had significant, but unrelated, interests in cold storage warehousing, oil and gas exploration and production, oil and natural gas gathering and transportation, office building management, and real estate development.

The assets were as diverse as the operations. The company owned four office buildings in Boston, New Jersey, and Houston (the last was under construction); three cold storage facilities in Georgia; 13 facilities for natural gas gathering and transporting in Texas, Louisiana, and Oklahoma; a portion of the land and buildings in a 1,000-acre office park in Tampa; mineral interests in the US and Canada; several inactive drilling rigs; and a portfolio of government securities and common stock.

The center of this sprawl? A holding company in New York City. Despite the fact that the engineering headquarters were in Boston, the company still maintained expensive office space in midtown Manhattan.

Stone & Webster, then, was a diverse misconglomeration, in which the central business had under-performed for several years.

Whose job is it to identify and rectify this problem?

In a public company, there are three obvious layers of accountability:

1. The disclosure of accounts. This forces a company to disclose answers on the most basic question – how is the company doing?
2. The board of directors. It is their job to replace management if it fails.
3. The shareholders. They can replace the directors if they don’t do their job.

We will see that Stone & Webster was able to subvert each of these three mechanisms for promoting accountability. As a result, the company continued to live in denial.

THE BALANCE SHEET

In business, numbers aren’t meant to lie. Performance is reflected in the fabled “bottom line.” However, because accountancy can sometimes be more art than science, this is not always the case.
A casual glance at Stone’s balance sheet would have shown a company reporting healthy, albeit diminishing profits. Stone & Webster diligently met all the rules of accounting disclosure, but the numbers hid the true story. The failure of the core business was disguised by the contribution of income from other sources. The most significant noncore addition to the company’s income came from its overvalued pension fund.

In the 1970s and early 1980s, thanks to the “cost plus” contracts they secured, Stone & Webster contributed generously to the company’s employee benefit plans, especially the pension fund. After all, pension contributions were part of the “cost,” which increased the ultimate fee to the company. Participants in the plan did not become fully vested until they had been employees for ten years—and few jobs lasted that long.

Thus, in the good years, the pension fund outgrew the company. However, as the workforce dwindled in the 1980s, there was no commensurate shrinkage of the plan. Large sums deposited earlier for pensions of terminated employees remained in the plan and became available for the company’s relatively few ongoing employees.

In the late 1980s, the excess assets in the plan passed the $100 million mark—far more than was needed for existing employees. The company amortized a portion of this surplus, and each year this portion represented an addition to the company’s income. The adjustment, it should be noted, was an accounting device and did not represent the transfer of any cash from the pension plan. Rather, it represented a reduction in the company’s operating expenses. Nonetheless, it increased the company’s reported earnings by an average $14.4 million per year from 1988 to 1994.

For example, in 1993 the company recorded a $2 million profit, but what the accounts did not state was that it benefited from a $14 million credit from the pension fund surplus, or 5 percent of the company’s gross earnings. The credit was not itemized in the income statement, as permitted by accounting standards.

Since 1987, when Stone & Webster first began the practice, the pension fund credits were responsible for reducing operating expenses by a total of $101 million. Without the adjustment, the company would have lost money every year except 1991 (see table 7.1).

The pension fund credit was not the only item propping up the balance sheet. As discussed above, there were other considerable passive assets completely unrelated to the company’s core business. For example, the company’s real estate portfolio was worth $169 million. The company also owned $38.2 million in Tenneco shares (a shipbuilding and automotive parts manufacturer) and $55 million in US Government bonds.

Stone & Webster asserted that the risky nature of the engineering and construction business made it essential to maintain substantial reserve assets in order to win new business. The company had no plans to liquidate these investments and re-invest them in the core operations, or simply pass them back to shareholders. Rather, the profits from these noncore investments were deployed to support the drifting central business.

These profitable sidelines allowed management and the board to ignore the reality of the company’s disastrous performance in its core business, and masked its failure to master a changing business environment.

In your opinion, did Stone & Webster have an acceptable business structure?

Had Stone & Webster been a company made up solely of that core division would the market have tolerated its failure for long?
Why would investors buy into a failing engineering business to enjoy the fruits of investing in government bonds and Tenneco?

Who is responsible for ensuring that a “warts and all” analysis of the company’s health is reported to shareholders? The directors? The auditors? The audit committee of the board?

THE BOARD

Clearly, in the first instance, it is the job of management to confront sustained under-performance. That Stone & Webster’s management allowed the company to drift in this way is perhaps partly explained by the fact that it was made up largely of career Stone & Webster employees. Bill Allen had been with the company since the end of World War II and Bruce Coles had started at Stone & Webster 26 years previously.
As we have seen in other case studies, it is often difficult for career insiders radically to alter a company’s direction and strategy. It is often easier for an outsider, who lacks the historical and emotional connection to the company, to effect a fresh start.

In such circumstances it is particularly vital to have a strong board, one that can demand a tough response to poor performance from long-term insiders. As we have explained in chapter 3 in this book, it is the responsibility of the board to select management, ensure they have the right strategy for success, and, if necessary, replace them if they don’t. The Stone & Webster board, however, was not capable of fulfilling this function.

In addition to the three inside directors, there were nine outside directors. With the exception of J. Angus McKee (chairman and CEO of Gulfstream Resources, Canada), none of the outside directors was a full-time executive in either business or finance. Moreover, the ability of some of the outsiders to bring an independent perspective was compromised by the length of their tenure. William Brown had served for 25 years, John A. Hooper for 20, and Peter Grace (who was 80 years old) for a whole half-century. One director who stood down at the 1994 annual meeting, Howard L. Clark, had served for 25 years.

Of the nine outsiders, four were affiliated to the company via consulting arrangements. Kent F. Hansen received $60,000 in consulting fees from the company in 1993. Fred Dalton Thompson, who resigned from the board in 1994 to make a successful run for the US Senate, was a partner at a law firm that had billed Stone $134,000 in legal fees in 1992. Also in 1992, the company received fees of $481,000 from Canadian Occidental Petroleum, of which Mr. McKee was president and CEO; and the company received $88,000 from W.R. Grace and Co., of which Peter Grace was chairman. These arrangements meant that there wasn’t a majority of independent outside directors on the board.

Of the four nonaffiliated outsiders, three were over 70 years of age (in addition to the octogenarian Peter Grace) and retired. One was a foundation executive and one was an academic.

However, most worrying was the stock (or lack of it) owned by many of the directors. Aside from Peter Grace, none of the outside directors owned more than a token amount of stock. For example, William L. Brown served on the board for nearly 25 years but had amassed a holding of just 400 shares. Meredith L. Spangler, although she had served on the board for just three years, had nevertheless purchased only 100 shares. The annual director’s retainer was $20,000. In 1994, four directors owned less than $10,000 worth of stock.

It is also noteworthy that, until late 1993, there was no nominating committee so there was no focus or energy to bring on fresh, independent nonexecutive directors.

Finally, the 1994 proxy revealed that Peter Grace did not attend 75 percent of meetings. Outside directors have a responsibility to provide a fresh, independent perspective, one that challenges the status quo if necessary.

Were Stone’s outsiders capable of performing such a role?

THE SHAREHOLDER ROLE

Directors, of course, are elected by shareholders. A board that fails to serve shareholders’ interests may find itself voted from office, but, here again, another layer of protective insulation stood between the company and its owners.

Thirty-seven percent of the company’s stock was held by the employee stock option plan (ESOP), an incentive arrangement designed to reward long-term employees at all levels in the company.
The trustee of the ESOP was Chase Manhattan Bank, which had a long-standing commercial relationship with Stone management. Chase received significant compensation for its services as a commercial and investment banker, a relationship that was strengthened by interlocks at board level. John Hooper, an outside director of Stone & Webster, was also a member of Chase’s board. A previous Stone & Webster CEO had been a member of Chase’s board.

As trustees of the plan, Chase was responsible for voting the shares in the ESOP in the best interests of the beneficiaries.

How can an ESOP trustee selected by management protect itself from conflicts of interest?

A SHAREHOLDER INVESTS

The two authors of this book were principals of the Lens Fund, an activist investment group that targeted under-performing companies and sought to use the rights available to shareholders to bring about change. In mid-1993, Lens began purchasing Stone & Webster’s stock. By year end, it owned about 172,000 shares of the company, or about 1 percent of the outstanding common stock, a stake worth about $6.4 million.

Having researched and analyzed the company, Lens concluded that the company was insulated from the discipline of the marketplace by the unreality of GAAP, a somnolent board, and a friendly block shareholder.

Do you agree with this conclusion?

A SHAREHOLDER’S STRATEGY

Lens’s first act was to seek a meeting with the company’s management, asserting that constructive dialog is a key element of the governance process. The first meeting took place in September 1993 with the company’s CEO, COO, and CFO. Management insisted that it was unwilling to consider asset sales, insisting that it needed to keep the reserves on hand to compete effectively for sizable construction jobs.

The Lens principals asked how the company could justify holding on to the Tenneco stock. The company replied that it didn’t cost them anything. Lens argued that there was an opportunity cost if the Tenneco stake was tying up capital that could be more productively used elsewhere. Furthermore, they noted that the benefit of the capital markets was that companies could seek finance as and when they needed it.

One of the authors of this book, Robert A.G. Monks, noted after the meeting: “It was a striking case of corporate stasis.” Later, the Lens principals wrote to the company suggesting that perhaps the company should privatize, with the ESOP buying out all the other investors. Lens wrote: “If a company cannot offer shareholders a competitive rate of return, it seems to me the company can determine whether it can justify having public shareholders at all.”

The company didn’t respond to this letter for two months, by which time it was too late for Lens to file a shareholder resolution.

Instead, Robert A.G. Monks proposed himself and Joseph Blasi, an expert on ESOPs, as members of the board. The company replied that the nominations committee (formed some months
previously, according to the company, although no announcement had been made) felt there would not be time to review their candidacies.

Lens also wrote to the trustee of the ESOP, Chase Manhattan Bank, suggesting that it was the trustee’s fiduciary duty to consider their candidacy for the board. They received the following reply: “The resources available to Chase enable us to fulfill our fiduciary responsibilities through internal means. Accordingly, we thank you for your interest in this matter but do not feel that it is necessary at this time to meet with your company.”

*Do you consider that the above consists of constructive dialogue?*

**THE LAW**

Lens filed a lawsuit against the company, its directors, and Chase, claiming that the company had committed fraud by failing to disclose that its engineering division had been operating at a loss and to identify its source of reported surplus from the pension fund. In essence, the suit demanded that the company disclose its financial position according to accounting principles that weren’t merely generally accepted, but offered a true view of the company’s performance.

In a statement, Lens said: “We’ve spent the last eight months asking Stone & Webster to conduct its affairs like a publicly owned company. It prefers to enjoy the benefits of the public market, but without the responsibility of full or accurate disclosure. With management and its agent Chase controlling 37 percent, we’ve turned to the court to help before it’s too late.”

The suit asked for two things – accurate financial disclosure and that the company postpone its annual meeting to permit a proxy contest or solicitation of “no” votes for election to the board. Finally, the suit asked the court to remove Chase as trustee of the ESOP because it had failed to vote the shares for the exclusive benefit of the employee members.

The court declined to postpone the annual meeting and Lens eventually lost the suit. However, in 1995, Stone & Webster restated its figures in precisely the way Lens had requested (see table 7.1) and, in a second court case, Lens was successful in an effort to secure access to internal company documents.

**1994 ANNUAL MEETING**

At the annual meeting in 1994, the company announced that William Allen was retiring as chief executive (to be replaced by Bruce Coles) but that he would continue to serve as chairman for another year.

Lens withheld its votes from the director candidates and explained why. Nell Minow said that Bruce Coles, as president of the company and CEO-elect, was part of the management team that had let the company drift.

A second executive, William Egan, was also a candidate. As the company’s executive vice-president and CFO, he had been responsible for the decision to combine the pension surplus with the operating earnings.

Of the nonexecutives, Lens withheld their votes from Kent Hansen, who owned only 200 shares, despite having served since 1988. His consulting fees from the company have been disclosed in past proxies but not in that of 1994. Further, Mr. Hansen was chairman of the nomination
committee, which the company claimed was made up of outside directors, although Mr. Hansen received twice as much in consulting fees as he did in director’s fees.

Finally, Ms. Minow pointed out that Donna Fitzpatrick, joining the board to replace Howard Clark, had purchased only 100 shares.

In a press release, Lens defended its decision to withhold its votes: “This board needs a message that shareholders will not support a board that hides negative earnings in the pension surplus, a board that fails to respond to five years of unacceptable performance.”

UNITING THE SHAREHOLDERS

Lens was not alone in finding the performance of Stone & Webster unacceptable. Frank Cilluffo, a private investor, owned or represented nearly 6 percent of Stone & Webster’s stock, a holding worth over $23 million.

At the 1994 annual meeting, Mr. Cilluffo said: “As a shareholder for the past three years, I have continually had to wrestle with the question of defining our identity. Are we an engineering firm, an investment company, an oil and gas company, an REIT, or a cold storage enterprise? It appears from our past performance that it has been very difficult to optimally manage the performance of all these industry segments. Any concerned shareholder must wonder whether it would behoove the company to focus on a single industry segment.”

He offered a seven-point recovery plan:

1. the sale of the nonengineering businesses;
2. the sale of under-utilized real estate assets;
3. possible consolidation of various engineering and management offices;
4. the sale/leaseback of owned real estate offices where appropriate;
5. maintenance of tighter employment levels, reflective of current levels of business;
6. appointment of additional knowledgeable outside directors;
7. mandatory retirement age of 67 for management and directors.

Following a similar agenda, and owning between them nearly 8 percent of the stock, Lens and Mr. Cilluffo represented a strong voice for change. How did the company respond?

A YEAR OF LITTLE PROGRESS

Between 1994 and 1995, the company’s performance went from bad to worse – in 1994, it lost money in net terms for the first time in 60 years. It laid off one-sixth of its employees. Over the course of the year, there was incremental change, but not the thorough, immediate action that Lens pressed for.

The company agreed to sell the Tenneco stock and proposed to buy back up to one million shares. Some of the company’s excess real estate was put on the market and the company’s structure streamlined. The company asserted that the changes would account for $55 million in annual cost savings. William Allen, the chairman, also announced that he would step down following the annual meeting. The company announced that Kent Hansen would replace him. Lens expressed concern that Mr. Hansen only owned 200 shares.

William Egan, the CFO, also announced his departure as both executive and director. Peter Grace also chose not to stand after a half-century of service.
The company proposed two new directors. The first was Frank Cilluffo, a candidate warmly welcomed by Lens. As the owner of a stake now worth over 10 percent of the company, he had a vital interest in the performance of the company—a interest that had been lacking in the boardroom for too long. Another new director was Elvin R. Heiberg, the president of his own consulting firm. In contrast to Mr. Cilluffo, he owned just 100 shares.

At the 1995 meeting, the CEO Bruce Coles said: “We have new incentive compensation, a new CFO, and our Cherry Hill facility is on the market. We have brought our cost structure into line with revenues. The first quarter we have recorded a profit of 32 cents a share. In the first quarter of 1994, we had a loss of 86 cents a share. Some would say we’ve been averse to change. I say we’ve embraced change.”

The moves weren’t enough for Lens, who pressed for revolutionary rather than evolutionary change. While the fund welcomed the sale of the Tenneco stock, Lens felt the asset divestment was proceeding at too slow a pace. When they pressed the company to take more urgent action, they were advised that Goldman Sachs were keeping the company’s capital structure under review and advising on divestments.

Lens replied that unless it knew the scope of Goldman’s inquiry, it could not know how effective the bank’s advice would be. The fund continually pressed for details of Goldman’s remit. No answers were forthcoming.

The issue was later raised by Lens in a letter to the board: “We have no idea what it is you asked Goldman Sachs and Co. If you had asked them for a plan of maximization of shareholder value, with full license to consider disposition of corporate assets, that would be one thing. If, on the other hand, they were asked to approve a management plan (the elements of which we are in ignorance), that would be another.”

Do you feel that shareholders of a company in a turnaround situation should be privy to the company’s strategic plan?

To whom was Goldman Sachs accountable? Who were they working for? What kinds of conflicts might the bank have faced?

In advance of the 1995 season, Lens again sought to use the proxy process as a device for airing their concerns. Lens and Lens’s contacts filed no fewer than ten shareholder proposals calling for such items as annual election of the board of directors, a requirement that there be a minimum share ownership by the directors, and asking that the company retain an independent investment bank to study asset divestment.

In a filing the size of a Manhattan phonebook, the company appealed to the SEC to have the resolutions excluded. Some of their arguments were petty at best. For example, they argued that Lens’s statement that Peter Grace had served on the board for half a century was factually inaccurate. In fact, Mr. Grace had served 49 years and several months at the time Lens filed its resolution, and by the time of the annual meeting, he would indeed have served for 50 years.

To Lens, the company’s response to the resolutions was excessive, an unproductive use of company resources, and yet further evidence that the board wished to remain insulated from external discipline.

However, Stone & Webster won the day. The SEC proxy rules allow for only one resolution per shareholder. The company argued that in essence all ten resolutions were effectively from the same source—Robert A.G. Monks, principal of Lens.

What do you think is the purpose of the shareholder resolution process? Is it to allow concerned shareholders a cheap and effective way of communicating with their fellow investors? Is it a level playing field?
The company made it difficult in other ways for Lens to advance its concerns. Monks asked to address the annual meeting from the podium; the request was declined. He tried to respond directly to the CEO’s summing up for the year, but was told he had to route all his remarks through the chairman. He sought to ask questions directly of the nominees for the board; the chairman said he would first ask the nominees if they wished to respond. Monks’s aim, of course, was to expose the director candidates to some tough questions – the kind of questions that the nonexecutive directors should have been asking for some time.

When Monks asked one director for an example of the way the board carried out self-evaluation, the chairman intervened saying that Monks had asked a question he had not submitted in advance. Another shareholder interrupted to demand an answer, saying “are you allowed to answer a question that hasn’t been pre-screened?”

To Lens, this all represented further evidence that the management was unwilling to engage in meaningful debate about the company’s future. But what does a company have to fear from its shareholders? Presumably a company’s managers and its shareholders want the same thing – the long-term prosperity of the firm. So what does a company gain by attempting to silence its critics?

The 1995 Stone & Webster annual meeting speaks volumes about corporate democracy, or rather the lack of it. In this instance, management controlled the timing and procedure of the annual meeting, and could afford the vast resources of the company’s legal department and outside counsel to ensure that an outsider couldn’t compete on level terms.

Does the Stone & Webster story tell you that the current system favors one group over another? How might the system be improved?

Luckily, Lens had prepared a back-up in case (as happened) all its resolutions were dismissed. An investor called Alan Kahn had filed, with Lens’s assistance, a resolution calling for the company to hire an independent investment bank to study divestment. This was the critical question in Lens’s view, since it required management rigorously to justify the sprawling conglomeration of unrelated assets to a credible external agency with no conflict of interest.

Mr. Kahn asked Robert Monks to propose the resolution on his behalf. Mr. Monks said the company cried out for a thorough examination from an independent, outside source – a description not met by the company’s use of Goldman Sachs. Monks agreed that Goldman was the ideal institution to carry out the inquiry but only if the company asked them the right questions.

However, the resolution went beyond the immediate issue. Rather, it was a device for framing shareholders’ wider concerns about the company’s performance. It was a peg on which to hang concerns over the company’s asset dispositions, the quality of the board, the defensiveness of management, and ultimately the long-term under-performance. Given the repeated failed overtures between Lens and the company, both in their meetings and in the courts, Monks said: “voting for this resolution is the only way we can articulate our concern for the company.” The resolution, in a wider sense, became a vote of no confidence in the board.

The company’s CFO replied that the company was doing a lot of things Lens wanted. He said the charge that the company was hiding the pension credit was “an out and out lie.” He said that hiring another investment bank, given Goldman’s assignment, was unnecessary.

The resolution won 35.6 percent of the vote. If the votes of the employee plan, voted by Chase, are stripped out, the resolution won over 55 percent of the vote – a demonstrable vote of no confidence.
The resolution’s success was based, in part, on the fact that it was supported by Frank Cilluffo, from inside the boardroom. His position as a director, backed by his sizable stake, meant his support had substantial credibility.

**FIRST PROGRESS**

Within three months, Bruce Coles quit the company. Given that Allen, after a 50-year career at Stone & Webster, had also departed at the annual meeting, the company had an opportunity to bring in new, outside blood. Lens pressed for further independent outside directors to join Mr. Cilluffo and asked the company to search for a CEO from outside the company with Lens’s help. The company agreed to these requests.

Lens continued its aggressive pursuit of the company, even seeking purchasers for the company. Fluor Corp. and Raytheon both investigated the possibility of a merger.

In September 1995, Lens issued a press release entitled: “Lens tells Stone & Webster to sell the company.” In a letter to the board, Lens wrote: “We must conclude that the only way to realize full value of assets and the jobs of skilled professionals is to sell or merge the company. We are now past the point of studying the divestiture of assets. This company needs to put itself on the market as the best chance to realize full value for shareholders.”

Stone & Webster understood that it might soon find itself in play. According to one account, Goldman informed the company that its assets were indeed more than its market value – hence it was ripe for takeover.

*Does there come a point where a company is unable to change organically and internally, and requires an external agent to effect change? Is a takeover an effective means for accomplishing this or is it a symptom of a governance system that has failed?*

Under greater pressure than ever to perform, the board continued to make changes – they agreed to pay directors in stock and consulted Lens on the criteria for new board candidates and a new CEO.

**NEW MANAGEMENT**

In February 1996, the board appointed a new CEO, H. Kerner Smith. His first job was to call all the major investors and engineering analysts, reversing the company’s traditional policy not to talk to anyone. Analysts began to follow the company once again.

The Bloomberg business news wire reported in June 1997 that the new CEO was bullish on the company’s prospects and viewed analysts’ estimates as conservative. Bloomberg noted: “The Boston-based company is starting to court securities analysts and investors as never before. In May 1996, about three months after Smith joined the company, Stone & Webster provided analysts with its first earnings guidance in its 108 year history.”

Smith’s other extraordinary discovery was the lack of an overarching strategic plan. Instead, he found separate business plans for the four core engineering businesses. He initiated what Lens had been requesting for so long – a review of the company’s capitalization and outline for the most effective deployment of assets. He put in place an ad hoc board committee to study the issue. Within a year, the company estimated that Smith’s strategy was worth about $55 a share. The company continued to sell off noncore assets and replaced a third of top management as a means of trying to deinstitutionalize the company’s culture.
CASE STUDIES: CORPORATIONS IN CRISIS

The 1996 proxy statement demonstrates that this new broom reached the boardroom. Three directors retired at the annual meeting – William L. Brown (after 26 years), John A. Hooper (22 years), and Kenneth G. Ryder (9 years).

Joining the board in their place were John P. Merrill (chairman of Merrill International, international project development), Peter M. Wood (former managing director of JP Morgan), and Bernard W. Reznicek (former chairman and CEO of Boston Edison) – all experienced businessmen. Later in the year, an additional nonexecutive director was added, David N. McCammon, a retired finance executive from Ford.

By the time of the 1996 annual shareholders’ meeting, the only directors remaining from 1994 were Angus McKee and Kent Hansen.

It was not all good news, however. Merrill and Wood only bought 200 shares, showing questionable confidence in the company’s future.

The 1996 proxy revealed further reforms. The board adopted confidential voting, allowing the ESOP votes to be cast in secret. The company also announced that, effective from January 1997, directors would be remunerated in stock. Each nonexecutive would receive an annual retainer of 400 shares and $8,000 in cash. The directors could also elect to receive all meeting fees in stock.

THE FINAL PIECES FALL INTO PLACE

In October 1996, Stone & Webster announced a “major operational and financial restructuring.” The key components were:

- **Headquarters consolidation.** Stone & Webster’s corporate headquarters in New York City were consolidated with the Boston offices of the company’s principal operating subsidiary, Stone & Webster Engineering. The Manhattan office space was offered for sublease. The company finally admitted that its commitment to clients “does not require us to continue to own substantial real estate holdings or to maintain extensive space in a high-cost midtown New York location.”
- **Streamlined organization.** The company reshaped its line management, saying that the company’s “structure has been flattened and broadened to improve accountability and encourage a more entrepreneurial environment.”
- **Real estate sale.** Stone & Webster announced the sale of its Boston headquarters building and the planned sale and restructuring of other real estate in Boston.

The good news continued. In February 1997, the company announced:

- a revised compensation plan, based on the company’s objective of achieving shareholder returns in the top quartile of the engineering and construction industry;
- a reformed nominating committee, with an expanded remit, renamed the governance committee;
- formal procedures for an annual review of CEO performance.

In May 1997, the board appointed Kerner Smith chairman as well as CEO. Kent Hansen, the caretaker chairman, was appointed Lead Director. At this point, the board consisted of 11 members, including 9 outsiders. Of that 11, all but two had been appointed since 1992.

Kerner Smith celebrated his appointment by projecting a 15 percent increase in earnings per share over the previous year. The stock hit a high in the mid-fifties in response.
Lens took considerable credit for the changes that had taken place in over four years’ involvement with the company. In its 1997 annual report, the fund stated: “Lens has played a role in changing virtually every aspect of the governance of Stone & Webster, ranging from the replacement of eight directors and two CEOs to the divestment of non-core businesses, the fundamental recasting of the financial reporting, the creation of a nominating committee, and the adoption of confidential voting, especially important in a company with its ESOP as the largest owner. The company’s focus on its engineering business has been strengthened. The Tampa land development, oil and gas holdings, the cold storage business, and the Boston office buildings have been sold or are scheduled to be sold. The company has moved out of its expensive and redundant New York headquarters office, and Stone & Webster is on its way to becoming a world competitor in its field. The stock price has appreciated 52 percent over the past 12 months.”

And Kerner Smith’s view of the fund’s involvement? “Lens keeps us on our toes.”

*Could these changes have taken place without the involvement of energetic outside shareholders motivated to improve performance?*

**POSTSCRIPT 2000**

In 2000, the company filed for bankruptcy. While it prospered for a while following Smith’s reforms, upheavals in the Asian markets and other reversals were insurmountable obstacles.
CASE STUDIES: CORPORATIONS IN CRISIS

Mirror Group/Trinity Mirror

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In 1998, Mirror Group had under-performed the market for several years. Although its core business was fundamentally sound, it appeared to be wasting shareholders’ money on noncore and non-performing businesses. Policy and personalities had led to major splits on the board. These splits were severe enough to contribute to the failure of talks about a merger with another newspaper group. By strengthening the position of the nonexecutive directors at Mirror, Hermes Focus Asset Management (HFAM) believes that it enabled the Group to resolve the stalemate on the board, to focus and proceed with its strategies for the good of long-term shareholder value.

When the merger with Trinity was completed, HFAM realized a significant profit, cashing out of 40 percent of our investment, but remained invested to enjoy the benefits of renewed focus on the core newspaper business. We have continued to test management’s thinking and helped encourage what we believe have been positive steps forward in realigning the internet strategy and operational improvements in the regional newspapers. The new chief executive has announced a strategic review and aims to further enhance the value of the business. Her arrival has been received well by investors.

HFAM became interested in the Mirror Group in 1998, having identified it as a fundamentally strong company in spite of years of under-performance relative to the market (see figure 7.2). The Mirror was the second national mass-market newspaper title and the group’s Sunday titles were ranked second and third in the UK. Though these nationals were facing the long-term decline shown by the UK newspaper market, they were highly cash-generative. The Daily Record was Scotland’s leading daily tabloid and the Group’s regional newspaper concern had a leading market position in the Midlands while developing a significant position in Northern Ireland. The company also had some young growth businesses, in specialist magazines and exhibitions, which we believed had some potential.

In HFAM’s opinion, however, there had been a recent failure to implement a coherent strategy for developing the group. The management seemed to be paying less attention to these core businesses than to peripheral unconnected divisions, mostly added by acquisition in recent years. These included Live! TV, Scottish Media Group, Blink TV and Reg Hayter. Those acquisitions, which might have had some strategic value, had been poorly timed and priced, and value had been lost. In considering the Mirror Group’s recent history, HFAM calculated an erosion of shareholder value of over £200 million in the previous 5 years, attributable to what we regarded as a number of poor financial and/or strategic decisions.

Mirror had purchased Midland Independent Newspapers (MIN) for £355 million in July 1997. Though this was a strong business and very much in Mirror Group’s core area – and the management had done a very good job of making the promised cost savings and boosting profits – it seemed to be an expansion into another mature area at the top of the advertising cycle. We estimated the current value of MIN at around £400 million. Though this was higher than the price
paid, the value had increased by less than the 22 percent rise in the media sector over the same period. Furthermore, Mirror Group’s ill-fated investment in Independent Newspaper Publishing had resulted in net losses to shareholders of over £50 million.

In addition, the unimpressive Live! TV seemed to be a sink for shareholders’ funds, in a business which had at best limited synergies with the rest of the group. We estimated the value destroyed by this investment and the ongoing losses at around £50 million. Finally, the company’s 19 percent stake in Scottish Media Group also seemed to have under-performed. It was then worth £85 million, compared with its £62 million cost, even though the media sector had leapt 85 percent over the same period. We estimated the loss to shareholders at £30 million, though we recognized that the stake might have some strategic value in a further round of television consolidation. Further to these specific losses, we were concerned about the small unconnected acquisitions – of Blink TV and Reg Hayter – which did not seem to make any strategic sense.

In the light of these concerns, and our understanding that there were splits within the board, the focus of our shareholder programme was the role of chief executive David Montgomery. Although he had done a tremendous job in his early years as CEO, cutting costs and making sense of the company in the wake of the Maxwell scandal, it seemed that shareholders had lost faith in Montgomery’s ability to make strategic decisions that would generate shareholder value. HFAM believed that if the company was to have an independent future there was need of a new chief executive in whom shareholders had confidence.

For us, the company’s strategic discussions needed to include consideration of: disposing of the Scottish Media Group stake; disposal of Live! TV; and disposal of peripheral assets to avoid further management distraction. The objective was to restore value to the existing core business before...
reconsidering longer-term strategic issues such as the possibility of a merger with another regional newspaper group. HFAM made its first investment in October 1998.

**JANUARY 1999**

Our shareholder program was launched on January 11, 1999. Trinity, the UK’s largest regional press group, revealed that it had broken off merger talks with Mirror Group for the second time in a year. Despite reports that the merger, if it were to go ahead, would yield annual cost savings of up to £20 million, there were two sticking points, according to the City rumor mill. The first centered on the rumored bid price of 155p, approximately 0.375 of a Trinity share. The second focused on reports that Trinity’s insistence that David Montgomery would take a limited role in any new venture had split the Mirror board. Trinity indicated that merger talks would not resume until they were convinced that Mirror’s board was united.

It was this internal split and the fear of an unacceptably low opportunistic bid for the Mirror Group that triggered HFAM’s shareholder program. In an attempt to strengthen Mirror’s position, HFAM felt that shareholders would unite behind a campaign for a new chief executive who could keep open all future strategic options – a continuing independent Mirror, a merger, or a cash sale.

The following two weeks were some of the most hectic in the life of HFAM as we had multiple meetings with shareholders and various members of the Mirror board. We needed to act particularly quickly because the company was facing a low opportunistic bid – announced on January 18 – from Regional Independent Media (RIM). This offered 200p a share, well below what we believed was the true value of Mirror Group.

Having taken soundings from shareholders representing over 50 percent of Mirror Group equity, and following discussions with some of the nonexecutives, on January 20 we wrote to the chairman, Victor Blank, formally requesting the nonexecutive directors “as a matter of urgency, to consider the appointment of a new chief executive committed to realizing value for shareholders over time.” In our discussions with the executive board members it became apparent that the divisions on the board extended beyond the disagreement over the Trinity merger; in fact it seemed that there had been a breakdown in relations between the chairman and chief executive.

On January 21, we agreed to bring forward a planned meeting with Montgomery to the following day. Later that afternoon, Blank asked HFAM to sign a requisition for an EGM1 to remove Montgomery in case this was needed. We agreed. Montgomery resigned on January 26.

The Mirror Group had already rejected the bid from RIM and on March 1 it also rejected a 215p-a-share offer from Trinity. Subsequently, both RIM and Trinity made formal applications to the Secretary of State for consent to the transfer of ownership of newspaper titles and newspaper assets owned by Mirror – a necessary process before any merger or takeover could be completed.

HFAM’s activities in the intervening period made clear to the board of Mirror Group that we would lend our support to whichever one of three strategies the board agreed on. We believed that each of these strategies – a merger with a rival media group, a cash bid, or an independent Mirror Group – could achieve our target valuation. HFAM confirmed to the Mirror executive directors that we would support a well-reasoned decision for the Mirror Group to be maintained as an independent company if that was the board’s view. We also held a number of meetings with Trinity directors to consider the desirability of a merger from a Mirror shareholder perspective in advance of the Competition Committee’s announcement.
JULY 1999

That announcement came on July 23: the Committee gave its consent for the proposed transfer to Regional Independent Media Holdings and to Trinity, on the condition that Trinity divest its titles in Northern Ireland. A week later, the boards of Trinity and Mirror Group announced that they had reached agreement on a proposed merger to form Trinity Mirror plc (see figure 7.3). Under the terms of the merger, Mirror Group shareholders would receive 0.325 New Trinity shares and 82p in cash for each Mirror group share. Trinity and Mirror Group shareholders would hold approximately 48.4 percent and 51.6 percent respectively of the merged group’s issued share capital. On this date, the terms of the merger valued each Mirror Group share at approximately 271.5p and the whole of Mirror Group at £1.2 billion.

Trinity declared the offer for Mirror Group wholly unconditional on September 6, 1999. The new Trinity Mirror shares were admitted to the Official List. HFAM sold a portion of its stake in the weeks either side of this transaction, but we retained the majority of our holding because we believed that the combined Trinity Mirror had potential to add real shareholder value. In particular, the new company had an attractive strategic position from its increased scale in the rapidly consolidating regional newspapers market. What was more, we believed that the company’s unique material gave it an opportunity fully to exploit the burgeoning internet marketplace.

In meetings with Trinity Mirror management around the time of the merger, we made it clear that we believed one key strategic issue for the company was how to exploit its content and market

![Mirror Group performance from October 1, 1998 to merger.](chart)

**Figure 7.3** Mirror Group performance from October 1, 1998 to merger.
position in the internet age. In particular, we argued that the company should consider splitting off its internet operations from the old economy activities, perhaps through a partial flotation. We continued to emphasize the need for a focused internet strategy throughout the remainder of 1999 and into early 2000. Unfortunately, the management was understandably distracted from these challenges by the need to carry through the complex integration of Trinity and Mirror. Furthermore, the company’s share price was depressed by rising newsprint prices, which pushed the whole sector downwards, and by a company-specific problem over circulation irregularities in Birmingham, which came to light in November 1999.

The full announcement of a detailed internet strategy was only made in March 2000, alongside the company’s preliminary results. We continued to raise concerns about the internet strategy over 2000 in meetings with both the senior management and the divisional executives. Our assessment was that while Trinity Mirror had some very sensible internet businesses that fitted with its existing divisions and content – in sports and betting it had IC Sport, and it also had various sites for specific local and regional information – we doubted that the other businesses had any real strategic fit. We also believed that they would continue to be substantially loss-making. In particular, the company’s operation of an internet service provider, IC 24, was effectively paying customers to use it, and the company was unable to articulate any competitive advantage in this field. The other sites – IC Showbiz and IC Choice – similarly seemed expensive and noncore.

SEPTEMBER 2000

By September 2000, it appeared that the management had begun to agree with our assessment. It seemed likely that the company would sell IC 24 and refocus the company’s internet efforts on sports and betting, and the regional sites. Over the following months, HFAM suggested that the portal could simply be shut down rather than kept alive with further injections of shareholders’ funds until a possible but very uncertain sale.

However, the next news from the company was the surprise purchase of Southnews, a rival local and regional newspaper publisher based in the South-East. Announced at the end of October, the deal cost £285 million. While it made great strategic sense, filling a gap in Trinity Mirror’s coverage countrywide, we had concerns about the price Trinity was paying – a premium of nearly 60 percent over the former share price, or around £100 million. The executives worked hard to provide HFAM and the rest of the market with evidence that the price, though full, was not out of line with previous similar deals. They also argued that they could make enough cost savings, particularly in printing, to justify the price paid.

In March 2001, Trinity Mirror finally announced changes to its internet strategy. Overall, it was to scale back its investment in the area. In particular, it announced it would sell IC 24 and its 50 percent stake in the sporting site Sportinglife.com – which it co-owned with the Press Association – freeing itself to concentrate on its wholly owned sports and betting websites. The stock market reaction was highly favorable.

JUNE 2001

The year as a whole, however, turned out to be a difficult one for the company. It was hit hard by the market-wide fall in advertising revenues: in June it announced a 10 percent year-on-year
CASE STUDIES: CORPORATIONS IN CRISIS

Decline, in line with that faced by the whole media sector. In December it revealed that the number for the national papers was nearly 21 percent. Throughout the year, Trinity had therefore focused on cost-cutting and operational management. In particular, the company had great scope to enhance the returns at its regional papers, which had always been run as separate businesses, frequently with up to 15 percent differences between cost levels in specific areas at the different businesses. By sharing best practice, the company had huge scope to close the margin gap with its competitors. This “From Biggest to Best” program was headed by Joe Sinyor, who at the end of 2000 had been appointed chief executive of newspapers, reporting to overall CEO Philip Graf.

HFAM agreed that this focus on operational matters was the best way forward for the company. There were rumors in the market that the company was considering selling its national newspaper titles, and also unhelpful rumors about possible changes to the executive management of the group. In our meetings and communications with the company, we argued that any such deal should not be rushed into until the operational improvements had been achieved. A November letter to Graf made these views particularly plain: while we backed the operational focus he was leading, we emphasized the need to work harder at turning around City opinion about the company. Our discussions with analysts made it clear that City perceptions were driven by the company’s historic tendency to deal-making. Analysts were waiting on the next deal, so the company’s new focus on operational matters needed to be explained more clearly. Only then would perceptions change and the stock be revalued.

FEBRUARY 2002

The company’s hard work on operations began to pay off in early 2002. The market responded well to Trinity’s preliminary announcement in February, despite a £150 million write-down of assets, which pushed the company into loss. A particularly positive piece of news was the £16 million cash released from cost-cutting – and the further £22 million promised for 2002. It seemed the “Biggest to Best” program in the regionals was bearing fruit. Importantly, Trinity also announced a relaunch of the Mirror and Sunday Mirror titles, distancing them from the fiercely competitive so-called “red-top” market and giving up the rather fruitless aim of winning readers from rival titles. Instead, the focus was to be on retaining existing readers and encouraging them to read the titles more often. This, the company predicted, would drive more value for shareholders. Costs would also be cut as the Mirror papers’ advertising departments were to be placed into a joint venture with those of the Telegraph Group newspapers.

This news triggered the awaited re-rating of Trinity Mirror and HFAM began selling down our stake slowly from the start of March. This process was, however, hampered by volatile and illiquid markets, which made any substantial selling impossible. HFAM remained bound by our usual sales discipline of selling once a stock has reached our calculation of fair value, but not selling if the only price practically available on the market is 5 percent below this.

The difficulty in selling was exacerbated as the market began to lose confidence in the strategic relaunch of the Mirror. This loss of confidence was sparked by price cuts. Though these were said by the company to be an integral part of the relaunch and associated marketing spend, aiming to build loyalty and ensuring readers became more regular purchasers, it seemed to the market to run counter to the stated intention of abandoning competition with long-time rival the Sun. The Sun more than matched the cuts and launched a marketing campaign to bolster its position. It appeared to the market that Trinity Mirror was overspending on a mistaken pricing strategy.
Over mid-2002 we tested the reasoning behind the board’s decision to offer price cuts in various meetings. The debate also brought into sharp focus the division between the regional and national newspapers. The regional business was (even given the tough advertising market the company faced) a strong one, with scope for substantial increases in profits as the “From Biggest to Best” program fed through to cost savings and revenue growth. In contrast, managing the nationals business remained an issue largely of limiting decline and controlling its consequences. We explored the possibility of splitting these businesses with board members and other investors. We were assured that the board had considered this option, but had not received any offers for the national papers that would have enhanced the value of the group.

Further uncertainty was added to the market’s perception of Trinity Mirror by the announcement that finance director Margaret Ewing was leaving the company to join BAA plc. Concern mounted over the summer, as it became apparent that the price-cutting strategy was not sustaining the Mirror’s circulation, but that the Sun continued to gain readers at its expense. The market was losing confidence in the existing management team to take the business forward.

SEPTEMBER 2002

The tail-end of September saw the announcement that long-standing chief executive Philip Graf would be leaving in the summer of 2003 to pursue other interests. This was followed a week later with the embarrassment and further disruption of Ewing’s appointed successor Ric Piper in effect being sacked even before having joined the company. The Trinity board evidently felt that his joining the company would not be taken well in the market because of his former role as finance director at WS Atkins, which had just issued a profits warning that had undermined its share price. Piper has now reached a settlement with Trinity Mirror over loss of income.

Sly Bailey was announced as Graf’s replacement in December. Bailey is well respected in the magazine publishing business, having risen rapidly through publisher IPC to the role of chief executive shortly after the company had come under the ownership of private equity house Cinven. At IPC, Bailey had been charged with readying the business for sale within three years, something she achieved in only two when she sold the company to AOL Time Warner.

Bailey joined Trinity in early February 2003. Her arrival was preceded by the expected departure in January of Joe Sinyor, who had been a rival for the role of CEO. Bailey released unspectacular annual results at the end of February, which again showed evidence of continued slow progress on efficiency and merger benefits within the business. However, the numbers were again marred by a substantial impairment charge and the continuing decline in circulations at the nationals. Bailey faced a substantial challenge in ending those declines, continuing to make efficiency savings, and making clear what the synergies are between the two halves of the business. She announced a strategic review and took the sensible step of abandoning the failed price-cutting strategy. She also halted the move to link the Mirror and Telegraph advertising departments.

Bailey’s arrival and initial meetings were well received in the market. This, combined with the continuing operational improvements, led to strong share price out-performance in early 2003 (see figure 7.4). The fact that the price had out-performed in 2002 in the face of a difficult advertising market was a credit to the impressive operational progress over time. There was also a small speculative bid premium in the price based solely on a story that the board had rejected approaches from private equity firms in late 2002. HFAM’s sales discipline means that we continue to sell down our stake as and when the market allows.
NOTE

1. Under UK law, shareholders holding 10 percent of a company’s issued share capital can require a company to call an Extraordinary General Meeting to discuss resolutions that the shareholders propose. These resolutions can include the removal of any current member(s) of the incumbent board.
Adelphia

From “The Adelphia Story” on Adelphia’s website:

In 1952, John Rigas borrowed money from family and friends to buy a small movie theater in Coudersport, Pa., not far from his hometown of Wellsville, NY. To cover expenses and repay his debts, he kept his day job and spent evenings at the box office selling tickets and popcorn and running the projector. Many nights, he curled up on a cot in the theater to catch a few hours of sleep before driving back to work early the next morning.

An RKO film salesman urged him to take advantage of a local cable franchise that was for sale. After months of prodding, John reluctantly bought his first cable franchise for $300, a sum that seemed like a steep price for admission into an industry that did not yet exist. The next year he took his first steps toward constructing and operating a cable television system, one of the first in rural Pennsylvania.

In 1972, the company was incorporated under the name ‘Adelphia,’ derived from the Greek word for ‘brothers.’ A glorious growth spree would follow. Adelphia built its success on a strong commitment to customer care. ‘We strive to earn our customers’ trust by making sure that every customer is satisfied with the outcome of every contact he or she has with our people and the service we provide,’ says Adelphia’s founder John Rigas. ‘With this philosophy, we’ve grown up from a company with one customer, then 100, to the company we are today.’ By 1998, Adelphia passed the two million-customer milestone and now serves approximately 5.6 million cable television customers nationwide.

Rigas was known to be ambitious and to be willing to take on enormous risks. He overdrew his bank account to get the $300 to make his first cable franchise acquisition and borrowed heavily to finance his expansions. He continued to leverage heavily. “In 1996, Adelphia’s debt was 11 times its market capitalization, an off-the-chart number. (By contrast, Comcast’s ratio was 1.28; Cox Communication’s was 0.45.)”1 Rigas made a lot of acquisitions, some for Adelphia, some for the family’s private holdings.

On March 26, 2002, Adelphia had 5.7 million subscribers in 32 states and Puerto Rico. Five members of the nine-member board of directors were members of the Rigas family: founder John Rigas, his sons, Michael, Timothy, and James, and his son-in-law, Peter Venetis. The stock was trading at $20.39 a share, half of its high.

The next day, Adelphia disclosed that the Rigas family had borrowed $2.3 billion through various family owned partnerships off its balance sheet. Adelphia’s stock dropped 18 percent. A day after that, on March 28, Adelphia acknowledged that it might be liable for as much as $500 million in debt it guaranteed for Adelphia Business Solutions Inc., a telephone service company spun off
from the parent and run by James Rigas. It had filed for bankruptcy protection. On April 1, 2002, Adelphia said in an SEC filing that it needed more time to review its accounting and would not meet the deadline for filing its annual financial statement. The stock closed at $13.12.

On May 23, 2002, Rigas and sons Timothy, Michael, and James resigned as directors. The family agreed to turn over over $1 billion in assets to help cover loans, to turn over $567 million in cash flow from other cable companies the family owned, and to pledge all stock held by the family as collateral. Adelphia estimated it was liable for $3.1 billion in family debts. The stock was delisted by NASDAQ a week later. It was trading at 70 cents a share. On June 25, 2002, Adelphia filed for bankruptcy, saying that it could not meet the $7 billion in outstanding loans.

According to an article in Fortune:

“Adelphia inflated subscriber numbers. Routine expenses like service calls had been booked as capital items, inflating Adelphia’s reported cash flow. But what was perhaps most unsettling was the unabashed manner in which the Rigases helped themselves to shareholder dollars. Adelphia financed the family’s $150 million purchase of the [Buffalo] Sabres [hockey team]. It paid $12.8 million in 2001 for office furniture and design services provided by Doris [Mrs. John] Rigas . . . . [T]he primary source of income at Rigas’ farm wasn’t honey sales; it was providing landscaping, snow removal, and other maintenance duties for Adelphia.2

Adelphia shareholders also paid for the New York apartment occupied by Ellen Rigas (daughter of John and wife of Adelphia director Peter Venetis) and funded the $3 million production costs of her movie, ‘Songcatcher.’ They put $65 million in the Praxis Capital fund run by Venetis. They paid her brother Tim’s $700,000 membership fee at the Golf Club at Briar’s Creek. And they guaranteed $1 billion in loans to a Rigas family partnership, which used the funds to buy stock.

A month after the bankruptcy, five executives, including three members of the Rigas family, were arrested and led away in handcuffs, charged with looting the nation’s sixth-largest cable television company ‘on a massive scale.’ The SEC filed a related fraud complaint. James B. Comey, US Attorney for the Southern District of New York made a statement concerning the Adelphia indictments on September 23, 2002:

“The Indictment charges that, from 1999 through May 2002, the defendants participated in a scheme to defraud Adelphia’s creditors and investors by, among other things, making false and misleading statements concerning (1) Adelphia’s “off-balance-sheet” debt; (2) the company’s purported deleveraging through a variety of securities transactions; (3) Adelphia’s operating performance, as reflected in such metrics as its EBITDA (earnings before interest, taxes, depreciation, and amortization), basic cable subscriber growth, and plant rebuild progress; (4) Adelphia’s compliance with various covenants and financial ratios required under its loan agreements and the indentures related to its bonds and other debt securities; and (5) the unauthorized and unreimbursed use of Adelphia’s funds and assets by the Rigas Family.

‘According to the Indictment, Adelphia was one of the most heavily indebted companies in the cable television industry, in part as a result of its rapid expansion through a series of highly leveraged acquisitions of other cable companies.
According to the Indictment, Adelphia faced intense pressure from investors, lenders, securities analysts, and credit rating agencies to generate high levels of earnings to service its staggering debt load, and to reduce its leverage.

'However, according to the Indictment, Adelphia consistently failed to meet Wall Street’s expectations and in order to conceal that failure, and avoid such consequences as a decline in Adelphia’s stock price, inability to access the capital markets, and default on its debts, the defendants perpetrated a scheme to create the false appearance that Adelphia’s operating performance was consistently in line with Wall Street’s expectations, and that Adelphia was systematically deleveraging through, among other means, sales of equity securities to the Rigas Family.

'The Indictment charges that the Rigas Family used billions of dollars in Adelphia’s funds and assets for their own benefit. Among other things, the defendants allegedly caused Adelphia to pay more than $250 million in connection with personal loans to the Rigas Family. From 1999 through April 2002, John J. Rigas, Timothy J. Rigas, Michael J. Rigas, and other members of the Rigas Family allegedly took unauthorized and undisclosed cash advances from Adelphia, totaling more than $50 million. In addition, the Rigas Family spent approximately $13 million in corporate funds to construct a golf course located on land primarily owned by them, it was charged. Such uses of Adelphia’s funds and assets by the Rigas Family were not presented to or authorized by Adelphia’s Board of Directors, and were not disclosed to the non-family members of the board or to the public, according to the Indictment.

'The Indictment seeks forfeiture of at least $2.533 billion of the proceeds of the scheme to defraud.'

[Comey said that the] scheme charged in the Indictment is one of the most elaborate and extensive corporate frauds in United States history. The Rigas defendants and their co-conspirators exploited Adelphia’s byzantine corporate and financial structure to create a towering facade of false success, even as Adelphia was collapsing under the weight of its staggering debt burden and the defendants’ failing management of the company, and the Rigas Family lined their pockets with shareholder dollars. The defendants used many of the most sophisticated tricks in the corporate fraud playbook, including concealing Adelphia’s billions of dollars of off-balance-sheet liabilities, using dishonest pro forma reporting, and manipulating unaudited metrics such as EBITDA and subscriber growth statistics. Although the defendants for years deceived some of the most sophisticated financial professionals on Wall Street, the Indictment in this case demonstrates that this Office, along with its law enforcement and securities enforcement partners, will quickly get to the bottom of even the most complicated corporate frauds and bring swift justice to CEOs and other executives who use their positions to deceive investors and victimize public companies. “

The company’s director of accounting and vice president of finance pled guilty to fraud charges and promised to cooperate with prosecutors working on the charges against the members of the Rigas family.

Adelphia itself sued the Rigas family and the auditors, alleging that the majority presence of the Rigas family on the board should have made it a “high risk” audit and therefore subject to
additional scrutiny – and skepticism. The company (represented by its remaining directors) alleged that Deloitte knew, but didn’t tell the board, that the Rigases regularly took funds from Adelphia’s cash management system. If the “unorthodox cash system” had been revealed, the Rigases’ “massive self-dealing could have been and would have been prevented, saving Adelphia hundreds of millions, if not billions, of dollars in damages.”

They also alleged that despite reasons to be wary, Deloitte consistently gave Adelphia a clean bill of health. On March 26, Deloitte told the board that the 2001 audit “was one of the best audits they had ever had,” with only “four minor issues.” The report was scrapped the next day after Adelphia disclosed the co-borrowing deals, as lenders and investors challenged company debt figures.

In its statement to the press, Deloitte said, “the board, including its independent directors, knew and approved of many of the acts complained of.” It noted that it was considering its own lawsuit against Adelphia and current or former executives and directors “who supplied Deloitte with erroneous and incomplete information.”

The IRS noted that it, too, was investigating the Rigas family for failure to report the alleged payments as income.

Even though the new CEO was “a consummate Rigas family insider,” he and the other “independent” directors, believing they had been lied to, hired David Boies, the lawyer who represented the US government in the Microsoft case, to look into the books. They told the Rigases that if they did not sign over voting control to the independent directors, they would resign and go public with everything they had uncovered. After the Rigases relinquished control, the company was able to get a $1.5 billion bank loan. The acting CEO hopes to be able to restructure to regain solvency.

**WHAT HAPPENED?**

This was a modern-day version of the story of the Emperor’s New Clothes, the story about the two con men who tell a vain emperor that they have cloth so rare that it cannot be seen by those who are stupid or unfit for their jobs. Everyone, even the emperor, is unwilling to admit that the emperor isn’t wearing anything because they think that everyone else can see it.

John Rigas was a very big man in a very small town. Coudersport, Pennsylvania, had a population of just 2,600, and every single one of them knew John Rigas and almost every one had a reason to be grateful to him. Rigas, a benign “Lord Bountiful” for the town, brought in a symphony orchestra to play at the Christmas party he gave for Coudersport, sent busloads of children to Sabres games, and used the corporate jet to fly sick people to get treatment.

The *Fortune* article speculates that “There were things that John Rigas and his sons got away with in Coudersport that would never have been tolerated anywhere else.” Adelphia was such an overwhelming presence in the town that no one had the incentive, the ability, or the energy to take it on.

The family was very close. Two of the Rigas sons moved back in with their parents after they graduated. A third lived away for a year and then returned to Coudersport. After they all went into the business, it began to grow dramatically. *Fortune* quoted an executive: “Decisions were made at the dinner table rather than in a boardroom or somebody’s office.”

No one was there to provide any oversight. “Adelphia was a relatively rare hybrid: a publicly held company whose economic interest was owned by thousands of holders of its common stock,
but whose management interest was controlled almost entirely by the founding family. Because it was set up with a dual-class voting structure, the Rigas family had 11 percent of the economic stake in the company but controlled 56 percent of the votes.

That meant that the family controlled the board. Rigas, his sons, and his son-in-law held five of the nine seats on the board. The other four were friends and business associates who knew that if they rocked the boat, they would be replaced. Perhaps that’s why no one mentioned that it might be a problem to have Tim Rigas as both CFO and chairman of the board’s audit committee.

When the Coudersport tax collector noticed that the real estate taxes of both Adelphia and the Rigas family were paid with a single check, she, like everyone else in Coudersport, thought that the Rigases must know what they were doing. No one wanted to speak up for fear of being thought a fool or not suited for his job.

The Rigases routinely ignored calls from analysts. When a high-yield bond analyst said he could not figure out where the money was coming from for the stock purchases committed to by the family, they refused to answer. Then on March 27, 2002, in a footnote on the last page of Adelphia’s quarterly earnings press release, the company disclosed that it was liable for $2.3 billion in off-balance-sheet loans to the Rigas family. Even after that disclosure, there was another $175 million withdrawal from the company’s cash management system to cover margin loans. Even after he had resigned as chairman and CEO, Rigas showed up at a board meeting, only to be told that he had to leave. The emperor was finally told he was naked. In 2004, founder John Rigas and his son and former CEO Timothy Rigas were convicted on multiple fraud charges. The company’s cable assets were bought by former rivals Comcast and Time Warner.

NOTES

3. Ibid.
Arthur Andersen

Before there was Arthur Andersen, the $9.3 billion international accounting and consulting firm, with offices in 84 countries and 85,000 employees, there was Arthur Andersen, the 28-year-old son of Norwegian immigrants, who left Price Waterhouse to open up his own accounting firm in Chicago with just one other partner. It was 1913 and the combination of industrial expansion and the introduction of the new income tax made the prospects promising for specialists who were more than bookkeepers. Andersen’s announcement of the new firm offered clients help with “the designing and installing of new systems of financial and cost accounting and organization.”

In his first year in business, Andersen told a railroad executive that there was not enough money in the city of Chicago to make him approve a set of books that had not adequately recorded operating expenses. The railroad went bankrupt a few months later, helping to establish the young firm’s reputation for integrity. That story was told to all of the accountants who attended the firm’s intensive training program to teach them the standard they were expected to uphold and carry forward.

Before long, many other stories of the uncompromising integrity of AA’s auditors were added to the list. They were on the right side of many of the twentieth century’s most memorable financial scandals. After the stock market crash of 1929, they helped to unwind the pyramiding financing structure of Samuel Insull’s power companies, keeping them out of bankruptcy. The post-crash reforms requiring independent audits boosted their business. As AA grew, Andersen kept tight control of its work through the “one firm, one voice” concept, telling employees and clients that services and results must be utterly consistent. To make that work, AA established extensive in-house training facilities, ultimately taking over an entire college campus.

Another of Andersen’s innovations was the “Blueback” memo, commentary from the audit partner to the client about any issues that might be of interest to the client regarding its operations.

Andersen died in 1947. His successor, Leonard Spacek, presided over AA’s growth into the foremost accounting firm in the world. Instead of affiliating with other firms abroad, he opened up AA offices, so that the “one firm” concept would apply worldwide. By 1963, they had 55 offices in 27 countries, staffed with locals who had been through AA’s rigorous training. All partners shared in the global revenues, so all were committed to the success of the entire firm.

It was Spacek’s idea to make the symbol of the firm its heavy mahogany doors. He said that they represented “confidentiality, privacy, security, and orderliness.” Identical doors were installed in every AA office throughout the world and the doors were incorporated into the firm’s logo. The original doors were selected by Arthur Andersen’s son-in-law (who told Andersen that they cost $200 instead of the real price of $1,000). They were such a powerful symbol of the firm that they were moved to AA’s corporate training center to inspire all who came to learn what AA stood for. In 2000, AA abandoned Spacek’s mahogany doors for a new and nonrepresentational symbol – a glossy orange sphere – that was intended to impart some dot-com era sizzle.

Spacek “honored the firm’s sense of itself as the financial world’s answer to the Marine Corps.” In his efforts to impose consistency in appearance and performance throughout the organization, no detail was too small. In one legendary memo, he wrote, “Everyone should make it a habit to
be busy all the time and avoid any appearance of being inactive or unoccupied. When walking in the halls, walk briskly.”

A former partner who started work at AA in 1951 remembered that, on their first day, the young men were given five dollars to buy a hat. They were told to wear felt hats from Labor Day to Memorial Day and straw hats in the summer. (No woman would make partner until 1976. By 1998 only 7.5 percent of the partners were women.)

AA continued to maintain its reputation for integrity. It resigned all of its clients in the savings and loan industry before the very accounting tricks AA refused to bless led to a series of massive failures and several criminal convictions.

However, just 15 years later, AA itself abruptly failed, after several of its clients were involved in massive accounting scandals and after AA itself was found guilty of obstructing justice in connection with its destruction of documents relating to its work for Enron. On August 31, 2002, AA issued a statement that was simple but with a devastating effect: “As of this day, Arthur Andersen LLP has voluntarily relinquished, or consented to revocation of, its firm permits in all states where it was licensed to practice accountancy with state regulators.”

**ANDERSEN CONSULTING**

AA was a pioneer in nonaudit consulting. It began as a way to help its clients. In 1954, they set up one of the original Univac computers at GE to help with its payroll and AA was soon selling its services as systems analysts in bringing computer technology to its customers. At first, the consultants were all accountants and were required to spend two years in audit practice before being permitted to do consulting work. When that rule was rescinded in the late 1960s, it stopped the waste of time on training people who were not going to stay in accounting but it eliminated the common ground and culture that had kept both sides feeling as though they were on the same team.

Some time in the 1970s, the consultants became more profitable per partner than the auditors. “The opposing forces of a stagnating audit business and a rapidly growing consulting business created a ‘stress’ fracture along these practice lines.” As one insider described it:

> The solid, trustworthy, proudly boring way of the accountants began to lose its appeal as auditing revenues plateaued. And the stability and respectability of Arthur Andersen was losing its pull as the booming economy gave young business majors many different career options. Slowly, a mighty culture was disintegrating into a soulless cult behind those doors, and I stumbled right into the middle of it.

The firm had always had a clear idea of its values — and its value. The defining story about Andersen’s refusal to sign off on the railroad executive’s books set the stage for AA’s view of itself and its uncompromising integrity. That was more than just a corporate value. It was the key corporate asset. Clients would come to a firm whose name on the audit provided an extra sense of confidence and comfort to investors, regulators, and employees. However, that began to change when the two sides of AA fell into bitter sibling rivalry. The audit side still controlled the firm’s management and the consultants chafed at being told what to do by people who were not part...
of their group. They chafed even more at subsidizing the less profitable side. They felt they were paying for much more than they were getting.

Spacek’s successor in 1970 was Harvey Kapnick. He was concerned about the possible ethical conflicts that might arise between the consulting and audit sides. His concerns were practical and political – after being called to testify before a Senate committee on the issue of potential conflicts between accounting and consulting, he concluded that the government would require a split and that AA should do it first. He proposed a spin-off of the consultants into a separate firm at the partners meeting of 1979. However, he handled the issue poorly and failed to get the approval of the partnership. The partners thought they would be at a competitive disadvantage if they split and they didn’t want to lose the lucrative fees. “‘The audit partners loudly refused to let go of the consulting golden goose.’” Kapnick was forced out.

Kapnick’s successor, Duane Kullberg, did his best, and it worked for a while, but hostilities between the two sides of the firm continued to simmer. When Kullberg was given a copy of a memo the consultants drew up that showed an estimate of their value as a separate entity, the relationships deteriorated further. To make things more confusing, the audit side of AA set up its own consulting divisions.

The two groups became separate in operations and marketing in 1989 – so much for the concept of “one firm, one voice.” The Andersen Consulting offices did not even have the trademark mahogany doors. It was like a bad marriage. They tried counseling, bringing in mediators, but it did not work. At an April 1997 meeting in Paris, the nearly 2,800 partners for the first time had a contested election for head of the firm, with one candidate from consulting and one from the audit side. Then, both lost, neither gaining the required two-thirds majority. In December, the consulting partners voted unanimously (with one abstention) to split themselves off from AA. The final split was accomplished through arbitration of a thicket of legal and financial disputes.

Andersen Consulting changed its name to Accenture and omitted any mention of AA in the corporate history on its website. The audit side was deeply bitter. It also left them with less money; $100,000 per partner had to go to the consulting side according to the terms of the arbitration.

Both pride and pocketbook pushed what was left of AA to become much more aggressive in seeking and expanding business and that meant rebuilding the consulting practice. Auditors became salesmen. They were put under a lot of pressure to meet specific revenue goals. In an absurd 1989 partnership pep talk, audit chief John Edwards brought a live tiger on stage while the “Rocky II” theme song “Eye of the Tiger” boomed out, as he urged the accountants to go for the gold.

AA was determined to show Accenture that it could do better and make more money without them. You can’t do that if you are going to tell a client that there isn’t enough money in Chicago to make you sign his cooked books.

A CONFORMIST CULTURE

AA specifically sought new hires who were malleable and inclined to conform. Job applicants were evaluated across a complex set of metrics, but positive indicators of a prospect’s ability to “fit in” included being the first one in the family to attend college. Young people without first-hand observation of the professional working world were considered easier to mold into the “one firm’s” idea of how to do the job. The firm had a strong bias for hiring people just out of school and rarely brought in outsiders with established careers, who might have their own ideas about how to do things, until the 1990s.
At the firm’s St. Charles training facility, all new hires learned the AA system for doing an audit in a sort of accounting “boot camp,” with the idea that no matter which office was in charge, any other accountant in the firm would be able to open up the schedule and find every document and number in the same order as every other audit in every other office.

The idea of “one firm, one voice” promoted not just consistency but conformity. Instead of unanimity in upholding the highest standards, it led to a lowest common denominator approach. One-time partner and organizational behavior and corporate ethics specialist Barbara Ley Toffler said that her experience at AA led her to understand the connection between the words “culture” and “cult.” She said that the highly conformist employees were jokingly referred to as “Androids,” and that “it would never occur to them to question any practice, despite the cosmic changes taking place both inside and outside the Firm.”

Toffler attended a class called “Transitions” to teach lateral hires how to adapt to life at AA. The class outlined six “CLMs” (career-limiting moves), the first of which was “overcustomizing your office.” Two more were “trying to do it all alone” and “sugarcoating the truth,” but in practice there was no incentive for raising questions or problems with anyone senior. On the contrary, “If a person had a problem, that was prima facie evidence that that person didn’t fit here at AA,” according to one executive.

The consequences of this “do what the partner wants without asking questions” culture were tragic when David Duncan, the lead partner for Enron, told the staff to comply with the firm’s document destruction policy following the revelations of accounting problems at Enron. Whether it was what he intended to imply or not, this direction led to the destruction of more than a ton of documents and roughly 300 emails and computer files – more shredded in three days than the firm normally destroyed in a year. Duncan was there and made no effort to stop it. “Andersen staffers were seen huddled around file cabinets, riffling through desks and picking through piles of paperwork in the Houston office’s common workspaces, their hands stinging from papercuts.”

**WHO WATCHES THE WATCHERS?**

Harvey Kapnick created a prestigious Public Review Board made up of outside experts like the former chairman of the Securities and Exchange Commission to visit AA facilities throughout the world and review their practices to make sure that they were meeting the highest standards of integrity. After the consulting/audit split, the board was discontinued, and no equivalent mechanism was ever established.

For most of AA’s history, its internal “Professional Standards Group” had the final word on any ethical dispute or question of the application of accounting principles. The group’s head until 1980, George Catlett, had an office no more than 50 feet from the office of the CEO, but that ended in 1992. The PSG called for the increasingly popular form of executive compensation, stock options, to be expensed at the time of the award, They were overruled, and from that time on, their power was severely diminished. One of the group’s partners, Carl Bass, was removed from the Enron account at the client’s request, after he challenged the way they wanted to characterize the sale of options owned by one of the partnerships managed by CFO Andrew Fastow. “Andersen was the only one of the Big Five where a local partner could overrule the Professional Standards Group. In retrospect, the system for airing such conflicts at Andersen seemed designed to ensure that top executives never learned of them. Instead, they were handled several layers down in the organization by people with clear and strong incentives to maximize revenues.”
AA and KPMG were the first of the then-Big Six accounting firms to offer consulting on ethics, compliance, and risk management to its clients, but it never set up an in-house ethics officer or created any of the other structures it was being paid to develop for others. There was an “Independence and Ethics” office to distribute the required disclosure forms (auditors had to disclose their mortgage companies, banks, investment firms, stock holdings) and to raise questions if there appeared to be a potential conflict of interest with a client. They underwrote the development of an ethics training module for business students, but their extensive training for the staff did not cover those issues. An auditor who thought something was wrong was discouraged from raising his concerns. “[N]o matter what you thought privately, a partner still always outranks a manager, and to challenge that hierarchy with uncomfortable questions just wasn’t done. Anyone who dared got the equivalent of a public spanking.”

AA became so enmeshed with Enron that AA insiders and former insiders were responsible for the internal and external audits of the company. “By the fall of 2000, the two business giants were so enmeshed that dozens of the Chicago accounting firm’s most ambitious auditors reported to work each day at Enron.” Auditors from both firms took vacations together and played fantasy football against each other over the Enron computer system. “It was like these very bright geeks at Andersen suddenly got invited to this really cool, macho, frat party,” said Leigh Anne Dear, a former senior audit manager at Andersen who worked in Enron Tower. “One executive still at Enron describes the allure: ‘It’s like Patty Hearst, you start identifying with your kidnappers.’”

The Independence and Ethics office did not interfere. Indeed, an in-house video shown to the partners commended the close relationship with Enron – and the $58 million in fees in 2000 alone – as a model for other audit clients.

AA was involved in a series of accounting scandals even before Enron and WorldCom: Delorean, Sunbeam, Waste Management, and the Baptist Foundation of Arizona, the largest religious foundation bankruptcy in US history. However, instead of auditing its own practices, it seemed to consider each an isolated incident for which it bore no responsibility, and none was considered serious enough to require a systemic evaluation or any structural changes. The US Attorney who prosecuted AA for destroying Enron documents met the firm’s pleas that the entire partnership should not be punished for the actions of a few rogue employees with one word, based on this history: “Recidivists.”

By the time AA failed, seven layers of management separated the Professional Standards Group from the office of the CEO.

**CORPORATE GOVERNANCE**

AA, as a limited partnership, had little independent oversight. As noted above, it had a Public Review Board, which was shut down when the firm split, and it overruled and then marginalized its internal standards-setters when they disagreed with the clients about accounting for stock options. The firm’s own governance and compensation structures created incentives that benefited individual outposts and partners over the good of the firm as a whole.

The 20-year battle over the relationship between the auditors and the consultants demonstrated the limitations of trying to run a large, complex organization as a partnership. Toffler’s book documents the almost unthinkably enormous partners’ meetings at which the “election” of a new leader was in reality determined ahead of time. Worse was the one dreadful meeting that foreshadowed the fall of the firm, when neither of the candidates received the requisite number of votes, creating
great uncertainty and disruption. The firm’s CEO at the time of the Enron revelations was Joseph Bernardino. His “emphasis on growth over audit quality, his reluctance to walk away from big clients with questionable accounting, and a stunning ignorance of potentially crippling issues all contributed to the firm’s undoing,” according to Business Week’s John Byrne in an August 12, 2002 cover story. However, they were as much a reflection as a cause of what was wrong at AA at the end.

**HUBRIS**

AA’s failure has been described in epic terms. According to Chicago Tribune columnist David Greising, it was the force that has led to documented implosion and destruction since the days of the ancient Greeks – hubris. He wrote:

> Hubris dictated Andersen’s decision in the 1980s to assume it could turn auditors into salespeople and not undermine auditor independence. Hubris caused the firm to deny or minimize errors in failed audit after failed audit, and particularly in the Enron disaster. Hubris ultimately caused Andersen to gravely underestimate the threat it faced in [Department of Justice prosecutor Michael] Chertoff, or the outrage of an investing public who felt scammed by Andersen’s poor work . . . . The firm seemed utterly incapable of recognizing that it had seriously failed in its core mission of protecting investors against fraudulent financial reporting – and the consequences of that failure.17

Arthur Andersen, the founder of the firm that lasted for almost 90 years, said that he wanted to “measure our contribution more by the quality of service rendered than by whether we are making a good living out of it.” Quoting this high aspiration in a 1995 letter to partners, then-chief executive of the worldwide audit and tax practice Dick Measelle said that Andersen Consulting partners were more like “merchants” while the auditors were more like “Samurai” (concerned more with honor and loyalty than with profits). He encouraged the partners to be both, setting a path with tragic consequences.

> A firm that made its name auditing the performance of others in the end faced the ultimate accounting for its own failings.18

In 2005, the United States Supreme Court unanimously overturned Arthur Andersen’s conviction of obstruction of justice on the basis that the law Andersen was charged under was not correctly portrayed to the jury. The Court ruled that the law required that someone “knowingly… corruptly persuaded(ed)” others to destroy or withhold evidence. Arthur Andersen managers did instruct their employees to delete Enron-related files, but those actions were within their document retention policy. If the document retention policy was constructed to keep certain information private, even from the government, Arthur Andersen was still not corruptly persuading their employees to keep said information private. However, the ruling came too late – the firm was already gone.
NOTES

4. Toffler, Final Accounting, p. 39.
6. Part of this section is freely adapted from Toffler’s chapter, “Cain and Abel Andersen,” in Final Accounting, an excellent history of this struggle.
7. Ibid., p. 39.
8. Ibid., p. 43.
9. Ibid., p. 59.
11. Ibid.
13. Toffler, Final Accounting, p. 197.
15. Ibid.
16. Ibid.
18. Ibid.
“Power tends to corrupt and absolute power corrupts absolutely.”

As a director between 1985 and 1994, I have had a front-row seat to watch one good example of corporate success, Tyco Laboratories. Between 1995 and 2001 Tyco became one of the largest companies on the planet. In 2002, it became almost a code word for everything wrong with a corporate culture.

Let’s start at the beginning. In the creative atmosphere of greater Boston in the 1950s, it was said that two men, a wheelbarrow, and an abandoned textile mill were all that was needed for a successful new venture. Throw in a few PhDs, at a million dollars a pop, and you could have a successful public offering of the nascent company’s stock. Arthur Tyler’s idea was to provide organization and financing for inventors, and thus Tyco was born. The company has been far afield, from joint ventures with Mobil and virtual war with the Russians over deep-water lobstering to a variety of attempted hostile takeovers before the concept was popular.

The company grew rapidly in the mid-1980s, under the leadership of John Franklin Fort, into an integrated worldwide leader in automatic sprinkler equipment. With worldwide sales of $3.5 billion, it was one of the Fortune 200. Fort, a Princeton engineering graduate with an industrial management degree from the Massachusetts Institute of Technology, has risen through the operating ranks of the company. There were no corporate jets, there were no corporate clubs, and there were only 35 employees at the corporate headquarters in Exeter, New Hampshire. A simple incentive system was key to the decentralized management style. Compensation was based on profits of individual business units. The company did not believe in options. Restricted stock was issued to executives and the company loaned them money to pay their taxes. Compensation was direct and to the point; there were no footnotes on the corporate balance sheet for yachts, farms, consultancies, and the like, just direct grants of stock on top of a modest cash base. Thus, the executives’ net worth and their attention were focused on creating shareholder value at Tyco.

Tyco’s acquisition record in the late 1980s was impressive. All four of its acquisitions over those years fit its current business mix and offered genuine merger benefits without causing dilution of earnings. Acquisitions were made to increase size; they were made to further industrial integration and to improve profits.

The company demonstrated many of the elements that have given American business its deservedly high reputation in the years following World War II. These included strong leadership from a chief executive officer who focused on technology, operations, and profits. The company had an industrial purpose. Corporate resources were not diverted to unrelated technologies.

As Fort approached his tenth year as CEO and his thirtieth as a Tyco employee, he told members of the board of his desire to retire early in 1991 and his recommendation that Dennis Kozlowski
succeed him as CEO. Shortly thereafter the possibility of expanding Tyco’s business worldwide through the acquisition of Wormwold surfaced. To help consummate what was the most important transaction in Tyco’s history to date, Fort stayed on beyond his desired retirement date. In July 1992, Kozlowski became CEO. Fort stayed on as a director.

Under Kozlowski, the rate of growth accelerated to hyper speed. Tyco acquired so many companies in such rapid succession that keeping score was difficult. The emphasis evolved from an industrial strategy to a financial one, buying bloated businesses, stripping them of excess personnel and facilities, and treating the associated costs as nonrecurring in the company’s income statement. Investors embraced the “slash and burn” modus operandi, believing that as long as new acquisitions are made, growth can continue indefinitely. It seemed that Tyco, like the universe, was infinite and expanding. Kozlowski appeared on the cover of Business Week as America’s “most aggressive” CEO.

Tyco branched out into the medical care business with the Kendall acquisition in 1992 and it moved its corporate domicile to Bermuda with the “reverse acquisition” of ADT in 1997 (see discussion of Bermuda reincorporation in chapter 1). During this period, it made over 70 “bolt on” acquisitions to further integrate its existing lines. The pace of acquisitions became frenzied, and by year end 2001 Tyco had acquired a finance company and was credibly seeking to rival GE, widely viewed as the finest company in the world.

Although not as diversified as GE, Tyco’s manufacturing and services operations were comprised of electrical and electronic components (year end 1991: $13,572bn), disposable medical supplies ($8,812bn), fire detection and suppression systems ($7,471bn), and flow control products ($4,179bn). Tyco became one of the most valuable corporations in the world in the relatively short term of Dennis Kozlowski’s leadership.

This vast expansion placed severe strains on Tyco’s governance structure. Extracts from letters that I wrote to the CEO at various times prior to my resignation from the board will give some indication of the struggle for governance structure within a culture of virtually limitless expansion.

APRIL 26, 1990: TO JFF

The boards of directors of a Massachusetts corporation are given the ultimate responsibility for conducting the business of the enterprise. In discharging this responsibility, the Tyco Board of Directors over the years has made certain implicit and explicit decisions as to its modus operandi. The Board’s authority stems from the shareholders and the Board directs the venture with the objective of maximizing the long-term value of its owners. The Board has consciously adopted an informal mode of operation. The Board has considered a number of different modes for conducting its business and has decided that under the circumstances now prevailing, and the personalities involved at Tyco, that the best results can be obtained by having the Chief Executive Officer both preside at meetings and be initially responsible for the preparation of an agenda. The Board has decided not to adopt a formal strategic plan for Tyco, preferring instead to communicate continuing concerns directly at meetings. Directorial concern focuses on long-term value optimization for shareholders. This involves an aggressive policy with respect to acquisitions and the Board has been particularly concerned that close attention be focused on stand-alone operating divisions; that periodic assessments of value be made; and that management be alert to the preservation of values.
Management reports (other than detailed financial statements) are oral rather than written; there are no formal agendas for meetings, although any subject that an individual director wishes to discuss is routinely entertained; formal votes, with motions and seconding, are customarily not taken; the mode is one of board consensus with individual directors having the opportunity to express disagreement at all parts of the process; communication among directors both during and outside of meetings is encouraged.

Is this a bit informal for a $5 billion company?

JUNE 7, 1990: TO JFF

The Board has adopted a formal meeting schedule so as to: (i) enable the continuance of the present pattern of 100 percent attendance by members; (ii) add certainty as to times when subjects necessary for Board review can be dealt with; and (iii) accommodate concerns not to have meetings that are not necessary for the efficient conduct of Tyco's business. The Chief Executive Officer presides at Board Meetings. The Board has adopted this mode of operation after consideration of: (i) the character and operating style of the Chief Executive Officer; (ii) the needs of Tyco at this stage in its growth; and (iii) a preference for efficient, non-bureaucratic procedures to as great an extent as possible. The Board, of course, has the continuing responsibility to review its mode of operation in light of changing personnel and circumstances (emphasis added).

Casual, yes, but attentive.

We are embarking upon a period involving the need for mastering several significant new challenges simultaneously [Wormwold acquisition, in particular]; I feel that the Board should take the time carefully and thoroughly to review its functioning and to conclude how best to discharge its responsibilities in the new environment.

How should a director compel attention to governance matters?

SEPTEMBER 19, 1990: TO JFF

(i) there is disagreement as to whether the CEO should also be the presiding officer of the Board.... Review it periodically.
(ii) The Board is, in my opinion, paid too much for what it presently does, and too little for what it should be doing henceforth.
(iii) Board Terms should typically be for a fixed period of time, and be renewable.

At what point does a director become obtrusive in pressing a point of view on to management?
SEPTEMBER 26, 1991: MEMORANDUM TO THE BOARD

#5 – The board will need to become more effectively involved:
(i) There is immediate need for two additional directors – ideally one with top level US manufacturing experience, another with European (continent) contacts and experience.
(ii) Need to focus on executive succession – a new #2 person.
(iii) There is need for capability in the area of compensation .
(iv) There is need for financial information in aid of an understanding of the cash flow situation of Tyco.
(v) The board chairman and the CEO should be different persons. We need to probe further to assure that all the directors are timely getting the information they may reasonably require. There should be discussion and formal legal action making clear the scope of authority delegated to the Board by top management.

The informality of board functioning is no longer tolerable. How can this be made a part of the agenda for action?

FEBRUARY 3, 1992: TO LDK

#3 – As we add new directors, we have the chance to add procedures. I feel that the board should evaluate its own performance and that of the individual directors once a year . . . We can’t expect the guys down the line to react constructively to evaluation if we do not have a comparable discipline all the way to the top. Also, the board should annually assess the CEO . . . Directors should not expect to serve indefinitely. They should have explicit understanding that their service will be re-examined periodically – like say three years.

Will the new CEO be interestable in governance questions? If not, what are a director’s options?

APRIL 21, 1992: TO LDK

#3 – At the beginning of the meeting in Wisconsin, I asked the ‘insiders’ to leave so that the Board could better consider the questions of compensation. The insider directors neither addressed my request, nor did they leave. This put me into a most difficult position. Either I had to press my point, which would tend to introduce a confrontation element into our board culture for the first time in my experience, or acquiesce. In doing the latter, I am conscious of having tolerated, even encouraged, a coerced and impoverished discussion of the compensation issues. I, personally, tried to make clear as tactfully as possible that I have been very uncomfortable with the level of compensation to ‘X.’ Candor tends to get lost in politeness . . .

#5 . . . At the very least, there is confusion arising out of a lack of direction and clarity as to what we expect from various committees (and their relationship to the board) and as to the relative roles of insiders and outsider directors in this determination . . .

#8 – It is apparent to me that we need standards and an evaluation process for directors. Clearly, outside directors should not be considered as having a lifetime job.
Confrontation is inevitable. Will it be productive? What are a director’s options at this stage?

AUGUST 21, 1992: TO LDK

“(1) The board has not defined for itself a role. The board has not jelled as a group.... The board does not have sense of itself....

(5) The board has not set a mission for itself. There is no scheduled review. The board does not evaluate its own performance.

(13) The boardroom atmosphere has been strained. The meetings have not been led. The mode has been a monologal meandering with occasional directorial interjections. Increasingly, the board’s desire to question has encountered resistance, even hostility. At best — no leadership in the boardroom; at worst — an atmosphere of anger....

(18) I am still a bit uncomfortable as an outside director with extra-board communication with Tyco principals. I have limited myself to letters to the CEO, leaving with him the complete discretion as to what use he may want to make of the contents. We need a definite policy as to: (i) periodic and occasional meetings between outside directors; (ii) a definition of who is and who is not an ‘outside’ director of Tyco; and (iii) the designation of a particular individual as the ‘convener’ of such meetings.”

The need to avoid acting like a “cabal” prompts the desire to have “legitimate” meetings of outside directors.

FEBRUARY 11, 1993: TO LDK

“#2 – Tyco directors are unwilling to adapt to any kind of self-evaluating process....

#6 – The committee structure of the board is in shambles. The Audit committee is poorly led.... The Compensation committee worked hard in August... and came up with recommendations that were largely ignored or overruled. ‘X’ declined to take a cut in pay; and it is unclear what survives of the Committee’s actions. There are no minutes....

#10 – The board lacks leadership and the will seriously to address the company’s problems.... ‘X’ has no use for the board. It is becoming clear that the Board has no use for itself.... The board apparently will not insist on a role for itself.”

The board is dysfunctional. See also the “anonymous” memo from a director to the CEO in chapter 3 (case in point: “A director demands more from the board”).

AUGUST 30, 1993: TO LDK

“ What can the board do that will be most helpful to Tyco? Is there benefit in having an energy in the board apart from management that sets the agenda, conducts meetings, and is responsible for informing directors between meetings? Do we want to make changes in the structure and personnel of the board at this time? My own sense is that the board will be relatively useless in the absence of a commitment to self-examination and criticism.”
An appeal to the CEO: the board will be useless unless you personally pay attention.

JANUARY 3, 1994: TO LDK

“What is wrong [about a board] is to have no defined role, no mission, no explicit benchmarks against which performance of the board can be evaluated. This is what I worry about here . . . . We should also have regular meetings of the outside directors in executive session at least twice a year . . . .”

I resigned as a director shortly after this note.

The transition of Tyco from an impressive, but modest-sized, conglomerate to one of the 25 largest companies in the world and a “name that will be known in infamy” has been well documented. It is not our purpose here to more than note the plethora of allegations of criminal and civil conduct by certain top officers of Tyco. We are focused on certain elements of board culture that I experienced some eight years before Tyco became a household name and before any of the conduct that is the content of the allegations occurred.

At the behest of certain Tyco directors in early 2002, the firm of David Boies, Esq. conducted an exhaustive forensic audit of the company’s finances and governance. Its conclusions of December 30, 2002, included:

“Board of Directors. As previously reported, the entire Board of Directors appointed at the last Annual General Meeting (‘AGM’) has agreed not to stand for re-election at the next AGM. A number of Directors have already resigned and been replaced and Board Committees have been reconstituted. The Board of Directors has reviewed all of its responsibilities to ensure that it has procedures to assure that it is receiving sufficient information to fulfill its obligations. This includes a formal review of all equity compensation plans, compensation programs, and other similar programs with written approval or disapproval. For any delegated responsibilities to committees or officers, the Board will ensure that the delegation fits within certain parameters and that the Board regularly reviews the performance of the committee or officer to whom the responsibility has been delegated. At least annually, the Board and an appropriate committee will review charitable contributions, compensation to officers, loans to employees, and the use of corporate assets. The Board is preparing and will approve detailed written charters for each of the committees of the Board that clearly articulate the committee’s duties and responsibilities.”

Is there a resonance of concerns noted earlier?

What conclusions can be drawn about the desirability, for example, of an “independent” chairman of the board whose entire responsibility is to assure the integrity of board proceedings?

Who had the opportunity to recognize the pending problems and who had the opportunity to act?
WorldCom

by Beth Young

Spurred by the failures of Enron, Tyco, Adelphia, and other companies amid allegations of self-dealing and fraudulent accounting and disclosure, in early 2002 the US House of Representatives passed legislation authored by Michael Oxley (R-OH) which was regarded by many as easy on both the accounting profession and companies. In the Senate, Banking Committee chairman Paul Sarbanes (D-MD) sponsored a much tougher bill that provided for an independent accounting oversight body and effected significant reforms related to the gatekeepers – including boards of directors, auditors, and securities analyst – that had failed to protect investors.

By June, however, the smart money had Senator Sarbanes’s bill dead in the water. However, all of that changed, almost overnight, when the biggest scandal yet broke. On June 25, WorldCom made an announcement that shocked even investors jaded by the prior meltdowns: WorldCom had improperly and intentionally capitalized as assets $3.8 billion in expenses over five quarters, and had paid down expenses with money from reserve accounts earmarked for other purposes, artificially boosting WorldCom’s income. After further investigation, the amount was raised to at least $9 billion. Ultimately, WorldCom took a write-off of $79.9 billion, the biggest onetime write-off any US company has ever taken. WorldCom wrote off its entire $45 billion in goodwill and reduced the $44.7 billion value of its property, plant and equipment, and other intangible assets.

The announcement came on the heels of the April 2002 resignation of WorldCom’s CEO Bernard Ebbers, amid questions over personal loans from WorldCom, and the March 2002 initiation of an SEC investigation into WorldCom’s accounting. In the end, WorldCom’s CFO Scott Sullivan pleaded guilty to conspiracy, fraud, and making false statements to regulators about WorldCom’s financial condition. Ebbers was eventually convicted of conspiracy, fraud, and filing false documents with regulators and was sentenced to 25 years in prison.1

Outrage about WorldCom breathed new life into the Sarbanes legislation (dubbed Sarbanes–Oxley after it emerged from conference). It quickly passed the Senate by a unanimous vote, despite an intense lobbying campaign by the accounting industry, and was signed by President Bush.

WorldCom’s place in history was not limited to a well-timed legislative intervention, however. In July 2002, WorldCom became the largest US company ever to file for bankruptcy protection. A year and a half after emerging from bankruptcy protection, WorldCom – then known as MCI – merged into Verizon.

How did a company of WorldCom’s stature end up engaging in such blatant accounting chicanery? A combination of an overly enmeshed relationship with Wall Street, poor corporate governance, and lax oversight by auditors created a culture that prioritized WorldCom’s stock price over all else and undermined the monitoring mechanisms necessary to prevent fraud.
GROWTH BY ACQUISITION

Founded in 1983 as Long Distance Discount Services, WorldCom relied heavily on acquisitions to fuel its growth. From its founding through 1999, WorldCom made 60 acquisitions on its way to becoming the second-largest long-distance company in the US. Almost all of WorldCom’s acquisitions were paid for with WorldCom stock.

Initially, WorldCom was in the voice telephony business, but increasing competition and new technology reduced revenues and profits in that business. WorldCom thus sought to diversify itself in the mid-1990s, acquiring companies that enabled it to enter the markets for data and satellite communications, internet services, and web hosting, among others. These businesses, however, then experienced their own slowdown, making it difficult for WorldCom to meet its own revenue and earnings forecasts.

WorldCom’s growth-by-acquisition strategy had four important implications for the company and its investors. One was simply that the company grew very rapidly. Such rapid growth, involving far-flung operations, posed a significant management challenge, straining WorldCom’s resources and internal controls. Unfortunately, WorldCom’s internal audit department, which should have been responsible for ensuring that appropriate controls were in place, was focused primarily on operational matters and was significantly understaffed. Adequate systems were not in place to prevent manual adjustments, like the adjustments that constituted the fraud, from being made without any reporting.

Second, WorldCom’s constant stream of acquisitions made it very difficult for investors to compare results from one period to another. A report by bankruptcy court examiner Dick Thornburgh (the Thornburgh Report) stated that WorldCom’s “unprecedented and unceasing growth may have obscured the ability of investors to focus upon and evaluate objectively the actual strength and financial performance of the Company at various junctures.” The opacity of WorldCom’s accounting thus may have increased the temptation to manipulate the numbers. It has even been claimed that WorldCom’s feverish deal-making was in fact designed to create reserves that enabled WorldCom to manage its earnings.

The third consequence of WorldCom’s acquisitiveness was that the price of WorldCom stock used as acquisition currency was of paramount importance. Analyst earnings expectations were a frequent subject of discussion at meetings of WorldCom’s top management. Former WorldCom CFO Sullivan testified at Ebbers’s criminal trial that he “falsified the financial statements to meet analysts’ expectations.”

Finally, WorldCom’s frequent acquisition and financing transactions made WorldCom a sought-after corporate finance client for investment banking firms, creating conflicts of interest that disabled key gatekeepers from acting in investors’ interests. The Wall Street firm that received the most engagements from WorldCom over the five-year period ending in early 2003 was Salomon Smith Barney (SSB). A complaint filed by New York’s Attorney General Eliot Spitzer alleged that SSB received over $107 million in fees from WorldCom between October 1997 and February 2002. That complaint also alleged that SSB’s telecommunications analyst Jack Grubman made overly optimistic predictions regarding WorldCom’s stock price—a he gave WorldCom stock SSB’s highest rating until April 2002—in order to secure investment banking business for SSB.

Spitzer also accused SSB of allocating shares being issued in initial public offerings to SSB accounts maintained by WorldCom CEO Bernard Ebbers and other WorldCom directors in order to win
investment banking business from WorldCom, a practice known as “spinning.” The Thornburgh Report asserts that those IPO shares were sold for an aggregate profit of more than $18 million. Similar allegations were made by the SEC and other regulators. An April 2003 settlement between regulators and ten Wall Street firms accused of similar conflicts of interest resulted in Grubman being banned for life from the securities industry and ordered to pay a $15 million fine.  

WORLDCOM’S BOARD OF DIRECTORS

With the challenge of integrating multiple global businesses and the pressure on WorldCom to perform to Wall Street’s expectations, it was imperative that the board of directors fulfill its duty to monitor WorldCom’s management. It appears, however, that the board did not vigorously safeguard shareholder interests but instead “deferred at every turn” to Ebbers, in the words of court-appointed corporate monitor Richard Breeden.

According to the report prepared by Breeden (the “Breeden Report”), which analyzed WorldCom’s weaknesses and prescribed governance reforms for the post-bankruptcy company, the passivity of the WorldCom board allowed Ebbers “nearly imperial reign” over WorldCom’s affairs. The Breeden Report opined, “One cannot say that the checks and balances against excessive power within WorldCom didn’t work adequately. Rather, the sad fact is that there were no checks and balances.”

Ebbers exercised complete control over the board’s agenda and over the flow of information to the board. Board meetings were short and consisted primarily of formal presentations. Board involvement in strategic planning and risk management was minimal, and a corporate culture promoting revenue growth and personal enrichment over transparency, ethical behavior, internal controls, and legal compliance was nurtured.

The consequences of the WorldCom board’s pliability were most damaging in the areas of financial reporting and compensation. Considering the complexity of WorldCom’s financial reporting systems – really a patchwork of systems from acquisitions – the audit committee had its work cut out for it. The Breeden Report concluded, however, that “the Audit Committee did very little work in proportion to the size and complexity of the Company,” spending only three to six hours per year on its tasks. Membership on the audit committee was generally the result of a recommendation from Ebbers.

The Thornburgh Report evaluated the audit committee’s performance as well and concluded that “the Committee rarely scratched below the surface of issues that arose.” Although the audit committee believed that the internal audit department reported to the committee, members of WorldCom management controlled internal audit’s budget, staffing, compensation, and workplans. Minutes from the audit committee’s meetings show no sessions with the head of internal audit from 1999 through March 2002. The audit committee assumed, without ever confirming, that internal audit coordinated its work much more closely with auditor Arthur Andersen than was in fact the case. The Thornburgh Report faulted the audit committee for not requiring Andersen to provide the committee with annual Management Comment letters, in which the auditor identifies concerns raised during the audit, from 1998 through 2001; the internal controls weaknesses that plagued WorldCom would have likely been flagged in such letters. The minutes of audit committee meetings were spotty and unreliable.

The board also failed abjectly in its responsibility to implement compensation arrangements that were in the company’s best interests; indeed, the Breeden Report asserted that WorldCom’s compensation practices “made a mockery of shareholder interests.” Although compensation
generally was inadequately linked to company performance, three areas in particular stand out. First, the board approved a $283 million “retention grants” program in 2000, which included payments of $10 million each to Ebbers and Sullivan. No evidence was presented about the need for a retention program or how it should be designed to best accomplish the retention goal. This program, over which Ebbers had total discretion, became a slush fund from which Ebbers could ensure loyalty and secure his dominance over the company. He did not consult with compensation experts or the board or perform any market analysis in setting the amounts of these bonuses.

Second, the board extended in excess of a mind-boggling $400 million in loans to Ebbers, and guarantees of his obligations, to help him meet margin calls on loans secured by Ebbers’s WorldCom stock holdings, which were diminishing in value and threatening Ebbers’s hold on his many extramural business ventures, including a marina, a hockey team, timberlands, a trucking company, and a large ranch. Though there were serious questions from the outset (which only intensified later) about Ebbers’s ability to repay these loans, minimal due diligence was performed. The loans were initially made by two compensation committee members, Stiles Kellett and Max Bobbit. Both Kellett and Bobbit had received large amounts of WorldCom stock when their companies were acquired by WorldCom, and Kellett had an undisclosed jet lease from WorldCom on non-arm’s-length terms. Kellett was also a co-investor with Ebbers in VirtualBank, a private company. Ebbers received at least $50 million in loans by wire transfer before the full board learned of the transaction. The board did not object, however, when it was informed.

Third, the severance arrangements entered into when Ebbers was ousted as CEO in April 2002, before the fraud was uncovered but when it had become apparent that the company was overleveraged and facing mounting financial problems, were unjustified. The board awarded Ebbers $1.5 million per year for the rest of his life, with his wife (who was 39 at the time) enjoying a $750,000 per year benefit following his death. Large interest subsidies on the loans made by the company, worth tens of millions of dollars annually, were also included in the package. The Breeden Report estimated the value of the severance package at a quarter billion dollars. (WorldCom’s subsequent bankruptcy filing and Ebbers’s failure to make required payments on the loans ultimately put the kibosh on the severance arrangement.)

WORLDCOM’S AUDITOR

A company’s outside auditor is charged with ensuring that the financial statements “fairly represent” the company’s financial position, results of operations, and cash flows. Arthur Andersen used a “risk-based” methodology for conducting its audit of WorldCom during the period in which the fraud took place. This approach tests controls and then, if those controls are found to be effective, reduces the substantive tests, such as examining specific transactions and ledger entries.

In 1999, 2000, and 2001, Arthur Andersen, analyzing factors including the risk of error or fraud, classified WorldCom as a “maximum risk client.” A number of problem areas, such as overly aggressive revenue and earnings targets and the frequency of prior misapplications of generally accepted accounting principles, were identified. Audit work papers for 1999, 2000, and 2001 show that Arthur Andersen noted risks relating to the company’s manipulation of financial results to meet financial targets and misstating of line costs (a major component of the fraud that did occur) and other expenses.
Nonetheless, Arthur Andersen concluded that management’s integrity – which mysteriously went from a rating of “low” prior to 1999 to “good” – offset these identified risks and eliminated the need to change its audit procedures.\(^2\) The Thornburgh Report criticized the audits for not carrying out even planned procedures, using flawed methodologies to test controls, failure to complain about denial of access by management to ledgers and other materials, allowing management to have excessive control over the audit, relying on questionable representations by management, and failure to communicate with the audit committee on key audit issues.\(^2\)

WorldCom’s collapse illustrates the importance of strong, well-functioning gatekeepers – including boards of directors, auditors, and securities analysts – in protecting investors. During market and sector expansions such as the one from which WorldCom benefited in the 1990s, such checks may seem superfluous or even overly burdensome. However, they are essential to ensure that managements such as WorldCom’s, confronted with competitive pressures and a shaky business model, do not succumb to the temptation to fudge the numbers.

NOTES

5. Ibid., p. 12.
6. Thomas Caton and Stephanie Kirchgaessner, “How WorldCom’s ‘Big Fraud’ Began,” *Financial Times*, Dec. 24, 2002. (After the collapse of the Sprint merger, “’They had to do another deal to refill reserves because the cookie jar was running low,’ says a person with detailed knowledge of the company.”)
10. Ibid., p. 25.
11. Ibid.
12. Ibid., p. 32.
13. Ibid., pp. 34–5.
16. Ibid., pp. 177–84.
17. Breeden Report, p. 82.
26. Ibid., p. 29.
29. Ibid., pp. 206–11.
Gerstner’s Pay Package at IBM

by Paul Hodgson

THE ANATOMY OF A CONTRACT

Louis V. Gerstner Jr. was appointed as IBM’s chairman and CEO in March 1993 after leaving RJR Nabisco, where he was also chairman and CEO. He was recruited using an employment agreement with what must then have been very generous compensation and an array of “special payments” – to compensate for lost income that might have been earned from his previous employer. He was hired at a salary not only more than double that of his predecessor CEO at IBM but also well above market levels even for a company the size of IBM.

All aspects of Mr Gerstner’s 1993 compensation were governed by this employment contract. The board “approved Mr Gerstner’s employment agreement after an extensive search . . . with the assistance of two executive search firms.” The compensation committee report in the 1994 proxy goes on to say, “in settling the final compensation amounts” the board focused on hiring a CEO “with an outstanding business record who could provide the leadership necessary to improve IBM’s competitiveness and profitability.”

Despite the enormous cost of employing Gerstner, over the nine years following his appointment, stockholders appeared to have received value for this, as they experienced an increase of 938 percent in total shareholder return (TSR) during his tenure.

The purpose of this report is to investigate the effects of contractual provisions on his compensation history.

THE COMPENSATION ELEMENTS OF THE 1993 CONTRACT

- **Base salary:** $2,000,000.
- **Target annual incentive:** $1,500,000, with a guaranteed three-quarter target bonus in 1993 of $1,125,000.
- **Target long-term incentive award:** $500,000.
- Eligibility for stock option awards and other equity-based awards.
- Benefit programs, including, without limitation, pension, profit sharing, savings and other retirement plans, medical, dental, hospitalization, short- and long-term disability and life insurance plans, accidental death and dismemberment protection, travel accident insurance, and any other retirement or welfare plans that the company may adopt.
- Supplemental pension – a retirement benefit that supplements pension to the level he would have been eligible for from Nabisco had he remained there until age 60 (i.e. increases it to the level of $2,447,867 per annum).
- Reimbursement of business expenses.
In addition, Gerstner was granted 500,000 stock options in 1993, to vest over four years, and a target award of 10,301 performance stock units, dependent on the company’s performance against EPS and cash flow measures over three years.

As can be seen, the only elements not strictly “guaranteed” by the contract are the level of award of equity-based incentives such as restricted stock or stock units, or stock option grants. Indeed, in his nine-year tenure from 1993 to 2001, Gerstner received only two awards of restricted stock units, and, as shown later, there were three years, including the latest covered here, when he did not receive a stock option award. No comment is ever made about the lack of such awards in any of the relevant compensation committee reports.

Other elements of additional compensation not specified in the original contract were covered by the catch-all phrase “any other benefit program.” These included the ability to defer up to 100 percent of salary, and certainly that part of it above $1,000,000, following the introduction of Section 162(m) of the Internal Revenue Code. A summary of the deferral programs in operation at the company is given later.

All other payments, and this is made quite clear in the first few compensation reports during his term of office, are based on contractual provisions and not, as is the case with most of the other executives at the company, based on market influences or compensation surveys.

EACH CONTRACTUAL AMENDMENT REQUIRED FURTHER COMPENSATION

However, there were three amendments to the contract, each resulting in additional compensation—sometimes as a direct enticement for Gerstner’s agreeing to them. The first amendment, in 1996, reduced his salary but increased his target annual and long-term incentives. The next, in 1997, was to retain his services as chairman until his planned retirement in 2002 and instituted a 10-year consultancy agreement following on from this. A special award of 2,000,000 stock options was made. Finally, in 2002, this arrangement was again amended to encourage him to agree to delay his retirement one more year and Gerstner received a restricted stock unit award of over 125,000 shares. Each of these amendments will be discussed in more detail in the course of the report, and their potential costs, which went far beyond the immediate expense, will be analyzed.

“SPECIAL PAYMENTS” – COMPENSATION FOR “FORFEITED” INCOME FROM PREVIOUS EMPLOYER

Before going on to detail the whole of Gerstner’s compensation history, the special payments will be looked at in detail. The contract also set out a range of special payments to be made to Gerstner, in order to gain his services from his former employer. Again, the 1994 proxy offers an explanation of these elements of the contract: “The board also recognized the need to consider Mr. Gerstner’s compensation at his former employer as well as the value of benefits under various plans of this former employer that would be forfeited upon his resignation.” Elsewhere, while total compensation for other executive officers is targeted at the upper quartile of the competitive market, “for officers recently recruited, compensation rates reflect the need to recruit them.” This is standard practice; most executives move to another job only if the challenges or the rewards are greater than those at their present position. Gerstner’s compensation at his
former employer, however, was a salary of around $1,200,000, bonus opportunity, stock option and restricted stock unit grants, and pension. The package offered to him by IBM was well in excess of this.

**SPECIAL PAYMENTS TO GERSTNER**

- Gerstner held options over 3,171,320 Nabisco shares with an exercise price of $5 and 40,000 Nabisco shares with an exercise price of $7.50. The contract guarantees him a sale price of $8.125 per share and will make up any shortfall. This cost IBM $7,752,854 and was paid out in 1994.
- $725,000, equal to the amount of spread on unexercisable Nabisco options, forfeited on his termination with Nabisco.
- $1,478,750 for an award of performance shares forfeited on his termination with Nabisco.
- $500,000, representing his first quarter bonus from Nabisco.
- $1,381,764 for forfeited benefits under his Personal Retirement Account.
- $25,000 for financial and tax planning services that would have been paid by Nabisco.
- $637,500, representing the difference between $8.125 and the price realized upon selling 300,000 shares of Nabisco stock.
- An aggregate of $176,582 for other expenses, including legal fees, relating to his change of employment, payments to purchase the automobile provided by Nabisco and tax gross-ups.

**IMPROPER PRINCIPLE**

While the above sums, totaling $12,677,450, seem small compared with some of the “compensation for lost income” that has been paid out lately, for example by Home Depot and Verizon, it should be remembered that this was many years ago, and however small or large the sums involved, the improper principle that lies behind the practice is constant. Incentives are not forfeited if an executive leaves a company, they are not earned. Compensation for this so-called forfeiting is an unjustifiable part of any employment offer. Either incentives are a reward for performance or they are an expected part of compensation. If they are the former, then there should be no “compensation” for them. If the latter, then companies should not be claiming relief for them under IRC Section 162(m), as they are not truly performance-related.

While none of these special payments are justified, the least defensible is the guarantee of a stock price of $8.125 for any Nabisco shares that Gerstner sells. This affected two elements of his “lost” income. Firstly, his 3,211,320 vested stock options are guaranteed to be worth $8.125 when he sells them. Nabisco stock was not at this level when he exercised the options and IBM had to pay out just over $7.75 million in compensation. The second element affected was Gerstner’s holding of 300,000 Nabisco shares. These were sold at only $6 each, costing IBM $637,500 in compensation. However, these shares were sold because they were collateral for a loan taken out by Gerstner from Nabisco and the purpose of the loan was to buy these shares. One cannot imagine an equivalent situation for any other class of stockholder.

In total, comprising payments from Nabisco that included annuities to fund his pension, the special payments and his regular IBM compensation, Gerstner received $22,854,329 from employment in 1993.
THE CONTRACT IN PRACTICE

Table 7.2 gives us the details of Gerstner’s compensation at IBM for the nine years from 1993 until the latest available information for fiscal year 2001. The elements include: base salary; annual bonus – typically based on one or more financial targets, such as profit, earnings, or cash flow, as well as other qualitative measures; long-term incentive awards in the form of performance stock units based on EPS and cash flow targets; and any value realized from the exercise of stock options. The columns giving other annual compensation and all other compensation consist of several different kinds of payment. They largely represent contractual obligations that the company entered into at the time of his recruitment. Later, however, other annual compensation came to represent the cost of benefits such as the use of corporate aircraft or company vehicles. The first explanation of the amounts given was in 1999, when $27,354 covered use of corporate aircraft and $15,191 for the use of a company car when commuting. In 2000, the amount included $36,778 for aircraft usage and in 2001, $43,101.

Following 1994, and the final “special payment,” all other compensation was entirely made up of company matching contributions to an all-employee deferred savings plan and an executive plan. The all-employee plan is a deferred income plan set up according to IRS guidelines, under which employees may defer up to 15 percent of their income (up to a maximum level). The company then matches these at the rate of 50 percent for the first 6 percent of compensation deferred. The second plan, as amended in 1994, allows executives whose salary exceeds $1 million to defer a large proportion of their income, matched on the same basis as the all-employee plan, but invested only in IBM stock units. The effects of Gerstner’s increasing salary excess over $1 million can be seen in the increasing cost of company matching contributions. Full descriptions of these schemes are reproduced later in the report.

GERSTNER’S STOCK OPTION GRANTS

Table 7.3 details the history of stock option awards for Gerstner. Figures have not been recalculated to take account of the two stock splits, in 1997 and 1999. If they had, the effect would have been to render the 1997 awards, for example, combined at 4,400,000. Some of the option grants are exceptional. The 500,000 stock options awarded in 1993, for example, were part of the employment agreement. The special grant of 2,000,000 options, in 1997, was partially in recognition of a further amendment to his employment agreement – part of an initiative to retain his services and “to recognize his outstanding performance and leadership.” It also appears to have taken the place of grants in 1998 and 1999, but no information is given on why grants were not made in those years. In addition, the grant in 2000 of 650,000 options was made with an accelerated vesting condition. The options become exercisable in two equal installments over two years, so that they will all vest before his planned retirement in March 2003.

While the pattern of one-off, multiyear awards for Gerstner is a defensible compensation practice, these awards, even annualized, were far in excess of awards made to board colleagues. However, assuming one of the primary purposes of the stock option scheme is to align Gerstner’s interests with stockholders by increasing his stockholding following the exercise of options, table 7.4 demonstrates that this has not really occurred.
### Table 7.2  Compensation 1993–2001.

<table>
<thead>
<tr>
<th>Year</th>
<th>Base salary</th>
<th>Annual bonus</th>
<th>Other annual compensation</th>
<th>Restricted stock</th>
<th>LTIP payout</th>
<th>Stock option profit</th>
<th>All other compensation</th>
<th>Total compensation</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$2,000,000</td>
<td>$8,000,000</td>
<td>$82,888</td>
<td>0</td>
<td>$2,190,819</td>
<td>$115,130,197</td>
<td>$300,000</td>
<td>$127,703,904</td>
</tr>
<tr>
<td>2000</td>
<td>$2,000,000</td>
<td>$8,000,000</td>
<td>$96,400</td>
<td>0</td>
<td>$3,585,407</td>
<td>$59,887,423</td>
<td>$276,000</td>
<td>$73,845,230</td>
</tr>
<tr>
<td>1999</td>
<td>$2,000,000</td>
<td>$7,200,000</td>
<td>$66,376</td>
<td>0</td>
<td>$5,250,717</td>
<td>$87,732,699</td>
<td>$285,000</td>
<td>$102,534,792</td>
</tr>
<tr>
<td>1998</td>
<td>$1,875,000</td>
<td>$7,500,000</td>
<td>$12,384</td>
<td>0</td>
<td>$4,145,419</td>
<td>$32,801,922</td>
<td>$191,250</td>
<td>$46,525,975</td>
</tr>
<tr>
<td>1997</td>
<td>$1,500,000</td>
<td>$4,500,000</td>
<td>$5,081</td>
<td>0</td>
<td>$2,092,018</td>
<td>$6,705,008</td>
<td>$102,600</td>
<td>$14,906,707</td>
</tr>
<tr>
<td>1996</td>
<td>$1,500,000</td>
<td>$3,270,000</td>
<td>$5,938</td>
<td>0</td>
<td>$2,072,567</td>
<td>$3,489,228</td>
<td>$128,250</td>
<td>$10,465,983</td>
</tr>
<tr>
<td>1995</td>
<td>$2,000,000</td>
<td>$2,775,000</td>
<td>0</td>
<td>$7,044,375$^2</td>
<td>$1,274,663</td>
<td>$132,859</td>
<td>$138,000</td>
<td>$13,364,897</td>
</tr>
<tr>
<td>1994</td>
<td>$2,000,000</td>
<td>$2,600,000</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>12,355,055</td>
</tr>
<tr>
<td>1993$^4$</td>
<td>$1,500,000</td>
<td>$1,125,000</td>
<td>$160,130$^5</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>7,709,726</td>
</tr>
</tbody>
</table>

$^1$There is no indication what this amount represents, nor why amounts have now been included for 1996 and 1997 which, in previous proxies, had been given as zero.

$^2$Represents the provisional award of 65,000 restricted stock units, which vested after five years (i.e. when the stock price was between $100 and $120, and there had been two stock splits. Value at vesting likely to have been in the order of $28 million).

$^3$Special payments in connection with forfeited income from previous employer.

$^4$Appointed part-way through the year, salary and bonus for part year only.

$^5$Income tax reimbursement on special payments.
### Table 7.3  Stock option grants 1993–2001 (nonadjusted).

<table>
<thead>
<tr>
<th>Year</th>
<th>Stock option award</th>
<th>Exercise price</th>
<th>As a percent of all options granted</th>
<th>Value with 5 percent annual stock price appreciation</th>
<th>Value with 10 percent annual stock price appreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No. $</td>
<td></td>
<td>%</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>2001</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2000</td>
<td>650,000&lt;sup&gt;1&lt;/sup&gt;</td>
<td>109.62</td>
<td>1.53</td>
<td>44,811,000</td>
<td>113,559,000</td>
</tr>
<tr>
<td>1999&lt;sup&gt;2&lt;/sup&gt;</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1998</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1997</td>
<td>2,000,000</td>
<td>103.56</td>
<td>10.02</td>
<td>130,260,000</td>
<td>330,100,000</td>
</tr>
<tr>
<td>1997&lt;sup&gt;3&lt;/sup&gt;</td>
<td>200,000</td>
<td>72.13</td>
<td>1.0</td>
<td>9,071,000</td>
<td>22,989,000</td>
</tr>
<tr>
<td>1996</td>
<td>300,000</td>
<td>126.69</td>
<td>3.91</td>
<td>23,901,000</td>
<td>60,573,000</td>
</tr>
<tr>
<td>1995</td>
<td>100,000</td>
<td>74.63</td>
<td>1.55</td>
<td>4,693,000</td>
<td>11,894,000</td>
</tr>
<tr>
<td>1994</td>
<td>225,000</td>
<td>60.94</td>
<td>3.24</td>
<td>8,622,000</td>
<td>21,852,000</td>
</tr>
<tr>
<td>1993</td>
<td>500,000</td>
<td>47.88</td>
<td>2.8</td>
<td>15,055,000</td>
<td>15,055,000</td>
</tr>
</tbody>
</table>

<sup>1</sup>Grant becomes exercisable in two equal installments, not the normal four.

<sup>2</sup>Stock split in 1999, original figures given.

<sup>3</sup>Stock split in 1997, original figures given.

### Table 7.4  Stockholding history 1993–2001.

<table>
<thead>
<tr>
<th>Year</th>
<th>Stockholding</th>
<th>Increase/decrease over previous year</th>
<th>Increase/decrease over previous year</th>
<th>Options exercised</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No. of shares</td>
<td>No. of shares</td>
<td>%</td>
<td>No. of shares</td>
</tr>
<tr>
<td>2001</td>
<td>799,624</td>
<td>–103,193</td>
<td>–11.43</td>
<td>1,253,156</td>
</tr>
<tr>
<td>2000</td>
<td>902,817</td>
<td>–63,169</td>
<td>–6.54</td>
<td>703,156</td>
</tr>
<tr>
<td>1999</td>
<td>965,986</td>
<td>21,252</td>
<td>2.25</td>
<td>205,956</td>
</tr>
<tr>
<td>1998</td>
<td>944,734 (472,367 prior to stock split)</td>
<td>75,898</td>
<td>8.74</td>
<td>202,680 (101,340 prior to stock split)</td>
</tr>
<tr>
<td>1997</td>
<td>868,836 (434,418 prior to stock split)</td>
<td>144,316</td>
<td>19.92</td>
<td>205,956 (51,489 prior to stock splits)</td>
</tr>
<tr>
<td>1996</td>
<td>724,520 (181,130 prior to stock splits)</td>
<td>150,108</td>
<td>26.13</td>
<td>11,632 (2,908 prior to stock split)</td>
</tr>
<tr>
<td>1995</td>
<td>574,412 (143,603 prior to stock splits)</td>
<td>342,588</td>
<td>47.78</td>
<td>0</td>
</tr>
<tr>
<td>1994</td>
<td>231,824 (57,956 prior to stock splits)</td>
<td>110,000</td>
<td>90.29</td>
<td>0</td>
</tr>
<tr>
<td>1993</td>
<td>121,824 (30,456 prior to stock splits)</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>
MANAGING FROM THE PERSPECTIVE OF AN OWNER

As table 7.4 demonstrates, the largest gains in stockholding were during the first four years of Gerstner’s tenure. In fact, new stock ownership guidelines were introduced in 1994. For the CEO, the requirement was to own four times base salary within five years. Gerstner had exceeded his guideline by 1995, even with the higher salary then in operation. Indeed, his early commitment to stockholding is demonstrated by the following passage taken from the compensation committee report detailing his nine months of employment:

“Of the 30,456 shares listed as owned by Mr. Gerstner in the Beneficial Ownership of Shares table, none was part of the terms of Mr. Gerstner’s employment agreement. Thirty thousand of these shares were purchased by Mr. Gerstner in the open market from April 1993 through January 1994 with his personal funds. The rest had been acquired prior to his employment by IBM.”

In 1997, the stockholding guideline was increased to four times the sum of annual salary and target annual incentive. Gerstner’s holding was still in excess of this, and it shows that he was following one of the company’s key compensation guidelines: “managing from the perspective of an owner with an equity stake in the business.”

STOCK ACQUIRED THROUGH EXERCISE OF OPTIONS NOT RETAINED

Following 1997, however, and despite a series of very substantial option exercises, the growth in Gerstner’s stockholding slowed significantly and then went into reverse. While this does not inspire confidence in either stockholders or the market, it should be remembered that, even with the lower stockholding, at the 2001 fiscal year end – before the stock price went into decline – his holding was worth $97,626,094.

What seems surprising is that Gerstner’s stockholding was not built from the exercise of stock options, but rather from other forms of stock acquisition or award. Certainly some of it will have resulted from the restricted stock awards that made up half of any eventual long-term incentive payment. However, this cannot have accounted for all the acquisitions. Indeed, far from using stock option awards to build stockholding, as soon as he began to exercise large numbers of stock options these appear to have been immediately sold.

1995

Compensation during 1993 and 1994 has already been covered in detail in the preceding sections describing the immediate effects of the contract. Below, the report will examine the progress of compensation year by year. 1995 was the year that saw the first restricted stock unit award; some 65,000 were granted, which vested over the next five years. It was also the first year that Gerstner received a payout from the long-term incentive scheme awarding performance stock units. The award vested at the maximum, 13,391 units, rather than the 10,301 target award. This was paid
out half in cash and half in shares restricted for a further two years. It also saw the first exercise of any options by Gerstner, though the number of shares and the value realized was relatively small (see table 7.2 for details). Finally, as in the previous year, the annual incentive award was above target. Only one change to the way compensation was delivered was made during the year. A deferred income plan was amended to allow salary in excess of the new $1 million cap to be deferred.

1996

In contrast, 1996 was a year of very significant change. Effective January 1, Gerstner’s employment agreement was amended, ostensibly to further align his compensation with the performance of the company. His salary was reduced from $2 million to $1.5 million and his target incentive awards were increased. The target annual bonus was increased from $1.5 million to $2 million and the target long-term incentive from $500,000 to $1.5 million. This led to an exchange of $500,000 fixed pay for a target potential variable pay of $1.5 million.

While it has to be admitted that the incentive element of this exchange is at risk, and therefore in theory needs to be higher to compensate, the calculations do not present an equivalency. The change ties in more of his pay to the company’s performance, but the board’s decisions regarding levels have the result of protecting his compensation level and the end result is a 25 percent increase in target total compensation (see table 7.5).

What is apparent by setting the figures out in this way is that company and individual performance could be below target, worse than the previous year, and Gerstner could still earn as much as he would have done for on-target performance under the previous arrangements.

ALTRUISTIC PRESENTATION

Of course, performance never fell below target, so this never occurred. Nevertheless, the changes are presented altruistically, as if Gerstner is sacrificing salary in order to tie his interests closer to those of the other stockholders. The end result, however, is merely increased potential to earn. It should also be remembered that by 1999 his salary had risen back up to $2 million again. Furthermore, from 1997 onwards, any severance benefits continued to be based on his original salary.
In addition, the target level of the long-term incentive is misleading. The amendment indicates that it will be increased to “at least $1,500,000.” However, as can be seen from table 7.2, in 1999, the year when the long-term incentive plan (LTIP) award dating from January 1996 eventually paid out, the target was worth considerably more than $1.5 million. With a payout of $5,250,717, representing 108 percent of the original 13,929 stock units, adjusted for stock splits, the award was valued using the stock price in the January of that year. Even looking at original grants, it is quite obvious that the target award is used as a minimum. Prior to the stock split, the January 1997 share price averaged at around $160. Using this stock price to value a target award of 20,798 stock units, at grant the units were worth just over $3 million – which is technically “at least $1,500,000.”

It has been said that each amendment to the contract resulted in further compensation for Gerstner. Although there is rarely any direct association made between special awards and contract changes, the connections are still fairly evident. For example, the compensation committee does not specifically relate any “extra” compensation to this first in the series of amendments. Undoubtedly, however, several special one-off awards facilitated the changes. First, the 65,000 restricted stock units already referred to were awarded in the year in which the contract was renegotiated. Second, a special award of 300,000 stock options was made in the year the amendments became effective. This award, larger than normal, contained a delayed vesting feature. The options were not exercisable until three years from the grant date, to encourage Gerstner to continue in employment with the company.

POLICY AND DISCLOSURE CHANGES

The compensation report for the 1996 fiscal year also contained a change either in compensation policy or disclosure policy or both. First, the report ceased to indicate whether targets for the annual bonus had been met or exceeded. Instead, a detailed synopsis of IBM’s performance is given to justify the ever-increasing compensation levels. In addition, the scope of targets appears to have been widened, or perhaps disclosure has just improved. In previous reports, only the financial measures were described in any detail. Qualitative targets were referred to, but not listed. In the report for 1996, however, the qualitative targets are given in full. They include: product and technology leadership; growth in market share; revenue growth; implementation of key business programs; and customer satisfaction. Table 7.6 shows the difference in disclosure, and also provides a record of the level of achievement and incentive payout at the company during Gerstner’s term of office.

1997

Gerstner’s employment agreement was further amended in November 1997 to ensure he remained with the company as chairman until he reached the age of 60 in March 2002. Also part of this second amendment was a consultancy agreement to retain his services for a further ten years beyond his retirement. In recognition of this latest amendment, Gerstner received a special award of 2,000,000 stock options and his termination arrangements were amended so that he would receive his “without cause” benefits following any termination with the consent of the board. The contract also indicated that these termination benefits would be based on his original $2 million salary, rather than the $1.5 million he was currently receiving as base pay.
**SEVERANCE BENEFITS FOR TERMINATION WITHOUT CAUSE**

The following is a summary of the severance payments, taken from the 1993 contract, which Gerstner would have received had he been terminated.

- Base salary through termination date.
- Further three years’ base salary, or until age 60, whichever is the shorter.
- Long-term incentive awards will vest at target pro rata with the salary continuation period.
- The balance of any unpaid incentive awards.
- Stock options vest in full on termination date and remain exercisable for their respective terms.
- Supplemental pension benefit vests in full.
- Payment in full of all remaining “special payments.”
- All accrued benefits from all benefit programs, including all deferred compensation.
- Unpaid business expenses.
- Continued accrual of supplemental pension benefit for the salary continuation period.
- Continued medical, dental, hospitalization, life insurance, and any other benefit plans until the end of the salary continuation period or until equivalent benefits are provided by a subsequent employer.
- Any other benefits.
- He is under no obligation to seek other employment and there shall be no offset against due amounts on account of remuneration received from subsequent employment.

---

**Table 7.6** IBM’s performance record.

<table>
<thead>
<tr>
<th>Year</th>
<th>Performance record</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>Operational targets met, Gerstner’s bonus was guaranteed</td>
</tr>
<tr>
<td>1994</td>
<td>Above-target performance led to above-target annual incentives, no payout from the long-term incentive due</td>
</tr>
<tr>
<td>1995</td>
<td>Above-target performance again led to above-target annual incentives. Maximum number of stock units paid out for three-year performance</td>
</tr>
<tr>
<td>1996</td>
<td>Targets appear to have been met, but an extra cash award was made based on the highest-ever reported EPS from operations, record high revenues, and a significant increase in market capitalization. Maximum number of stock units paid out for three year performance</td>
</tr>
<tr>
<td>1997</td>
<td>Attainment of targets “certified,” revenue growth, EPS increase, and further rise in market capitalization. Maximum number of stock units paid out for three-year performance</td>
</tr>
<tr>
<td>1998</td>
<td>Very large growth in stock price and market capitalization, very large annual bonus payouts, but only 80 percent of the performance stock units due were awarded</td>
</tr>
<tr>
<td>1999</td>
<td>Record revenues, record after-tax profit, record EPS and another very large bonus payout. 108 percent of target stock units earned</td>
</tr>
<tr>
<td>2000</td>
<td>Record revenues, record after-tax profit, record EPS and another even larger bonus payout. 120 percent of stock units earned</td>
</tr>
<tr>
<td>2001</td>
<td>Another very large annual bonus payment, based on continued good performance in the face of an industry downturn, performance in excess of the DJIA average. 112 percent of the performance stock units paid out</td>
</tr>
</tbody>
</table>
CONSULTANCY CONTRACT DETAILS

Full details of the terms of the consultancy contract were also given at the time of the employment agreement amendment. Gerstner will receive fees with a daily rate based on his pre-retirement salary (which by then will have risen back up to $2 million). He will also be reimbursed for reasonable expenses. A seemingly exhaustive list of benefits that he will receive during the consultancy was also given:

"... access to Company aircraft, cars, office, and apartment, and to financial planning and home security services and he will be reimbursed for club expenses for Company business. He will also be treated as a retired employee of IBM, including for purposes of pension, retiree medical benefit coverage for him and his spouse, stock options (which will vest and remain exercisable for the remaining term) and long-term incentive performance awards (which will be paid based on Company performance over the entire performance period for such awards)."

The contract amendment also introduced a range of confidentiality and noncompete clauses. For the ten years of the consultancy contract and an additional ten years following this, Gerstner must abide by these new competition agreements.

1998–2001

In the years following the second contract amendment, Gerstner’s bonuses increased exponentially over past awards. While amounts received rose steadily throughout his tenure, 1998 saw a large increase up to $7.5 million (see table 7.2 for details); bonuses of $8 million were received in 2000 and 2001. In 1999, the company sought reapproval of the terms of the annual incentive program. The description of the annual scheme reveals that the maximum bonus for executives, Gerstner included, is not based on any percentage of salary, or absolute cash figure, but a calculation based on the company’s net income for that year. The extract is given below:

"Each year, each covered executive may be entitled to a maximum award equal to three-tenths of one percent of the Company’s earnings before income taxes as reported in the Company’s consolidated financial statements, but before taking into account any losses from discontinued operations, extraordinary gains or losses, the cumulative effect of accounting changes, and any unusual, nonrecurring gain or loss."

1998 was also the first year of four successive extremely substantial option exercises, culminating in 2001, when he realized a value of $115,130,197 on the exercise of 703,156 options. In 1999, the company also introduced a new long-term incentive plan. However, this was only one of three times during Gerstner’s tenure that the long-term incentive plan had to be put up for shareholder approval. On each occasion, the number of shares available for award was increased and the maximum number of options or stock subject to other awards
for individual participants was raised. In 1993, a further 5 percent of outstanding stock was reserved for award. In 1997, another 5 percent was reserved and the maximum number of options that could be awarded was increased to 2,500,000. In 1999, the increase in the reserved shares was set higher, at 6.5 percent of stock, and the ceiling on option awards was doubled to 5,000,000.

DEFERRED COMPENSATION PLANS

Gerstner’s contract set his retirement benefits, and the structure and funding of these appears to have changed little since 1993. However, besides the retirement plans, there were two other deferred compensation plans at IBM for which Gerstner is eligible, which have been amended several times, most recently in 2002. The first of these schemes is an all-employee plan – the tax deferred savings plan, which is now called the TDSP 401(k) plan. The second is the Executive Deferred Savings Plan, formerly the Extended Deferred Tax Savings Plan. Most of the amendments that have occurred during Gerstner’s time at IBM were made to improve his and other executives’ tax situation, as well as to equalize plan benefits between the all-employee and the executive schemes. The first amendment has already been referred to, which allowed the deferral of salary in excess of the $1 million salary cap. A further amendment to the executive plan allowed participants to defer and have matched up to 15 percent of all income, to match the structure of the all-employee plan. In the latest change, from 2002, participants in the all-employee plan can defer up to 80 percent of their total pay up to IRS limits. The text describing the schemes is given below:

“Other deferred compensation plans
Effective January 1, 2002, the IBM TDSP 401(k) Plan (the ‘TDSP’) (previously known as the IBM Tax Deferred Savings Plan) allows all eligible employees to defer up to 80 percent of their income on a tax-favored basis into a tax exempt trust pursuant to Internal Revenue Service guidelines. IBM matches these deferrals at the rate of 50 percent for the first 6 percent of compensation deferred. The employee accounts are invested by the plan trustee in a selection of investment funds, including an IBM Stock Fund, as directed by the employees. Corporate officers participate in the TDSP on the same basis as all other employees. For 2002, Internal Revenue Service limits on the TDSP preclude an annual investment of more than $11,000 ($12,000 for participants who are at least age 50 during 2000) or an eligible compensation base of more than $200,000 for any one employee.

IBM established the IBM Executive Deferred Compensation Plan (the ‘EDCP’) in 1995. The EDCP allows any US executive, including officers, to defer additional monies and receive a Company match on the same basis as the TDSP except that the Company match for the EDCP is credited only in units of IBM common stock which are not transferable to other investment alternatives during employment. In addition, participants can defer all or a portion of their annual incentive until termination of employment under the EDCP. In the event that the salary of a Company officer who is subject to the limits of section 162(m) of the Code exceeds $1,000,000, such officer may defer up to 100 percent of his or her salary. The EDCP is not funded and participants are general creditors of the Company. All investments in the EDCP earn income
based on the results of the actual TDSP funds’ performance, but the income is paid out of Company funds rather than the actual returns on a dedicated investment portfolio.

The Company also provides executives with the opportunity to defer payout of certain restricted stock unit awards on terms similar to the EDCP. These deferrals are recorded as deferred units of Company stock. These amounts are not transferable to any other investment alternatives until paid out, and are not funded (participants are general creditors of the Company). There is no Company match on these amounts.

2002

In 2002, the employment agreement was again amended, to extend Gerstner’s period of chairmanship until March 2003, at a salary of $2 million – the same as his salary as chairman and CEO – and an annual incentive to be determined. Nothing is said about any further long-term incentive awards, though at the end of fiscal 2001 he still held 64,954 performance stock units and 40,057 restricted stock units, having a combined value of $12,702,131, and 5,767,492 exercisable and non-exercisable options worth a total $382,125,236. In connection with the latest amendment, and on his move to the chairman position alone, he received a special restricted stock unit award covering 125,000 shares valued at around $13 million, to vest on retirement.
Premier Oil – Shareholder Value, Governance, and Social Issues

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BACKGROUND

By late 2000, Premier Oil had become a cause célèbre amongst those concerned with governance, and more particularly with the social, ethical, and environmental responsibilities of business. Its share price was languishing and it appeared unable to deliver on its stated strategy (see figure 7.5). Working with the company, with other shareholders, and with NGOs, Hermes helped the company to resolve these issues.

Figure 7.5  Premier Oil absolute (upper) and relative (lower) share price performance for ten years to start of engagement (July 2000).
Hermes accelerated its engagement with Premier Oil in mid-2000. For several years previously, Hermes had communicated its concerns over the company’s board structure and had voted against the re-election of several of the nonexecutive directors whom we did not regard as being independent. On the governance side, the fundamental problem was that the company was dominated by two major shareholders, Amerada Hess, a US company, and Petronas, the Malaysian National Oil Company, each of which held 25 percent of the shares. Not content with the control and influence they wielded as such major shareholders, each of them also had two nonexecutive directors on the board. Two further NEDs were also deemed nonindependent.

These board problems were reflected in a failure by the company to address some of the severe problems that Premier was facing. The strategy was not clear to us as shareholders: it appeared that the strategy proposed in November 1999 when Petronas invested in the company (and on the basis of which independent shareholders had approved that investment) was not being followed and it was not apparent to investors that an alternative had been developed. The company was in a strategic hole: it was not large enough to compete in production and downstream work with the emerging super-major oil companies, but it was also not as lightweight and fleet-of-foot as it needed to be in order to be able fully to exploit the exploration opportunities opened up by the super-majors’ focus on larger-scale fields. Its freedom of action was also limited by the company’s high level of gearing.

In addition, the company had allowed itself to become exposed to major ethical and reputational risks as a result of being the lead investor in the Yetagun gas field in Myanmar. Myanmar, formerly known as Burma, was a country ruled by a military dictatorship that had refused to accept the results of democratic elections in 1990, where summary arrest, forced labor, and torture were widely reported, and had therefore become a pariah state. Premier’s involvement in the country had brought public criticism of the company from a range of sources, including Burmese campaigners, Amnesty International, trade union groups, and, not least, the UK government. It was not clear to us as shareholders that the company was effectively managing the reputational and ethical risks it faced as a result of its involvement in Myanmar.

To begin exploring these concerns, we held a meeting in mid-2000 with Dr. Richard Jones, Premier’s corporate responsibility director, and the company’s finance director John van der Welle. This was an opportunity for us to understand Premier’s considerable positive work on the ground in Myanmar – which included building schools, funding teachers, AIDS education, and environmental remediation. While we recognized that positive work, we had continuing concerns. The board had not publicly stated that it believed it was effectively managing all the risks that were associated with its presence in Myanmar, and nor did we have the confidence that the board as currently constituted could give shareholders the reassurance that they needed in that regard.

When we had analyzed all these issues, it came as no surprise to us that, in the absence of a clear strategy and with a restrictive capital structure, with the lightning rod of its involvement in Myanmar not being clearly managed, and a board that did not seem designed to address these issues in the interests of all shareholders, Premier’s share price had dramatically under-performed the market for several years.

WHY WE CHOSE PREMIER OIL

With the combination of these issues – governance, strategy, capital structure, ethical factors, and share price under-performance – Premier Oil was a natural choice for our first year’s selection
of companies for a Core Shareholder Program. As a fund manager with predominantly index-tracking mandates, Hermes believes it is in our clients’ interest to become closely involved with companies where we perceive there to be problems. In a sense, these actions are simply putting into effect the stewardship that our clients, as partial owners, should exercise over investee companies. Hermes has a tradition of intervention at under-performing companies but the 2000 Core Shareholder Program (CSP) was our first attempt to establish a more formal and structured basis for determining where we should intervene. Those companies where we had consistently voted against re-elections of directors but had not seen any sign of reform, and where share price performance remained poor, formed the basis of the ten stocks chosen for the first year of the CSP. Premier Oil was among these.

As we did with the other CSP companies, we wrote to the chairman of Premier, Sir David John, requesting a meeting to discuss the full range of our concerns.

While we were awaiting that meeting, Hermes was approached by two separate groups asking it to engage on the social, ethical, and environmental (SEE) issues raised by Premier. The first group was our clients, principally led by trade union pension fund trustees. The second was from other NGOs who were focusing on disinvestment from Myanmar. It is worth considering Hermes’ position relative to these two groups.

As regards the trade unions, Hermes believes it is appropriate that they, as client trustee representatives, should take a keen interest in the stewardship of their investment, including investee companies’ response to SEE issues. We were invited by Brendan Barber of the TUC to address the international body which coordinates trade union/shareholder campaigns. At that meeting we explained that Hermes could not support trade union campaigns based on a “special interest.” We would, however, be happy to engage where failure to address SEE issues was as the result of poor governance, and threatened long-term shareholder value. Premier was one such case.

The second group who encouraged us to take action were the NGOs. We were invited to a meeting organized by other fund managers with representatives from the Burma Campaign UK and Amnesty International. Alongside the UK fund managers with strong ethical investment mandates, a US-based investor with a reputation for activism on social, environmental, and ethical matters was represented at this meeting.

We were somewhat surprised to find that the purpose of the meeting was to discuss proposing a shareholder resolution criticizing Premier for its involvement in Myanmar, something which most at the meeting seemed willing to countenance, despite the fact that they had yet to meet the directors of the company to discuss this proposed plan of action. In any case, Hermes (by reason of our passive, index tracking mandates) was the only fund manager around the table that held a substantial stake in Premier Oil; indeed, most held no shares at all.

At the meeting we took what we felt was the responsible attitude of a part-owner of the Premier Oil business. We argued against the proposing of any immediate shareholder resolution, pointing out that there were much better ways to raise issues with the board that would not of themselves inspire confrontation. We volunteered to lead the engagement.

The meeting did provide us with the opportunity to make contact with some of the NGOs active in Myanmar and among the Burmese people. Notably, we began regular discussions with the Burma Campaign UK, explaining to them the different courses of action that the company might take. We also continued to hold regular discussions with other interested institutional investors. As part of our due diligence, we also accessed publicly and privately other sources of insight, such as the UK government, academics, consultants, brokers, and journalists. This gave us as rounded a view as possible.
OUR ENGAGEMENT

The meeting with Sir David John took place in January 2001, and was a frank and honest one. It was rapidly apparent to us that Sir David understood our concerns. In December, the firm had already added a new, fully independent NED, in the person of Scott Dobbie, chair of Crestco and a director of the Securities and Futures Authority. Sir David assured us that further developments on the governance side were in train. We approved of these developments, but said that we doubted that they would ultimately be adequate to address concerns. Sir David was also willing to discuss our strategic and ethical concerns. Importantly, he agreed to our request personally to meet representatives of the Burma Campaign UK (until that point their contact with the company had only been through Richard Jones).

We followed up this meeting with a detailed and direct letter outlining our concerns and asking Sir David to begin addressing them in the interests of all shareholders. Sir David’s prompt response assured us that the board would continue to work for a solution to “enable the true value of the company to be reflected in the share price.” In March 2001, Premier Oil added another fully independent nonexecutive. This was Ronald Emerson, a banking executive with extensive experience in Asia, and Malaysia in particular.

At the May AGM, Sir David made a very important public statement with regard to the shareholding structure of the company. It was an acknowledgment that the presence of two 25 percent shareholders was a burden on the company’s share price – a point we had clearly made in our meeting with him – and a statement of intent about seeking a resolution to this problem. He said: “We believe that the current share price remains low relative to the underlying value of the business partly as a result of the concentration of share ownership. The board is continuing to seek ways to reduce the discount on assets for the benefit of all shareholders.”

Further positive steps occurred in October 2001. The company began to clarify its strategic position by selling assets in Indonesia and restructuring its position in Pakistan, having gained shareholder authority at an EGM.

Throughout this time we were in close contact with pension funds in the United States who were engaged with Amerada Hess over their shareholding in Premier, and hence their involvement in Myanmar. We pointed out to them that Amerada’s statements appeared to be at odds with our understanding of UK law and with statements made at the time of Premier Oil’s shareholders circular at the time of its refinancing. Separate discussions were thus begun privately with Amerada to progress these issues.

Over 2001, we worked with other institutional investors on their proposal for a statement on how our investee companies should deal with any involvement in Myanmar. We argued that this document should follow the language of the guidelines we had developed with other institutional investors, which were later published by the ABI in October 2001. We felt that Myanmar should not be singled out as an issue above all others – while the risks of involvement there are significant, there are other countries and other issues where risks are at a similarly high level – and we were not keen to see companies overburdened with a variety of different disclosure requests on a range of issues. Furthermore, we believed that had we signed up to the sort of document that was being proposed it would have been harder for us to achieve the level of access and open conversations we had achieved at Premier Oil. We therefore dropped out of the discussions on this document. The other institutions persevered and eventually published their statement in December.
The first year of our engagement had brought some progress but had failed fully to address Premier’s fundamental problems. We met Sir David and Charles Jamieson, the CEO, in early 2002. This was an impressively frank meeting, where they were willing to be more open with us about the work they had been undertaking to resolve Premier’s problems. Over the years since 1999, they had proposed a number of solutions to the company’s strategic impasse, but each had been in some way barred by one or other of the major shareholders. They were, however, confident that both shareholders now had a different attitude and that a resolution in the interests of all investors could now be achieved – though it might take a number of months.

Following this meeting we sent Sir David a forthright letter expressing our concerns at the actions of the major shareholders and putting in writing our offer to lend him our support in the negotiations, should that prove valuable. We formally offered to call on our contacts at global institutions and share with them our concerns that certain of the directors of Premier had not proved themselves to be the friends of minority investors. We hoped that the implication of potential difficulties this might cause for fundraising by companies those directors were involved in could bolster Sir David’s hand in negotiations. We also raised again our concerns that public statements by Amerada – that its investment in Premier was somehow ring-fenced from Myanmar and that its directors did not participate in any discussions on the company’s involvement in that country – seemed to us out of line with UK company law and the fiduciary duties of directors to all their shareholders.

The company’s preliminary results announcement on March 13 highlighted the positive progress the business was making operationally, but more importantly it detailed the progress being made in relation to the company’s fundamental problems. It made clear the roadmap the company was using to solve its problems, talking about shedding mature assets in return for the exit of the major shareholders, and turning itself into a focused, fleet-of-foot exploration company once again. The statement read: “We are in specific discussions with our alliance partners on creating a new Premier, better balanced to achieve our objectives. While the restructuring process is complex and involves careful balancing of the interests of all shareholders, we are committed to finding a solution before the end of this year and I am hopeful this will be achieved.”

As part of our usual series of financial analysis meetings following preliminary or final announcements, we next met representatives of the company – this time Jamieson and John van der Welle – on March 27. This meeting gave us further encouragement that genuine progress was being made, as they suggested to us that the major shareholders both now clearly understood that any deal that they agreed would have to be approved by independent shareholders without them having the right to vote. Therefore, any deal would have to offer minorities full value to be allowed to proceed. The implication that we took away from this meeting was that negotiations were now on track to reach a resolution.

That resolution was announced in September 2002. Premier Oil said that it was to “swap assets for shares,” with Petronas taking the Myanmar operation and a share of Premier’s Indonesian activities, and Amerada a further segment of the Indonesian interest (in which Premier retained a stake). This was in return for canceling their 25 percent shareholdings and losing their right to appoint NEDs – as well as a substantial cash payment from Petronas. Thus the shareholding and governance issues were resolved in one step, and the cash was to be used to dramatically cut Premier’s debt burden. By the same action, Premier reduced its oil and gas production activities and
focused on “fleet-of-foot” exploration. Finally, it had withdrawn from Myanmar in a way that was fully acceptable to the Burma Campaign Group, other NGOs, and to the UK government.

However, most critically, the share price of Premier Oil rose 10 percent on the announcement. Indeed, news of Premier’s change in direction had been anticipated by the market for many months (see figure 7.6). As a result, Premier Oil’s share price doubled (relative to the oil and gas sector) during the period of our engagement, netting an excess return to Hermes’ clients of over £1 million, and more than 50 times that sum to other minority shareholders.

Figure 7.6  Premier Oil absolute (upper) and relative (lower) share price performance since start of engagement.
Executive Compensation at the NYSE

by D. Jeanne Patterson, Ph.D

The NYSE didn’t move fast enough from its roots as a Gentleman’s Club (involving the odd crook, to be sure – i.e. Richard Whitney) to the ‘grotesque governance’ of the 1990s. To be head of the NYSE was considered an honor for which one was paid a ‘numeraire’ by a board composed of people who reflected honor on the institution. The scarecrow from the past was badly outmatched in the world of Langone, the corrupt consults, the languid board, and the feral greed of Grasso.

It is not at all clear that the NYSE should have a CEO with so much power that he can establish his own salary and that he can help his friends (specialists firms) to maintain their power to extract significant monopoly profits from their positions in NYSE trading.

The NYSE’s preliminary pre-tax earnings were likely to be about $53 million for the first five months of 2005, versus $22 million in the same period the previous year. They weren’t even earning as much as they paid their CEO.

It is difficult in the context of a non-profit to determine the CEO’s ‘value added.’ In the case of a non-profit, this is almost an oxymoron. To the extent that he prolonged the ‘legal’ monopoly through which a few people ‘skim’ the transactions of one trillion-dollars-a-day for their own benefit, he was worth a lot, but can that be accepted as the last word?

Robert A.G. Monks

In the early twenty-first century, the New York Stock Exchange was not a government agency, a private entity, a nonprofit or publicly traded company. It was a little bit of all of them. Like a government agency, it operated as an SRO (self-regulatory organization), exercising the delegated regulatory and enforcement powers of the SEC and operating close to a monopoly. Like a private company, it operated without the public disclosure requirements and oversight of companies that sell stock to the public. While it was not a charitable organization, it operated as a not-for-profit, but when it came to paying its CEO, Richard Grasso, it was like a public company. In August of 2003, the NYSE announced that it would make Grasso a lump-sum payment of nearly $140 million in deferred compensation and retirement benefits as part of a new contract extending his tenure by two years. The response from regulators, members of the Exchange, the press, and the public was immediate and furious.
The NYSE decided to underwrite a study of its executive compensation system. The study is called the Webb Report, after its chairman, Dan K. Webb, Winston & Strawn, LLP. The report included significant recommendations in the public interest but was written as a self-study. Over Grasso’s objections, it was made public.

WAS THE PAY OUT OF LINE?

Grasso’s predecessor, William Donaldson, who was chairman of the SEC when Grasso’s compensation was revealed, never made more than $2 million a year in that position. Grasso, however, reportedly with the encouragement of compensation committee member Ken Langone, decided he should be paid like the CEOs of the companies listed on the Exchange.

Grasso worked for the Exchange for his entire career. His annual income went up consistently over the years. In 1995, he was named CEO and chairman and his pay was slightly over $2 million, but by the time of the shocking 2003 disclosure, the compensation included various components of deferred salary and pension funds, some with an exceptionally generous guaranteed internal rate of return (see table 7.7). The compensation arrangements were approved by the compensation committee and referred to the full board of the NYSE for approval in the February meeting following the compensation year (i.e. in 2000 for 1999 compensation). In some cases (the long-term incentive plan, for example), a plan was not intended to include the CEO. However, Grasso arranged through negotiations for his contracts to be included.

The board members were all busy men and women and were placed on the board of the NYSE for reasons other than their expertise in financial and personnel matters. The Webb Report, the internally funded consultant report, notes that a worksheet provided to committee members and to the full board did not include CAP figures. The Mercer Report provided the figures, as shown in table 7.7, with the following note at the bottom of the data: “Mr. Grasso will also receive a capital accumulation award equal to 50 percent of the variable compensation.” At least one compensation committee member, former New York State Comptroller Carl McCall, admitted that he had no idea what the total number was.

Table 7.7  Grasso salary ($), 1999 and 2000.

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<tr>
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<th>1999</th>
<th>2000</th>
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<tbody>
<tr>
<td>1. Base salary&lt;sup&gt;1&lt;/sup&gt;</td>
<td>1,400,000</td>
<td>1,400,000</td>
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<tr>
<td>2. Incentive compensation plan (ICP)</td>
<td>5,652,000</td>
<td>12,519,000</td>
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<tr>
<td>3. Long-term incentive plan (LTIP)</td>
<td>948,000</td>
<td>1,081,000</td>
</tr>
<tr>
<td>4. Variable compensation</td>
<td>6,600,000</td>
<td>13,600,000</td>
</tr>
<tr>
<td>5. Total cash compensation</td>
<td>8,000,000</td>
<td>15,000,000</td>
</tr>
<tr>
<td>6. Capital accumulation plan (CAP)</td>
<td>3,330,000</td>
<td>6,800,000</td>
</tr>
<tr>
<td>7. Total compensation</td>
<td>11,300,000</td>
<td>21,800,000</td>
</tr>
</tbody>
</table>

<sup>1</sup>not including special payments.

The use of comparables for the NYSE compensation started in 1995 (for the year 1994). A new list was presented to the compensation committee and the NYSE board every year by Hewitt, one of their compensation consultants. In the year 2003 (for 2002), the list included 16 firms:

Aetna Inc.
AIG
Allstate
American Express
Chubb Corp.
CIGNA
Citigroup
Fannie Mae
Federal Home Loan Bank
Fleet Boston Financial
Freddie Mac
GE Capital
GMAC
Mellon Financial
Merrill Lynch
Wells Fargo

In what way are these firms comparable? Where are the other “non-profits” in the list?
They included the quasi-governmental organizations (Federal Home Loan Bank, FNMA, and Freddie Mac) as “the best we can do.” The studies on nonprofit firms almost always conclude that executive compensation depends on the size of the organization (and not, surprisingly, the complexity of the organization). One way in which companies on this list are comparable was that several were in trouble with the SEC, including Fannie Mae and AIG. Note, also, which of these firms was represented on the NYSE board. The CEO of AIG, for example, was on the NYSE board.

Look at these firms by category of business.

Investment bankers:
Mellon Financial
Merrill Lynch
Wells Fargo

For-profit financial institutions:
Aetna
American Express
CIGNA
Citicorp
Fleet Boston Financial
GE Financial
GMAC

Government-sponsored entities, GSEs (not-for-profit):
Fannie Mae
Grasso spent years as the CEO, developing relationships and creating a friendly board. He was the boss at the NYSE, so he also influenced the human resources people (who worked with the compensation consultants and the board committee in making annual salary recommendations). Grasso had all the power he needed to manipulate his earnings through the NYSE people, the compensation consultants, and the board.

*Can you guess why Grasso’s compensation went down in 2002? (Hint: you may find answers in the Webb Report (link #2).) What have we learned about Grasso’s compensation that would explain the $6.9 million “benefits expensed”? (Would those “benefits expensed” substitute for options granted if this were a for-profit firm?)*

The specialist firms were interested in protecting their trading monopoly, and they needed an advocate.

> While the NYSE bills itself as ‘a private company with a public purpose,’ there is no doubt that its chairman’s most important role is to protect the interests of its members. Thanks in large part to Mr. Grasso’s efforts, the NYSE has, until recently, enjoyed a remarkable level of prestige, providing the cover necessary to protect its inherently unfair and inefficient trading system.

> Every security traded on the NYSE is assigned exclusively to a specialist firm. The specialist ultimately sees every order in its assigned stocks submitted to the exchange either electronically or through brokers on the floor. But while the NYSE grants specialists a privileged position in order to maintain a ‘fair and orderly market’ (which, curiously, is nowhere defined), the specialist is also permitted to simultaneously trade for his own account – an obvious conflict of interest.

John Bogle

> The NYSE may be organized as a nonprofit, but somebody might take a look at the vast revenues that flowed through the exchange for the benefit of its seat owners, the real pot of money Mr. Grasso was charged with guarding. In fact, the NYSE makes a lousy proxy for concerns about corporate compensation. It represents a completely different kettle of guppies than the typical Berle & Means quandary of dispersed, impotent owners and all-powerful, unaccountable management. The NYSE is owned by seat holders who show up on the premises every business day. Their livelihood depends on the place. They elect its board. They know what a telephone is for. They have every means and incentive to wield their collective clout to make sure their interests are being served.

Holman Jenkins

Federal Home Loan Bank
Freddie Mac

Other:
AIG
Allstate
Chubb
GMAC
CONFLICTS OF INTEREST

Almost all of the reports we have seen about the NYSE and its CEO have complained about the conflict of interest that existed between Grasso and the directors. There were also conflicts of interest because of interlocking interests among the directors. The Council of Institutional Investors report found that: “The Exchange says that it has three key constituencies: the members (broker-dealers, etc.), companies that list on the Exchange, and the investing public. Of these, it calls the investing public its ‘ultimate constituency.’ The NYSE suggests that because it has to balance the interests of these three constituencies, it has the same kinds of checks and balances as the federal government.” The monograph of the CII, however, considers the investing public to be “the missing guest at dinner.” Only one of these constituencies can vote. That same constituency, the broker-dealers, “picks the board and the nominating committee, and thus, indirectly, the other committees.”

A shortlist of potential conflicts of interest among the board members, provided by the CII, included:

- Langone was on the NYSE compensation committee while chairman Grasso sat on the Home Depot compensation committee – a company Langone co-founded and on whose board he serves.
- Directors Jung and Langone serve on the GE board.
- Directors Langone, Grasso, and Fink sat on the NYU board of overseers.
- Merrill Lynch was represented on the NYSE board by David Komansky, who serves on director Fink’s board at BlackRock. Merrill is now represented by O’Neal, Komansky’s successor, and TIAA–CREF is represented by former Merrill executive Allison.
- Chairman Grasso and director Allison both served on the Yale School of Management advisory board.
- Chairman Grasso sat on the advisory board of governance committee as co-chair, Panetta’s Institute in California.
- Chairman Grasso and director O’Neal served on the board of the Lower Manhattan Development Corporation. (Both have missed two-thirds of the corporation’s meetings.)
- A partner of director Sonsini’s sat on the board of director Bartz’s company, Autodesk.
- Directors Karmazin and Levin served together on the Lustgarten Foundation corporate advisory board.
- Director Cayne’s chairman at Bear Stearns, Alan “Ace” Greenberg, sat on Viacom’s board where director Karmazin was president.
- Directors Levin and Paulson served together on the Council of International Advisers.
- Directors Levin and Purcell served together on the Independent Committee for Education.
- Directors Mack and Paulson served together on the board of the Indian School of Business.
- Director Harrison’s company provided services to director Allison’s company.
- Director Cayne’s company handled the sale of a business to director Larson’s company.
- Director O’Neal’s company also did work for director Larson’s company.
- Directors Jung and Harrison served together on the Catalyst board.
- Director Harrison and director Mack’s companies provided financial services to director Schrempp’s company.
- Director Sonsini’s firm has done business with the companies of directors Cayne, Mack, and O’Neal.
CASE STUDIES: CORPORATIONS IN CRISIS

- Director Sonsini’s firm “regularly represented” director Paulson’s firm.
- Director O’Neal’s company provided tax advice to director Larson’s company (advice that was subsequently successfully challenged by the IRS).
- Director Mack’s company has provided banking services to director Karmazin’s company.
- Director Purcell’s company provided services to director Jung’s company.
- Director Cayne’s company and director Langone’s served together as underwriters.
- Director Purcell’s company and director Sonsini’s firm have provided financial and legal advice to mutual clients on the same cases.

Regarding those conflicts of interest, the Council of Institutional Investors had this to say:

"Connections between board members

Another way to look at this is to consider the firms represented on the NYSE board at the time of the CII monograph (2003), a shortlist of which is shown below. Most of the directors had leadership roles on the NYSE Board and were CEO of their own firm.

- Securities Industry Automation Corporation (SIAC)
- The Albright Group LLC
- MetLife (board member is director of MetLife)
- TIAA–CREF
- Autodesk, Inc.
- Bear Steams
- J.M. Duryea, Inc.
- Van der Moolen Specialists USA, LLC
- Black Rock, Inc. (later to be purchased by Merrill Lynch)
- J.P. Morgan Chase & Co.
- Avon Products
- Viacom, Inc.
- Invemed Associates, LLC (Langone)
- Brunswick Corporation
- Credit Suisse First Boston
- Health Point, LLC (McCall)"

Despite the language about independence and an absence of interlocks, the nominating committee members had a surprising number of connections to board members. A number of these connections were of the type that could make a nominating committee member dependent in one way or another on board members. For example, the committee had New York University’s president on it. Three of his trustees were on the exchange’s board of directors, as are additional executives of companies that also have representatives on the NYU board. Two of the nominating committee members had their colleagues – people who work for the same company – on the board. One committee member had what was reported to be his third-largest customer on the board. Three other committee members had overlaps with board members via a board–service link of one kind or another. This left only one nominating committee member with no obvious connection to the board – at least none that can be found from public sources.
In 2004, then-New York State Attorney General Elliot Spitzer filed suit against Grasso and Langone, charging that the board of the NYSE was misled about parts of Grasso’s pay. The complaint also alleged that the formulas were mis-applied so that Grasso was paid in excess of the benchmarks approved by the board. Spitzer also announced settlements with Frank Ashen, former head of human resources at the world’s largest stock exchange, and Mercer Human Resource Consulting, the financial consulting firm that advised the board on Grasso’s compensation. Ashen agreed to return $1.3 million to the NYSE. Mercer agreed to forfeit fees that the NYSE paid the consultancy in 2003, in settlement of the charges that it had mischaracterized the pay plan to the board.

Spitzer’s successor has indicated that he will pursue the claim against Grasso. At this writing, the court has determined that Grasso should return $112.2 million.
Relational Investors, LLP versus Sovereign Bank Corporation (2006)

by Ralph Whitworth, Founder, Principal, and Investment Committee Member

Shareholder activism can seem like a contradiction in terms. The tens of millions of individuals buying shares are promised limited liability. They do not risk and cannot be responsible for anything more than their investment. How can a purchaser of shares be required to do anything beyond paying the asking price?

Relational Investors, the premier “activist” investment manager, provides the answer. By definition, all investors buy stock they believe is underpriced and they expect to see it realize that hidden value. However, activist investors put their mouths where their money is. They take a position and then they try to get management to change.

A publicly traded corporation presents very real problems for its “owners.” All owners clearly benefit from a level of intelligent monitoring of the direction of the enterprise and, yet, it is economically irrational – to be euphemistic – in plain English, it is insane – for individual shareholders to play this role. They have the prospect of bearing all the costs and risks and the prospect, if successful, of only their pro rata portion of the gains. Over the last quarter of the twentieth century, institutional investors – pensions, mutual funds – became the majority owners of most publicly traded companies. Ownership in this form was split between legal title in the trustees and beneficial rights in the investors and plan participants. A relatively few legal owners acquired significant portions of the outstanding capital. CalPERS owned more than 1 percent, for example. Also, vast portions of the market – maybe as much as one-third – became invested either in “index” or “closet index” mode. These trustees had an incentive to assure that the governance standards of the whole market were sufficiently robust as to make equity investment in the long term competitively profitable with other alternatives. The popularity of hedge funds and private equity in 2007 suggests they were not entirely successful. Out of this institutionalization arose a structural need for some new creation to act for the trustees – who had no particular talent in this regard – as effective monitors of corporate boards and management. The federal enabling statute, specifically the Employee Retirement Income Security Act of 1974, contemplated the delegation of specialized fiduciary duties to so-called “investment managers.”

Activist investors had numerous problems of credibility. There was the classic economics formulation – if the market needed you, you would already be here, so go away. Then, pride is not absent in the investment community. “If we needed this, we would already be doing it ourselves.”

There emerged a variety of “entrepreneurs” in this country and Western Europe who would appear anecdotally – Sophie de Helias in France, Peter Butler in London, Lens in the US. Each had a measure of success, but the emergence of shareholder activism as a universally recognized legitimate category awaited Ralph Whitworth and Relational Investors.
Whitworth emerged from the American West with the open manner and sunny optimism of his early mentors, Governors Paul Laxalt (Nevada) and Ronald Reagan (California). A Georgetown law degree and several loyal years of making success out of Boone Pickens’s United Shareholders of America (“USA”) brought Whitworth to the launching of Relational in 1996. There is no substitute for talent and experience – engagements with Waste Management, the automobile industry, and Mattel, among others, meant Whitworth had surmounted such experiences as directly negotiating with Ross Perot for his information and technologies services to taking on the chairmanship of Waste Management when successive generations of chief executive and chief financial officers succumbed to dysfunctionality of one kind or another.

By the time Relational began to accumulate stock in Sovereign Bank in 2004, it was an understated but formidable contender, able to invest a billion dollars and still have back-up capability, relationships with the best professionals at all levels from politics to accounting and law, to business, and a disciplined process informed by the simple imperative of making money for shareholders. Relational’s business model, a basic management fee to cover operating costs, and a percentage fee for outperformance (Relational has dramatically outperformed every year from its inception) acted as incentive and solved the collective action problem. Relational’s success meant that it could not be bullied by the usual management malpractices of creating obstacles, whether or not legal, that would be too expensive for any individual shareholder to challenge.

In the Sovereign encounter, Relational enjoyed the consultation of Richard Breeden, respected former chairman of the SEC and, most dramatically, of Sullivan & Cromwell, considered by many to be the best of the older law firms. The idea that Sullivan & Cromwell would represent any challenger to the established order is perhaps the most dramatic confirmation that activist shareholding has indeed come of age. (Note that Breeden himself, after heading the investigations at Hollinger and WorldCom, began his own activist fund.)

Relational has a disciplined investment process. They focused on Sovereign for understandable reasons: Sovereign enjoyed a defensible, geographically concentrated franchise and mature cash flows ($800 million of tangible equity per year). It was excessively leveraged compared with peers but not distressed. Nonetheless, its shares were discounted. Most importantly for the mode of activist investors, the factors contributing to the discount were readily addressable in the near term. Their analysis suggested that the Sovereign shares were undervalued for specific reasons essentially based on the conflicts of interest among the principal executives and the director, inefficient operations and balance sheet, and the lack of management credibility. Management had embarked on a succession of acquisitions whose purpose did not appear to be increase of shareholder value but entrenchment of current management.

The choreography of this mating dance was worthy of Grand Opera.

- Before the situation escalated to pointed public exchanges, Relational had owned its shares for over two years, during which it conducted a vigorous, if not fruitful, dialogue with the company.
- Shortly after Relational announced its intention to run independent director candidates for election to Sovereign’s board, Sovereign unveiled a plan to sell a 25 percent equity stake in itself to Grupo Santander, a Spanish bank.
- When it became clear to Sovereign that, despite the parties’ best efforts to design around it, the stock sale could trigger a shareholder voting requirement under the New York Stock Exchange’s listing standards, the deal was revised slightly (with advice from the NYSE, unfortunately) to avoid the shareholder-approval requirement.
• Sovereign resisted Relational’s information request.
• Sovereign filed preemptive litigation to have the request declared illegal, attacked Relational as a short-term investor looking for a quick sale, and sent shareholders a positive article about the Sovereign/Santander deal without disclosing the long-standing business ties between Sovereign and the author’s employer, a financial consultancy that had done business with Sovereign.
• Sovereign’s board also changed the bylaw governing the holding of Sovereign’s annual meeting of shareholders, which had the effect of allowing Sovereign to postpone the 2006 annual meeting until after the sale to Santander closed; this dilution of existing holders’ stakes, coupled with Santander’s probable management-friendly orientation, is likely to make Relational’s proxy challenge more difficult.
• Sovereign convinced the legislature of Pennsylvania, where it is incorporated, to enact changes to its corporate law designed to help Sovereign in its dispute with Relational. Governor Ed Rendell was expected to sign the bill into law quickly, given the absence of debate in the legislature. Pennsylvania is no stranger to special-interest-driven corporate law changes: in 1990, it adopted a sweeping set of anti-takeover measures – the strongest in the nation – in response to a hostile bid for Pennsylvania-incorporated Armstrong World Industries. Amendments to the corporate code were also hastily adopted in Michigan several years ago to help Michigan-incorporated Taubman Centers repel a hostile bid by Simon Property Group.

The new law would protect Sovereign in two ways.

• First, it would exempt from the definition of a “control” transaction a transfer of 20 percent of a company’s stock if the stock was owned by the company (so-called “treasury stock”), as is the case with the Sovereign/Santander deal. (Sovereign was selling more than 20 percent of its shares – a mix of treasury and other shares – to Santander, although for purposes of the NYSE’s approval requirement the deal was treated as a sale of 19.8 percent.) Previously, Pennsylvania law requires an acquirer of 20 percent or more of a company’s stock to pay all shareholders “fair value” for their stock as well. Relational believed that fair value for Sovereign’s stock was higher than the $27 per share Santander would pay.
• Second, the new law would reverse the default rule for director removal, barring the removal of directors without cause unless there’s a “specific and unambiguous” statement to the contrary in the charter. Relational had announced that it intended to solicit shareholder support to remove Sovereign CEO Jay Sidhu from the board and reserved the right to seek removal of the entire board. Sovereign’s board is classified, so only one-third of its directors would be running for reelection at the next annual meeting.

Ultimately, the Commonwealth of Pennsylvania passed emergency legislation entrenching Jay Sidhu and obstructing the effort of Whitworth and his partner David Batchelder to have themselves elected to the board. Relational could credibly challenge this effort to entrench Sidhu as unconstitutional. From Relational’s preliminary proxy statement:

We have provided the required notice to the Company that we intend to propose the removal of Mr. Sidhu from the Company’s Board of Directors at the 2006 Annual Meeting. At the time we first proposed removing directors, the PBCL provided that “Unless otherwise provided in a bylaw adopted by the shareholders, the entire board of directors may be removed … without assigning any cause by the vote of shareholders … Notwithstanding
[the foregoing sentence], unless otherwise provided in the articles, the entire board of directors... may be removed from office by vote of the shareholders entitled to vote thereon only for cause, if such classification has been effected by a bylaw adopted by the shareholders.” The Company has a classified board. It does not have a bylaw addressing the removal of directors. It has the following provision in its articles governing the removal of directors: “No director of the Corporation shall be removed from office, as a director, by the vote of shareholders, unless the votes of shareholders cast in favor of the resolution for the removal of such director constitute at least a majority of the votes which all shareholders would be entitled to cast at an annual election of directors.”

As is readily apparent, that provision does not require “cause” for directors to be removed. Therefore, it was clear to us that the Company’s directors were removable without a showing of cause because there was a provision in the articles that sets forth how directors are removed which does not require a finding of cause (we would also note that the shareholders of the Company never approved any bylaw classifying the board). It was apparently equally clear to the Company, which for at least the last 13 years, in more than 27 filings with the SEC, including those in which it compared, item by item, the rights of its shareholders with those of companies it was acquiring, stated that its directors were removable without cause.

On December 22, 2005, we issued a press release indicating our intent to seek to remove certain directors of the Company. The following day, the Company filed suit in Pennsylvania, repudiating its prior years of disclosure and the clear wording of its articles, and claiming that directors are only removable for cause. Even worse, the Company reportedly claimed it had been aware of this “error” for months, and apparently was only waiting for the appropriate time to correct 27 erroneous SEC filings. Perhaps in recognition of the weakness of its argument, on February 1, the Company successfully lobbied the Pennsylvania legislature to rewrite the PBCL to provide that the above language would now read “unless provided in the articles by a specific and unambiguous statement that directors may be removed from office without assigning any cause.” We believe that this legislation, particularly with respect to the manner in which it was adopted, violates the Pennsylvania Constitution in a number of respects. This matter is presently under litigation.

Their candidacy for election to the board was well chronicled in the Preliminary Proxy Statement.

“As detailed in this Statement, we believe that the Company’s directors, including the incumbents, Messrs. Hard and Troilo, have inadequately protected shareholders and have presided over or directly approved numerous poor corporate governance practices. We are proposing the removal of Mr. Sidhu because we believe he bears the greatest responsibility for these actions. We cite the following examples:

- Value-destroying transactions structured to avoid shareholder approval.
- Transactions with directors with conflicts of interest.
- Repudiation of previously disclosed shareholders’ rights to remove directors without cause.
- Lengthy postponement of the 2006 Annual Meeting.
- Disclosing as little as possible about loans to and business relationships with directors, despite the relevance that disclosure might have to investors.
- Excessive director compensation.
– Unusual compensation programs linking director and officer bonuses.
– Adjustments to enrich director and executive bonus programs.
– Inequitable two-tiered director compensation structures.
– Excessive takeover defenses and other entrenchment devices.
– Poor communication regarding acquisition strategy and materiality definitions.

We believe that the election of directors at the 2006 Annual Meeting presents an opportunity to send a clear message to the current Board: shareholders will no longer tolerate the high cost of a persistent trading discount of their shares. Directors must be held accountable. We believe the addition of new independent directors, nominated and elected by the shareholders, and the removal of Mr. Sidhu as a director, can bring the required positive changes to this Board. We also believe that these actions would send a clear message to the remaining directors that the shareholders do not wish Messrs. Hard, Troilo, and Sidhu to serve on the Company’s Board of Directors, and they should not be reinstated by the remaining directors.

The Incumbent Nominees
Messrs. Hard and Troilo bear particular responsibility for the concerns we have enumerated, given their lengthy tenures on the Compensation Committee, the Audit Committee, and the Ethics and Corporate Governance Committee.

Mr. Troilo chaired the Compensation Committee from 2000 to 2005, and Mr. Hard has served as a member of the Compensation Committee for five years. As such, they bear substantial accountability for the excessive compensation of directors and the director bonus programs (from which they also benefited).

Mr. Hard has chaired the Audit Committee since 2001, and Mr. Troilo was a member of the Audit Committee from 1998 to 2000. The charter of the Audit Committee, which has been approved annually by Messrs. Hard and Troilo and the rest of the Board, states the Audit Committee has a duty to review reports and disclosures of insider and affiliated party transactions.

Messrs. Hard (since 1999) and Troilo (from 2001 to 2005) both have been members of the Ethics and Corporate Governance Committee. As members of this Committee, they bear substantial accountability for transactions, practices, and arrangements that are inconsistent with the Company’s Code of Conduct and Ethics and for poor corporate governance practices as set forth in this Statement.

The Relational Funds believe that Messrs. Hard and Troilo should not be re-elected. We urge you to carefully and critically consider the history of conflicts of interest, poor corporate governance practices, and inconsistent and poor disclosure before casting your vote. If you are concerned about these matters, and are not satisfied with the Company’s performance in recent years, please promote positive change by voting the WHITE card FOR the Shareholder Nominees.

The Shareholder Nominees
If elected, the Shareholder Nominees, Messrs. Batchelder and Whitworth, intend to be actively engaged and fully informed directors. They will recommend and seek to accomplish such actions as may be necessary to assure that shareholders receive complete
and accurate information concerning the Company’s compensation, management, and business practices. The Shareholder Nominees will work to ensure that the Company’s business and affairs are free from conflicts of interest and conducted in the best interests of the Company and our fellow shareholders. Neither the Shareholder Nominees nor the Relational Funds will have or will enter into any financial or business interests or arrangements with or involving the Company.

The Relational Funds believe that the Company should initiate a comprehensive program to improve the Company’s trading multiple and reduce business risk. If elected, the Shareholder Nominees will urge the Board to initiate a shareholder value improvement program. The Shareholder Nominees expect that such a program would include the following steps:

- Improving debt ratings.
- Reducing balance sheet leverage.
- Curtailing acquisitions.
- Improving operating metrics.
- Improving capital ratios.
- Establishing and strictly enforcing sound capital allocation discipline that focuses on long-term shareholder value.
- Realigning board and management incentives to emphasize each group’s distinctive roles and duties and long-term shareholder value.
- Avoiding inconsistent and misleading communications with investors.

This entire transaction was described by The Corporate Library in connection with its bestowing its lowest ranking – an F – on Sovereign Bank.

High Risk Alert

*Pennsylvania Legislature Puts its Thumb on the Scale in the Sovereign-Relational Proxy Contest Board Analyst.*

3 February 2006

Since last fall, Relational Investors, an active investment adviser that uses corporate governance reform as a mechanism for improving corporate performance, has been pushing for board-level change at Sovereign Bancorp (SOV), citing a lack of board independence, inadequate disclosure of conflicts of interest, broken promises by Sovereign management regarding acquisition strategy, and other factors. Every step of the way, Relational has been met with one shareholder-disempowering defensive tactic after another. In light of these actions, The Corporate Library downgraded Sovereign’s overall Board Effectiveness Rating to F, effective today.

On March 22, 2006 the parties announced that they agreed to settle all their outstanding differences, to build together a better bank for Sovereign’s shareholders and other constituencies, and to add two new directors to Sovereign’s board – including Ralph Whitworth.

Later in the year, Jay Sidhu announced that he was resigning all his positions with the company. Sovereign’s stock price increased 12 percent on this announcement and 25 percent during the following 90 days.
Fannie Mae is a part of the US housing industry. Although we don’t lend money directly to home buyers, we make sure mortgage funds are consistently available and affordable by buying mortgages from a variety of institutions that do lend money directly to home buyers.

The lenders with whom we do business are part of the primary mortgage market — the place where mortgages are originated and funds are loaned to borrowers. Primary market lenders include mortgage companies, savings and loans, commercial banks, credit unions, and state and local housing finance agencies.

Lenders sell mortgages into the secondary market — the place where mortgages are bought and sold by various investors. Secondary market investors include Fannie Mae, various pension funds, insurance companies, securities dealers, and other financial institutions.

Once a mortgage is originated, lenders have a choice. They can either hold the mortgage in their own portfolios or they can sell the mortgages to secondary market investors, such as Fannie Mae. When lenders sell their mortgages, they replenish their funds so they can turn around and lend more money to home buyers.

Lenders can sell mortgages to Fannie Mae that comply with our guidelines and loan limits. This is in keeping with Fannie Mae’s mission to help more low-, moderate-, and middle-income people buy homes. Our loan limits are adjusted each year, in response to changes in housing affordability nationwide.

Fannie Mae operates exclusively in the secondary mortgage market, where we help to ensure that money for mortgages is available to home buyers in every state across the country, every day. And we do this in two ways. First, we pay cash for mortgages that we buy from lenders and hold those mortgages in our portfolio. The lenders in turn can use that money to make more mortgages for more home buyers.

Second, we issue what are known as Mortgage-Backed Securities (MBS) in exchange for pools of mortgages from lenders. These MBS provide the lenders with a more liquid asset to hold or sell. Fannie Mae MBS are highly liquid investments and are traded on Wall Street through securities dealers.

In order to fund the mortgages we buy, we issue debt securities to investors. A significant part of our earnings is derived from the difference between the yield on those mortgages and the cost we endured to buy them. When we issue MBS, we guarantee that investors will receive timely principal and interest payments regardless of what happens to
the underlying mortgages. In return for the guaranty, we earn a fee. These fees are another source of Fannie Mae’s income.

As part of the secondary market, Fannie Mae’s role in providing a steady stream of mortgage funds to lenders across the country is complemented by new technologies that make the process of buying a home quicker, easier, and less expensive. We have developed automated systems that lenders are using nationwide – which allow many of their home-buying customers to get approved for a mortgage loan more quickly and affordably than ever before.

Fannie Mae harks back to the origins of the business corporation in the nineteenth century in America. Corporations were specifically created by government to accomplish a particular public objective. Therefore, in cases such as the Massachusetts-chartered Charles River Bridge Corporation, the government gave monopoly rights to those willing to invest for what it defined as the common good. They are called government-sponsored enterprises (GSEs) and are something of a structural duck-billed platypus, with some parts from government and some parts private enterprise. Originally, Fannie Mae was a government agency, but in 1968 it was restructured as a federally chartered corporation and shares were sold to the public a year later.

The central idea behind the GSEs was that they would encourage home-ownership by buying mortgages from banks. This was in an era when federal law forbade interstate banking – which meant that most banks were necessarily small. When Fannie or Freddie bought a mortgage, it freed up the bank’s limited capital, allowing it to make more loans. The purchase also relieved the bank of both the credit risk and the interest rate risk – that is, of having to worry that people might default, or that interest rates might rise during the life of the loan. Fannie and Freddie are one reason America is one of only two countries where lenders offer 30-year fixed rate mortgages . . .

Fannie and Freddie dominate the mortgage market, but they don’t originate home loans. Instead, they make their money in two major ways. One is conservative: They get a fee for guaranteeing the payments on mortgages they buy, which they then resell to investors, usually in the form of mortgage-backed securities. The more aggressive way is to hold on to the mortgages, assume all the inherent risk, and make money on the spread between their low cost of capital and the higher yield of the mortgage portfolio. (Alan Greenspan would later call this ‘the big, fat gap.’) The more mortgages the GSEs buy, the faster their profits can grow. Since 1995, Fannie and Freddie’s holdings of residential debt have grown an average of 20 percent a year, and together they now carry $1.5 trillion in home loans and mortgage securities on their books – more than the top ten commercial banks combined. Thanks in large part to this growth, Fannie has had double-digit profit gains for the last 17 years – and an average return on equity of 25 percent. But the GSEs’ size has people increasingly worried about what might happen if anything went wrong – and not just to Fannie and Freddie but to the entire financial system.

There is one additional concern: derivatives, which institutions rely on to hedge interest rate risk. Over time, Fannie and Freddie became two of Wall Street’s top users of derivatives.¹
Although both are structured as private companies, Fannie Mae has special privileges that give it a significant competitive advantage over its peers in the housing finance market. It is exempt from state and local income taxes and it has exclusive access to lines of credit from the US Treasury and the US Federal Reserve System.

In creating GSEs, Congress has been alert to the problem of government-sponsored enterprises metastasizing into areas of commerce well beyond the scope of the legislative purpose. There are enormous political risks as well as economic ones in allowing a government-run (and therefore subsidized or otherwise benefitted) entity to compete in the marketplace, and there is often the suspicion – and the temptation – to cherry-pick the best of both worlds. Fannie Mae is a publicly traded company but, like its counterpart Freddie Mac, it did not agree to make the same SEC filings required of other public companies until 2002.

\[quote\]
Another GSE: Synfuels

I will not soon forget appearing at confirmation Hearings before Chairman Scoop Jackson of the Senate Energy Committee in 1981 for appointment as a director of the United States Synthetic Fuels Corporation. I had noticed in the statute that it was considered a felony for the USSFC to engage in any activities beyond those specifically conferred by statute. I asked Jackson whether Congress really thought that negligence of the board of directors constituted a serious crime for which the members would have to serve time in jail. He smiled and said: ‘We want the thought to be in your minds at all times.’

Robert A.G. Monks
\[/quote\]

GSEs with public shareholders create a situation of dual accountability, to the owners and to the government. This tends to compound the significant problems of defining and enforcing the responsibility of directors of conventional business corporations. Running Fannie Mae is a challenging task. Frank Cahouet, who has had a distinguished career as CEO of Wells Fargo Bank and the Mellon Bank along with a few years as second in command at Fannie Mae, was asked how, on a scale of 1–10, he would classify the CEO’s job in terms of difficulty. Frank said, “101.” One of the reasons given for government to attempt to solve public problems through the medium of GSEs is to bring to the public service talent and competencies that are usually not available because of federal hiring and contracting requirements. Freedom from civil service salary and employment limitations is essential to attracting talent.

\[quote\]
More on Synfuels

In the case of USSFC, I remember going with the Chairman to meet with President Reagan to plead the need for competitive pay for top officers – there does not exist within the DNA of government world-class investment banking experience and this was needed if the mission were to be accomplished. In the case of USSFC, where all the appointees were Presidential with requirements of representation from both political parties, the problems of creating effective management energy as contemplated by statute were virtually overwhelming. The time requirements were infinite. I moved physically to Washington D.C. and worked at being a non-executive director about sixty hours a week for more than two years. Happily, the results were ultimately positive!

Robert A.G. Monks
\[/quote\]
The widely observed difficulty of assuring effective board monitoring is dually exacerbated in the case of Fannie Mae – first, as pointed out above, because of its accountability in two directions and, second, because of the method of selection of the directors.

The Fannie Mae Charter Act provides that there will be eighteen directors, five of whom will be appointed annually by the President of the United States, the remainder annually at the annual meeting of shareholders. The dynamics of board functioning with members accountable to two different constituencies are bewildering – hardly congenial to clear functioning. The normal challenge of making a profit is compounded when considerations of the public good need to be taken into account.

This was exemplified in the hostility over CEO compensation at Fannie Mae. A problem for virtually every public corporation, as explained in chapter 4, it is an even bigger problem when the recipient is a quasi-governmental official. Like its shareholders, Congress wants Fannie Mae to do very well, and it wants the CEO to be motivated to make it do very well. However, when the CEO is too successful, Congress gets very uncomfortable.

“When David Maxwell became CEO of Fannie Mae in 1981, the company was losing $1 million every single business day. Over the next nine years, Maxwell transformed Fannie Mae into a high-performance culture that rivaled the best Wall Street firms, earning $4 million every business day and beating the general stock market 3.8 to 1. Maxwell retired while still at the top of his game, feeling that the company would be ill-served if he stayed on too long, and turned the company over to an equally capable successor, Jim Johnson. Shortly thereafter, Maxwell’s retirement package, which had grown to be worth $20 million based on Fannie Mae’s spectacular performance, became a point of controversy in Congress (Fannie Mae operates under a government charter). Maxwell responded by writing a letter to his successor, in which he expressed concern that the controversy would trigger an adverse reaction in Washington that could jeopardize the future of the company. He then instructed Johnson not to pay him the remaining balance – $5.5 million – and asked that the entire amount be contributed to the Fannie Mae foundation for low-income housing.”

Fannie Mae faltered in the late 1970s and early 1980s and briefly had a negative net worth, but under Maxwell’s leadership it came back and with its counterpart Freddie Mac was very successful in courting a range of constituencies. Wall Street brokerage firms and investment banks loved them for the more than $100 million in fees annually from the issuance of Fannie Mae and Freddie Mac debt instruments and mortgage-backed securities. Industry loved them because of their close relationships with homebuilders, realtors, and trade groups, supported by “Partnership Offices” staffed by former politicians. And Congress loved them because lobbyists were paid to make sure they did and because they sold themselves as a public-purpose government entity that helps America’s disadvantaged to become homeowners. In Fortune, Bethany McLean (the journalist who was first to uncover the problems at Enron) meticulously documented Fannie Mae’s program for courting Congressmen by holding photo-friendly events in the districts of key committee members, making sure that there were plenty of opportunities to have them showing off the benefits of Fannie Mae funding for their constituents. Fannie Mae prepared
individual books for all members of Congress, outlining what it had done in their own district to promote housing (and bring funding).

“The opening of a Partnership Office is always a grand ceremony featuring prominent politicians. And it’s often accompanied by an announcement that Fannie’s American Communities Fund will make an investment in a high-impact local project. Politicians may not understand the secondary-mortgage market, but they do understand a photo opportunity and the dispensation of pork.”

What was the motivation for the board of directors, many of whom were political appointees, to provide much oversight? Personal investment is an indication of the commitment and optimism of the board of directors; in the case of Fannie Mae, as in most of the other case studies in this chapter, it was nominal.

Its regulator was also not in a position to provide much oversight.

Fannie’s allies in Congress made sure OFHEO [the Office of Federal Housing Enterprise Oversight] was placed in the Department of Housing and Urban Development, which had no experience regulating financial markets. In the years prior to Falcon’s appointment it was notoriously understaffed. Although its budget comes from fees paid by the GSEs, a Fannie-inspired amendment called for OFHEO to go through the appropriations process every year. Since Fannie and Freddie had numerous allies in Congress, this meant that the GSEs would effectively control their regulator. OFHEO, says one person who was there, had two choices: ‘Appease Fannie and Freddie or risk getting reamed in the budget.’ Former Treasury official Carnell once described OFHEO as a watchdog that was ‘hobbled, muzzled, and underfed.’

Fannie Mae resisted any attempt to control it. The day before an important Senate Banking Committee meeting to consider legislation, it ran a television commercial with a worried-looking Hispanic couple talking about how changes in mortgage financing rules could make it impossible for them to buy a home.

OFHEO REPORT

When concerns first arose about the accounting practices of Fannie Mae, following an accounting scandal at counterpart Freddie Mac (almost $5 billion in understated earnings, resulting in a $150 million fine), the regulatory agency with authority over both GSEs performed an additional review of Fannie Mae’s books and signed off on them as proper. So did the SEC.

However, questions arose again, and on the second examination, conducted by a different accounting firm, the results were not so favorable. It resulted in a $9 billion restatement and the resignation of CEO Franklin Delano Raines.
The Report of the Special Examination of Fannie Mae by the Office of Federal Housing Enterprise Oversight in May 2006 enumerates the failures of the board and in particular its audit and compensation committees in familiar terms: “The Board failed to be sufficiently informed and to act independently of its Chairman, Franklin Raines, and senior management,” “…the Board allowed management to determine with little opposition the information it received and missed many opportunities for meaningful oversight.” Beyond these general verdicts and very specific indictment over failures to oversee accounting, OFHEO condemns compensation committee failure in three main ways:

- “Having approved an EPS-based executive compensation program that provided strong incentives for earnings management, the Compensation Committee failed to monitor it or ensure that the proper checks and balances were in place to prevent manipulation of earnings targets or results.
- Together with the Audit Committee, the Compensation Committee permitted executive management to compensate senior internal auditors under the same EPS-biased plans that created the perverse incentives to manipulate earnings and undermined their independence; and
- The Committee allowed management to script its meetings and rubber stamped executive compensation proposals made by senior management.”

The report has a fascinating account of the personal involvement of CEO Raines in assuring that “unreliable” consultants would not be considered by the compensation committee.

In 2003 the Compensation Committee sought to hire an executive compensation consultant who was to be accountable to the Committee rather than to management. Nonetheless, Mr. Raines played a key role. In an undated letter from that year to Compensation Committee Chair Mulcahy, Kathy Gallo, Senior Vice President for Human Resources, wrote that the Fannie Mae management consultant on executive compensation, Alan Johnson Associates, recommended two firms that could serve as an independent Compensation Committee advisor: Fred Cook and Company and Brian Foley and Company. Ms. Gallo and Christine Wolf, Vice President for Compensation and Benefits, interviewed candidates from both firms. A subsequent September 2, 2003 letter to Ms. Mulcahy from Ms. Gallo, however, reflected the key role Mr. Raines played in Board decisions, even when it came to the actions of a Board committee on which he did not sit:

‘After our last conversation about an independent consultant to serve as the Committee’s expert, I updated Frank on your readiness to explore the Brian Foley (of Fred Cook) option. Frank was very much opposed to that idea because he has some significant concerns about both Fred’s executive compensation philosophies and the way he sometimes advances his agenda on the topic.

‘Frank’s concerns stem from observing Fred in a (distant) past interaction with the Fannie Mae board and more recently in the Business Roundtable meetings. Given that, Frank would strongly prefer that we not introduce anyone from Cook’s organization into a compensation advisory role for Fannie Mae. I regret not spotting this issue before I proposed Brian to you.’
Cook Consultants had helped design Fannie Mae’s first formal compensation philosophy in 1991. Gallo recommended two additional candidates for consideration, one of whom (Semler Brossy) had been the runner-up to Alan Johnson Associates in the selection of management’s compensation consultant. Shortly after receiving the recommendation from Ms. Gallo, the compensation committee chose Semler Brossy as its independent consultant. Management thus appears to have orchestrated the selection process to ensure that a consultant opposed by Raines did not receive the contract.

Short of depositions and testimony in a trial, the private sector does not provide as insightful an understanding of board functioning as does the case of Fannie Mae.

**AT THE END OF THE DAY, DO WE NEED FANNIE MAE?**

In 2007, Fannie Mae shut down its foundation, funded with $650 million of its stock. The foundation had been criticized for making donations to causes connected to its directors and influential legislators, but making the donations in-house meant even less transparency.

The evidence reveals that Fannie Mae’s management team appears to be the chief beneficiary of the federal privileges and the accounting irregularities. For example, in 2003, 749 members of Fannie Mae’s management team received a staggering $65.1 million in bonuses, a portion of which was attributable to the overstated earnings that followed from the accounting irregularities. Over the past five years, the top 20 Fannie Mae executives reportedly received combined bonuses of $245 million.

This disconnect between reward and mission suggests that any reconciliation with the Securities and Exchange Commission should also require that the FNMA’s management return their bonuses to a fund administered by a bona fide not-for-profit entity, such as Habitat for Humanity, for the purpose of assisting prospective homebuyers of modest means. 5

Fannie Mae is losing business to banks and hedge funds, which are financing their mortgage purchases with cheap, short-term debt.

> What Fannie and Freddie may not be able to do any longer is to have it both ways. They can’t profess to be devoted to the mission of providing affordable housing while generating turbocharged earnings growth. Freddie’s new CEO, Dick Syron, concedes that the company won’t grow at anywhere near the rates of the 1990s. He also concedes that the company has not done as much as it should have for affordable housing. ‘If we’re going to have special privileges, then we have to do something special,’ he says. One of Syron’s first moves was to redo management compensation to be weighted toward the achievement of affordable housing goals. ‘No one chartered us to be Goldman Sachs on the Potomac.’6

**The End of Synfuels: Template for the other GSEs?**

In the case of USSFC, I am pleased to recall that we were able to effect the liquidation of the corporation without the expenditure of the authorized $82 billion.

Robert A.G. Monks
UPDATE

As of 2008, Fannie Mae and the Federal Home Loan Mortgage Corporation (Freddie Mac) owned or guaranteed about half or 56.8 percent of the US $12 trillion mortgage market. On September 7, 2008, James Lockhart, director of the Federal Housing Finance Agency (FHFA), announced that Fannie Mae and Freddie Mac were being placed into conservatorship of the FHFA, the equivalent of Chapter 11 bankruptcy. Lockhart described it as “one of the most sweeping government interventions in private financial markets in decades.” The conservatorship was a condition of a government bailout estimated at as much as $158 billion.

The conservative American Enterprise Institute pointed to the inherent contradictions of the GSE structure. “The government mission required them to keep mortgage interest rates low and to increase their support for affordable housing. Their shareholder ownership, however, required them to fight increases in their capital requirements and regulation that would raise their costs and reduce their risk-taking and profitability. However, there were two other parties – Congress and the taxpayers – that also had a stake in the choices that Fannie and Freddie made. Congress got some benefits in the form of political support from the GSEs’ ability to hold down mortgage rates, but it garnered even more political benefits from GSE support for affordable housing.”

NOTES

3. McLean, “Fall of Fannie Mae.”
4. Ibid.
6. McLean, “Fall of Fannie Mae.”
Massey Energy

by John Coleman

Massey Energy Company is the sixth largest coal company in the United States by tonnage and the largest in Central Appalachia (West Virginia, Kentucky, and Virginia). In 2009, it produced 37 million tons of coal from 35 underground mines and 12 surface mines in the region.

The Company dates back to 1920, but in its present form traces to a 2000 spinoff. Since that time, Don L. Blankenship has been the Chairman and CEO. He has been with the Company and its predecessors since 1982, and under his leadership the Company has grown rapidly due to acquisitions. His leadership has also been highly controversial. Massey is a nonunion employer in union-sympathetic territory, and under Blankenship the Company has been embroiled in continuous controversy over environmental issues and workplace safety practices. Massey’s critics have long accused the Company of placing production ahead of safety and of deliberately flouting environmental laws.

In 2000, the dam burst at a coal sludge lake operated by Massey in Martin County, Kentucky, sending 230 million gallons of sludge into an abandoned underground mine and eventually into the Big Sandy River. State regulators determined that the disaster, 20 times the size of the Exxon Valdez accident in Alaska, had been caused by the barrier between the mine and the river being too thin.

In March, 2007, the Mine Safety and Health Administration fined Massey $1.5 million, the largest amount ever assessed for mine safety violations – as a result of the deaths of two miners in a January, 2006, fire at the Company’s Aracoma Alma mine in West Virginia. Of the 25 violations cited by MSHA, 21 were classified as “reckless disregard,” the most serious category of negligence under MSHA’s penalty structure. The violations included a failure to provide adequate equipment to detect buildups of dangerous gases in the mine, failure to train operators of the atmospheric monitoring system with respect to mine emergencies, a missing wall that allowed smoke into the mine’s main escape route, and failure to install essential ventilation controls.

In June, 2007, two members of Massey’s board who were principals in a hedge fund holding a 5.9 percent stake in the Company and who had won their board seats in a contested election in 2006 resigned in protest over the board’s failure to pursue a merger. In their letter, the resigning directors said:

“The Board clearly shared our view as to the attractiveness and importance of such a transaction, but its misguided insistence on keeping [Blankenship] in place as CEO outweighed strategic considerations and prevented the consummation of a deal that would have been in the best interest of all shareholders.”
The resigning directors went on to criticize “poor risk management” and “confrontational handling of environmental and regulatory matters,” saying that such practices had given rise to a “‘Blankenship Discount’ in the market price for Massey’s shares, and do a grave disservice to our shareholders by masking the underlying strength of the Company’s business, assets and workforce.”

Early in 2008, Massey paid $20 million to the Environmental Protection Agency – the largest civil penalty in the history of the EPA for wastewater discharge permit violations – to settle more than 4,500 accumulated violations of the Clean Water Act with claimed fines of approximately $2.4 billion.8

Massey’s stock price nearly tripled and trounced the S&P 500 Index9 in the first half of 2008, moving from $35.75 at the beginning of the year to $93.75 at the end of June, but then fell steadily, and even more sharply than the rest of the market,10 in the autumn stock market crash. By the end of 2008, it was around $14, and at the start of 2009 proxy season, it had declined further to approximately $10.

2009

In the spring of 2009, Massey’s board of directors consisted of 10 people:

- Blankenship, the Chairman of the Board and CEO.
- James B. Crawford, 66, the former CEO of James River Coal Company, and the nonexecutive Chairman of a diversified energy company. Chairman of the Massey board’s Governance and Nominating Committee.
- Robert H. Foglesong, 63, a retired four-star Air Force General who had served briefly as President of Mississippi State University and was now the chief executive of the Appalachian Leadership and Education Foundation. Chairman of the Compensation Committee.
- Richard M. Gabrys, 67, a CPA who retired as Vice Chairman of Deloitte & Touche LLP. Mr. Gabrys was then a member of the boards of three other public companies and six nonprofit organizations. Chairman of the Finance Committee.
- E. Gordon Gee, 65, the President of Ohio State University. Chairman of the Safety, Environmental and Public Policy Committee.
- Bobby Inman, 77, a retired Navy Admiral, former Director of the National Security Agency, and a professor of public policy at the University of Texas. Mr. Inman was (and is) the Company’s Lead Independent Director.
- Barbara Judge, 62, formerly a partner in a Wall Street law firm and a Commissioner of the SEC, and now the Chair of the United Kingdom Atomic Energy Authority. In addition to Massey, Ms. Judge served on the boards of eight other public companies and three nonprofit institutions.
- Dan R. Moore, 68, the Chairman of a company that owns multiple automobile dealerships in West Virginia and Kentucky, and formerly Chairman and CEO of a publicly held bank holding company. In 2008, Massey paid $252,000 in director fees to Mr. Moore and $183,000 to his company for vehicles and services. According to Massey, the transactions with Mr. Moore’s company “were conducted in the normal course of business on a competitive bid basis.”11 Chairman of Massey’s Audit Committee.
- Baxter F. Phillips Jr., Massey’s President.
- Stanley C. Suboleski, 67, a former Massey executive who had retired in 1997 and worked as a professor at Virginia Tech, briefly as one of the Commissioners of the Federal Mine Safety and Health Review Commission, and, since then, worked as a mining engineering consultant, providing services to Massey. During 2008, Mr. Suboleski received $58,000 for those services in addition to $120,000 in director fees.12
Four members of the board had ties to Massey other than stock ownership and the receipt of director fees (Blankenship, Phillips, Moore, and Suboleski). Of the remaining six directors, one was a university president (Gee), two were retired senior military officers (Foglesong and Inman), one was a lawyer who owed fiduciary responsibilities to no fewer than nine public companies as a member of each of their boards (Judge), one was a retired CPA who had been an officer of a national accounting firm (Gabrys), and one was CEO of an energy company (Crawford). Other than current and former Massey executives, only two members of the board (Crawford and Moore) had ever held senior leadership positions in public companies, and only one outside director (Crawford) had experience in the coal industry.

Although Massey had gone through the motions of designating a Lead Director and awarded the position to Inman, who was by far the longest-serving member of the board, but the duties of the position were vaguely defined. The published description read as follows:

"The Board of Directors appoints an independent member to be the Lead Director. The Lead Director’s primary responsibility is to ensure that the Board of Directors operates independently of management and that directors and stockholders have an independent leadership contact. The Lead Director presides over the meetings of the non-management directors that occur prior to each regularly scheduled meeting of the Board of Directors."

This description is notable for what it does not include. There is no mention of oversight of the CEO, no recognition of a right or duty to take the initiative, and no stated role in setting the agenda for board meetings. In sum, the job seemed to be little more than a front for control of the board by Blankenship.

On April 13, 2009, Massey filed its proxy statement for the annual meeting of shareholders to be held on May 19. For purposes of shareholder voting, the board was classified – divided into three classes of directors serving staggered 3-year terms – and the proxy nominated Crawford, Gee, Judge, and Suboleski for re-election. In the “Director Independence” section of the proxy, the board declared that all directors other than the two current Massey executives and Blankenship were “independent” within the meaning of New York Stock Exchange standards.

In response to the proxy, RiskMetrics, a well-regarded independent proxy advisory firm, recommended that its institutional investor clients vote against Ms. Judge’s re-election. RiskMetrics based its opposition on Judge’s striking overload of other board commitments. Other proxy advisors and shareholder activists joined in the recommendation.

At the annual meeting on May 18, 59 percent of the shares voted to “withhold” support from Ms. Judge. The other 3 board members standing for re-election also received “withhold” votes ranging from 14 percent to 27 percent, which were high compared to the norms for public companies that year. Massey, however, announced that Ms. Judge had been re-elected. The week after the annual meeting, Mr. Gee, despite just having stood for re-election and being elected, informed the Company that he would promptly leave the board. That occurred on the heels of the retention of Ms. Judge and Mr. Gee’s having been the target of protests by environmental groups. Rather than seek a candidate to replace Mr. Gee, the Company shrunk the size of its board by one.
2010

Despite a difficult market for coal sales to utility customers, Massey’s stock price performed exceptionally over the first quarter of 2010, climbing above $50, and the company was valued by the market at more than $4.5 billion.

On March 31, 2010, Change to Win Investment Group, the investment arm of a coalition of labor unions, pre-empted the proxy season with a public letter to Massey’s board. The letter noted that the unions’ pension funds, along with public pension funds in which members of Change to Win unions participated, were “substantial long-term Massey shareholders,” and that “[s]ince many of these funds own Massey through index funds – including S&P 500 index funds, to which Massey was added in June 2008 – and are therefore unable to sell regardless of board or management concerns, robust governance and director accountability are paramount.” Citing the 2009 shareholder vote disapproving of director Judge, Change to Win called upon Massey’s board “to immediately request [Ms.] Judge’s resignation as director and to initiate a process to name several new independent directors over the next 12 months.” Change to Win also cited evidence of other governance failings at Massey and reported that “independent proxy advisers have repeatedly expressed concerns with Massey’s board and governance. According to RiskMetrics, Massey’s Corporate Governance Quotient is in the bottom decile of the S&P 500. Similarly, the Corporate Library assigns Massey’s governance a ‘D’ grade, while Glass Lewis has graded Massey’s executive compensation practices an ‘F’ in each of the last four years.”

On April 5, a devastating explosion ripped through Massey’s Upper Big Branch mine near Charleston, WV. Rescuers were hampered by the presence of heavy concentrations of toxic methane gas. The death toll from the explosion eventually reached 29, making it the worst US mining disaster in 39 years. Subsequent investigations attributed the accident to poor safety practices on Massey’s part, including inadequate venting of methane and shoddy control of dust.

In addition to the profound loss of life, the accident gravely damaged the image of the Company both locally and nationally. As is common in mismanaged corporate crises, the financial damage caused by the accident paled in comparison with the destruction of shareholder value associated with the failure of the Company and its board to take decisive and sensitive action in the aftermath in response to community and shareholder concerns.

On April 12, Change to Win followed up its letter of March 31 with another public letter to Massey’s board, now demanding the ouster of Blankenship:

“In the wake of the . . . Upper Big Branch mine disaster, we call on the board to also immediately seek the resignation of Donald L. Blankenship as Chairman and CEO. We believe the . . . explosion, which claimed the lives of 29 miners, is the tragic consequence of the board’s failure to challenge Chairman and CEO Blankenship’s confrontational approach to regulatory compliance.”

Change to Win went on to say that the issues had been presented to the Council of Institutional Investors, an association of public, union, and corporate pension funds with combined assets exceeding $3 trillion.
The same day, Thomas DiNapoli, the Comptroller of the State of New York and the sole trustee of the $129.4 billion state employees' pension fund, which owned $14 million worth of Massey stock, called for Blankenship's resignation, saying:

"Massey's cavalier attitude toward risk and callous disregard for the safety of its employees has exacted a horrible cost on dozens of hard-working miners and their loved ones. This tragedy was a failure both of risk management and effective board oversight. Blankenship must step down and make room for more responsible leadership at Massey."  

On April 16, Massey filed its proxy statement for the annual meeting of shareholders to be held on May 18. The items of business included the proposed re-election of directors Gabrys, Moore, and Phillips. As it happened, each of those men was a member of the board's Safety Committee. The size of the board had shrunk to nine with Mr. Gee's 2009 resignation. Despite the demand from Change to Win, Ms. Judge was listed as a continuing board member and, despite her overload of public company board obligations, she had been promoted to Chair of the board's Governance and Nominating Committee. The items of business for the 2010 annual meeting also included four shareholder proposals. Two of them involved corporate governance: a proposed change to majority voting in election of directors and a proposed decategorization of the board of directors.

The Company stonewalled Change to Win and virtually all of the ongoing calls for improvements in its governance. The board firmly opposed every shareholder proposal except for the one about decategorizing the board, on which it took an ostensibly neutral position while stressing that a very large supermajority – approval of 80 percent of shares voting – would be required in order to change the pertinent bylaw.

With respect to majority voting, the proxy read as follows:

"Stockholder Proposal – Director Election Majority Vote Standard Proposal
Resolved: That the shareholders of Massey Energy Company ('Company') hereby request that the Board of Directors initiate the appropriate process to amend the Company's corporate governance documents (certificate of incorporation or bylaws) to provide that director nominees shall be elected by the affirmative vote of the majority of votes cast at an annual meeting of shareholders, with a plurality vote standard retained for contested director elections, that is, when the number of director nominees exceeds the number of board seats.

Supporting Statement: In order to provide shareholders a meaningful role in director elections, the Company's director election vote standard should be changed to a majority vote standard. A majority vote standard would require that a nominee receive a majority of the votes cast in order to be elected. The standard is particularly well-suited for the vast majority of director elections in which only board nominated candidates are on the ballot. We believe that a majority vote standard in board elections would establish a challenging vote standard for board nominees and improve the performance of individual directors and entire boards. The Company presently uses a plurality vote standard in all director elections. Under the plurality standard, a board nominee can be elected with
as little as a single affirmative vote, even if a substantial majority of the votes cast are ‘withheld’ from the nominee.

In response to strong shareholder support for a majority vote standard, a strong majority of the nation’s leading companies, including Intel, General Electric, Motorola, Hewlett Packard, Morgan Stanley, Home Depot, Gannett, Marathon Oil, and Pfizer, have adopted a majority vote standard in company bylaws or articles of incorporation. Additionally, these companies have adopted director resignation policies in their bylaws or corporate governance policies to address post-election issues related to the status of director nominees that fail to win election. Other companies have responded only partially to the call for change by simply adopting post election director resignation policies that set procedures for addressing the status of director nominees that receive more ‘withhold’ votes than ‘for’ votes. At the time of this proposal submission, our Company and its board had not taken either action.

We believe that a post election director resignation policy without a majority vote standard in company governance documents is an inadequate reform. The critical first step in establishing a meaningful majority vote policy is the adoption of a majority vote standard. With a majority vote standard in place, the board can then take action to develop a post election procedure to address the status of directors that fail to win election. A majority vote standard combined with a post election director resignation policy would establish a meaningful right for shareholders to elect directors, and reserve for the board an important post election role in determining the continued status of an unelected director. We urge the Board to take this important step of establishing a majority vote standard in the Company’s governance documents.

**Board of Directors’ Statement in Opposition to Proposal Regarding Majority Voting**

The Board of Directors carefully considered this proposal and believes that it is not in the best interests of Massey or our stockholders to amend our certificate of incorporation or bylaws to provide for the election of directors by a majority of votes cast. The proposed change is unnecessary and has the potential to disrupt what we believe are highly effective governance processes.

Our stockholders currently elect directors by the plurality voting system, under which the director nominees receiving the highest number of votes are elected. This system of voting is the accepted standard for the election of directors at many public companies in the United States. Our stockholders have a history of electing highly qualified, independent directors under this voting system, and the Board of Directors does not believe a change is warranted. The proposal to change to a majority voting system exposes our stockholders to unnecessarily high voting requirements, which could give undue leverage to special interest groups and lead to disruptive votes and board instability. The proposed change is unnecessary and has the potential to disrupt our highly-effective governance processes.

Currently our stockholders have cumulative voting rights with respect to the election of the directors. Cumulative voting rights entitle a stockholder to cast as many votes as is equal to the number of directors to be elected (three in our case) multiplied by the number of shares of Common Stock owned by the stockholder. Each stockholder may distribute his or her votes among all, some or none of the nominees as such stockholder sees fit. Cumulative
voting gives stockholders a meaningful role in the director election process. Indeed, the ability to cumulate votes in director elections is universally recognized as protecting stockholder rights. Cumulative voting gives Massey’s stockholders unique leverage in voting on the election of directors by allowing stockholders to cast all of their available votes for a single director nominee, thereby enhancing the voting power of minority stockholders.

While the rules governing director elections are well understood when cumulative voting rights are exercised under a plurality vote standard, cumulative voting under a majority vote standard presents technical and legal issues for which there is no precedent. These difficulties have led the American Bar Association Committee on Corporate Laws and a wide range of commentators to conclude that majority voting should not apply to public companies that allow cumulative voting. In the absence of uniform, workable standards that can be consistently applied by all companies and that take into account the special circumstances of companies with cumulative voting, the Board of Directors believes it would be inappropriate to adopt a majority voting standard. Massey’s current voting standard, unlike the proposal, does not interfere with cumulative voting in director elections. If this majority voting proposal is approved by stockholders, the Board of Directors will need to reevaluate whether it would be in the interest of all of Massey’s stockholders to propose eliminating the cumulative voting feature, a change which would diminish the ability that minority stockholders currently can exercise to have their voice heard in director elections. Our voting system must be a reliable process for the election of qualified directors to represent the interests of all of our stockholders.

The Board of Directors believes that we already have effective corporate governance processes designed to identify director nominees who will best serve our interests and the interests of our stockholders. The Board of Directors maintains a Governance and Nominating Committee that is composed entirely of independent directors and applies selected criteria to identify director nominees. These criteria are described under ‘Committees of the Board of Directors – Governance and Nominating Committee’ on page 16. We also include in our annual proxy statements information on how stockholders can communicate their views on potential nominees or other matters to the Board of Directors and our Bylaws contain a procedure allowing for the nomination of proposed directors by stockholders. As a result of these practices, we have consistently elected highly qualified and effective directors committed to protecting the interests of our stockholders.

The Board of Directors believes our current voting standard is both fair and impartial because it applies equally to all director nominees whether or not a candidate is nominated in a contested or uncontested election. In either case, the plurality voting standard is applied. The proposal, on the other hand, seeks to impose the majority voting standard only on director nominees in uncontested elections, while still applying the plurality voting standard to director nominees in contested elections. This would result in giving special interest groups undue influence, especially in situations where such groups and others are able to withhold votes to disrupt an uncontested election.

While some large public companies have embraced a majority vote standard and/or adopted director resignation policies, the Board of Directors believes that caution in this still developing area of corporate governance is the most prudent approach. For example, the proposal does not deal fully with the removal of incumbent directors who are up for re-election but do not receive a majority vote. Under Delaware law, these directors would ‘hold over,’ continuing to serve with the same voting rights and powers until his or her
successor is elected and qualified. Therefore, even if the proposal were adopted, we could not force a currently serving director who failed to receive a majority vote to leave the Board of Directors until his or her successor is elected at a subsequent stockholder meeting.

The proposal also would serve to unnecessarily increase proxy solicitation costs. Implementation of majority voting provisions could empower special interest groups to promote ‘vote no’ campaigns that are contrary to the best interests of all stockholders, forcing us to resort to expensive strategies to obtain the required vote. The end result would be increased spending for routine uncontested elections to the detriment of the majority of our stockholders.

The Board of Directors believes that the implementation of majority voting could lead to instability on the Board of Directors and uncertainty in the election process. In addition to the undue influence it could give to special interest groups described above, majority voting could also prove impractical. The stockholder proposal fails to address vacancies on the Board if a director is not elected because he fails to receive a majority of the votes cast. Consistent with Delaware law, our Bylaws permit the Board of Directors to elect a director to fill the vacancy or allow the position to remain vacant. If the proposal were adopted, the Board of Directors could be faced with the situation where several vacancies remain for an indefinite period of time, making it difficult to appropriately staff board committees and effectively oversee our business and affairs. This could cause additional uncertainty, disruption and expense for the Company. The Board of Directors strongly believes the current voting system represents the most fair and practical way to avoid these undesirable outcomes.

In addition, the NYSE recently amended Rule 452 which in the past allowed brokers to vote uninstructed shares of customers at stockholder meetings as management recommended on proposals that were considered ‘routine.’ Traditionally, uncontested elections of directors were considered routine matters for which brokers could vote uninstructed shares. However, Rule 452 was recently amended so that uncontested elections of directors will no longer be considered routine, eliminating the ability of NYSE-member brokers to exercise discretionary voting for uninstructed shares in uncontested director elections. As a result, elections of directors will be more difficult for companies with majority voting provisions, because without broker discretionary votes (which in the 2008 proxy season accounted for 19 percent of all votes at stockholder meetings and approximately 17 percent of the vote at the Massey 2009 annual meeting), it will be more difficult to achieve a majority vote. As a result of the amendment of Rule 452, companies with majority voting provisions will face increased solicitation costs to ensure a quorum is achieved and uncontested director nominees are elected.

The Board of Directors is fully committed to strong corporate governance and it is the Board of Directors’ fiduciary duty to act in the best interests of our stockholders. However, in the Board of Directors’ view, this proposal would not necessarily enhance the ability of stockholders to impact the outcome of director elections, nor would it influence director accountability. The Board of Directors therefore does not believe that this proposal is in our best interests or our stockholders.

The Board of Directors will continue to follow the debate about majority voting and monitor developments, and, if appropriate and in the best interests of our stockholders, will take further action to maintain our commitment to high standards of corporate governance. At the present time, however, the Board of Directors believes it would be unwise to alter the plurality-based director election process, which the Board of Directors believes has served our stockholders well to date.
With respect to classification of the board, the proxy contained the following text:

“Stockholder Proposal – Non-Binding Stockholder Proposal Regarding Declassification of Board of Directors

Resolved: That the shareholders of Massey Energy Company ask that the Board of Directors, in compliance with applicable law, take the steps necessary to reorganize the Board of Directors into one class subject to election each year. The implementation of this proposal should not affect the unexpired terms of directors elected to the board at or prior to the 2010 annual meeting.

Supporting Statement: We believe that the ability to elect directors is the single most important use of the shareholder franchise. Accordingly, directors should be accountable to shareholders on an annual basis. The election of directors by classes, for three-year terms, in our opinion, minimizes accountability and precludes the full exercise of the rights of shareholders to approve or disapprove annually the performance of a director or directors.

In addition, since only one-third of the Board of Directors is elected annually, we believe that classified boards could frustrate, to the detriment of long-term shareholder interest, the efforts of a bidder to acquire control or a challenger to engage successfully in a proxy contest. A staggered board has been found to be one of six entrenching mechanisms that are negatively correlated with company performance. See ‘What Matters in Corporate Governance?’ Lucian Bebchuk, Alma Cohen & Allen Ferrell, Review of Financial Studies, Vol. 22, Issue 2, pp. 783–827 (2009).

The New York State Common Retirement Fund urges you to join us in voting to declassify the election of directors, as a powerful tool for management incentive and accountability. We urge your support FOR this proposal.

Board of Directors’ Statement to Remain Neutral to Proposal Regarding Declassification of the Board of Directors

The Board of Directors has considered the proposal set forth above relating to the annual election of directors and has determined not to oppose the proposal and to make no voting recommendation to stockholders. The Board of Directors recognizes that staggered terms for directors is a topic of current interest and believes that there are valid arguments in favor of, and in opposition to, classified boards of directors. The Board of Directors would like our stockholders to express their views on this subject without being influenced by any recommendation that the Board of Directors might make. Accordingly, the Board of Directors remains neutral and makes no recommendation whether stockholders should vote “FOR” or “AGAINST” the stockholder proposal regarding declassification of the Board of Directors.

Under our existing board structure, the stockholders elect three of the nine members of the Board of Directors, amounting to one-third of our directors each year. Each of these directors is elected for a three-year term. Approval of the stockholder proposal requires the affirmative vote of the majority of shares represented in person or by proxy at the Annual Meeting and which are entitled to vote. The stockholder proposal, if approved by the stockholders, however, is non-binding. To declassify the Board of Directors requires an amendment of our Restated Certificate of Incorporation
the ‘Charter’) to eliminate the provision for a classified board of directors. To amend our Charter to eliminate the provision for a classified board of directors would require the affirmative vote of the holders of at least 80 percent of the total voting power of all outstanding shares of our voting stock.

Accordingly, if the stockholder proposal is approved at the Annual Meeting, the Board of Directors will propose at the 2011 annual meeting of stockholders to eliminate the provision for a classified board of directors.

**Board of Directors’ Recommendation**

The Board of Directors remains neutral and makes no recommendation whether stockholders should vote FOR or AGAINST the stockholder proposal regarding declassification of the Board of Directors.

In an apparent attempt to blunt the effect of the shareholder resolution on majority voting, Massey issued a separate release saying that its board had adopted a new policy under which:

> “[A]ny nominee for director in an uncontested election who receives a greater number of votes ‘withheld’ from his or her election than votes ‘for’ his or her election must promptly tender his or her resignation to the Board of Directors for consideration in accordance with the procedures set forth in the Guidelines. The Company’s Governance and Nominating Committee (the ‘Committee’) will then evaluate the best interests of the Company and its stockholders and will recommend to the Board of Directors the action to be taken with respect to the tendered resignation. Following the Board of Directors’ determination, the Company will promptly publicly disclose the Board of Directors’ decision of whether or not to accept the resignation and an explanation of how the decision was reached, including, if applicable, the reasons for rejecting the resignation.”

Thus, the board reserved for itself the right to retain a director who had been deemed unacceptable by a majority of shares voting.

The board also announced that on April 14 it had adopted a new policy requiring a director nominee who receives a greater number of votes “withheld” than “for” election must submit a resignation to the Governance Committee for its consideration.

On April 22, Massey announced that Ms. Judge had resigned from the board “effective immediately.” Although asserting that it was due to conflicting business commitments, the Company denied that the resignation had anything to do with shareholder pressure. The resignation further shrunk the board to eight, of whom fully half (Blankenship, Moore, Phillips, and Suboleski) had significant financial ties to Massey other than the receipt of director fees. On the same day, the board issued a statement affirming support for Blankenship. In a press release, Lead Director Inman said:

> “During times like these, a change in senior management is not appropriate or in the best interest of our members and shareholders. Therefore, we want to emphasize that Don Blankenship has the full support and confidence of the Massey Energy Board of Directors.”
On May 4, RiskMetrics, a leading proxy advisory firm, released its report and recommendations to fund managers and other institutional shareholders regarding the issues in Massey’s proxy statement. RiskMetrics recommended a shareholder vote against all three directors at the annual meeting, saying “the board has failed to respond to shareholders or take proactive steps to enhance the corporate governance.”

The next day, Glass Lewis, another prominent proxy advisory firm, made an identical recommendation, reasoning: “Due to the history of safety problems at the mine in question, as well as at other company operations, coupled with the significant financial impact on the company from this incident, potentially due to faulty safety practices, we believe that shareholders would be better served by new board oversight.” Blankenship was the highest-paid CEO in the industry in 2009, with total compensation of $17.8 million, up 62 percent from 2008. That amount included $358,000 for use of Massey corporate jets. Glass Lewis had given Massey a grade of “F” for its executive compensation practices for the preceding three years.

Massey hurriedly announced the creation of a board-level committee to investigate the Upper Big Branch accident. However, the committee included Phillips, Massey’s President, as a member.

On May 11, a letter signed by the heads of public pension funds in eight states joined RiskMetrics, Glass Lewis, and Change to Win in opposing re-election of the three directors, emphasizing that all three had been members of the board’s safety committee at the time of the Upper Big Branch accident. New York State Comptroller DiNapoli reiterated his demand for Blankenship’s resignation and added a call for the entire board to stand for election every year. In a letter that was later read out loud to shareholders present at the annual meeting, DiNapoli said, “It is clear to me that the [state pension] fund’s investment has been harmed by lapses in risk control.” Lead Director Inman was the target of protests on his University of Texas campus.

The advocacy campaign continued to highlight the fact that the three candidates for re-election were all members of Massey’s Safety Committee. They noted that the Safety Committee included members of management, met only four times per year (half as frequently as the board, the Compensation Committee, or the Audit Committee), and “tried to deflect criticism of [Massey’s] safety problems by emphasizing less relevant measures such as ‘Non-Fatal Days Lost.’” The bottom line for the shareholder advocates was that failure of board oversight and the company’s poor safety record had devastated shareholder value as the stock collapsed disproportionately after the 2010 accident.

On the Friday evening preceding the Tuesday annual meeting, with the proxy votes not yet publicly disclosed but showing overwhelming support for annual election of the entire board, Massey issued the following press release with respect to the shareholder proposal on which the board had taken a supposedly neutral position:

“Massey Energy Will Move to Declassify Board of Directors
Richmond, Virginia, May 14, 2010 – Massey Energy Company (NYSE: MEE) Chairman and CEO Don Blankenship and Lead Independent Director and Chair of the Governance and Nominating Committee, Admiral Inman, today issued the following statement:

‘As a result of stockholder input and the Board of Director’s ongoing review of Massey’s corporate governance policies and practices, the Board of Directors has determined that it will actively work toward the declassification of the Board.’
Within the next three to six months, the Board of Directors intends to hold a special meeting of the stockholders pursuant to which the Board of Directors will propose to the Company’s stockholders to approve amendments to Massey’s Certificate of Incorporation that would declassify the Board of Directors. Approval of the amendments to eliminate the provisions for a classified Board of Directors will require the vote of the holders of at least 80 percent of the total voting power of all outstanding shares of voting stock of Massey.

The Massey Board of Directors remains committed and open to working with stockholders on other important corporate governance matters.

On May 17, the day before the annual meeting, Massey’s stock closed at $33.29, having fallen more than 37 percent over the 6 weeks since the accident. That represented a decline in shareholder value of more than $1.7 billion – more than 10 times the actual charge of $129 million taken by Massey against earnings as a result of the Upper Big Branch explosion. The losses triggered a flurry of shareholder litigation.

On the day of the annual meeting, a prominent governance advisor to boards of directors published a thoughtful essay on the question of whether it was right for Blankenship to hold both the Chairman and CEO positions, and questioning Inman’s effectiveness in overseeing Blankenship:

In times of crisis, boards need to build and repair their bridges. One of the reasons the Disney board was able to get over its severe problems with shareholders is that the chairman and CEO positions were separated and a diplomat, Senator George Mitchell was made chairman of the board. Mitchell knew how to calm the waters, having handled the successful peace negotiations in Ireland. His calming influence and tact were responsible for the improved relations with shareholders including Roy Disney, which brought peace to the company.

Currently, the chairman and CEO positions are combined at Massey, and there is no shareholder proposal in this year’s proxy to address this. The proxy states: ‘We believe having Mr. Blankenship serve as our Chairman of the Board and Chief Executive Officer... minimizes ambiguity concerning who is leading us... [and] eliminates the potential for conflicts between the Chairman of the Board and the Chief Executive Officer.’

Boards, however, are not meant to be composed of CEO loyalists. Boards led by a CEO tend to become rubber stamps, rather than independent oversight bodies. Re-thinking the board leadership structure may be difficult, but the newest members of the board should seriously re-consider what makes sense in light of the situation Massey finds itself in.

The acrimony in the correspondence between Admiral Inman and shareholders has been palpable. (The letters can be read on GiW’s website.) Although there has been some recent cooling down, Inman was an admiral, a commander by training. Even if Inman were diplomatic by temperament, he has been a board member for 25 years (and Mr. Blankenship for 14 years).

All other directors but one have tenures of 5 years or less. With such seniority, it’s human nature for Inman and Blankenship to be defensive of the past and less open to outside suggestions for the future than newer members of the board. It is for this reason,
among others, that many boards have term limits for their members. That’s something Massey board should consider.

Blankenship and Inman have an opportunity at the annual meeting to listen and respond to shareholder concerns. On Friday evening, May 14, Massey sent out a press release indicating a step toward allowing all board members to come up for election annually. More measures like that one are critical to the future of the Massey firm.36

The mention of George Mitchell’s having offset the weaknesses of Disney’s CEO takes on additional irony when one learns that, just a few weeks previously, Inman himself had recently described Blankenship as “the best coal miner in West Virginia” but “tone deaf politically.”37

The final proxy voting results marked a watershed in shareholder organization — and revulsion. The slate of proposed directors was re-elected by margins that a leading business publication called “razor thin,” sending an unambiguous message to Massey about what would happen in future annual meetings. The “Withhold” vote ranged from 48.5 percent for Mr. Phillips to 49.8 percent from Mr. Moore.38 Change to Win commented: “It’s an unambiguous call for new directors. The vote casts a cloud over the legitimacy of this board. The onus is on the board now to name new directors.” In addition, the shareholders overruled the board with respect to majority voting for elections to the board, with 63.9 percent of votes cast in favor of that proposal. The proposal to de-classify the board racked up more than 95 percent of votes cast.

On the day of the annual meeting, the board amended the bylaws to provide for majority voting in noncontested director elections. However, the Company also issued the following statement, which essentially reaffirmed the position the Company had taken in the proxy statement before the shareholder vote,39 leaving the actual future of a shareholder-rejected director, as a practical matter, entirely up to the board:

“If a director nominee who is serving as an incumbent director is not elected at an annual meeting, Delaware law provides that the director would continue to serve on the Board of Directors as a ‘holdover director,’ until such director’s respective successor is elected and qualified, or until such director’s earlier resignation or removal. Therefore, in connection with the adoption of the majority voting standard and as described in Section 3.03 of the Bylaws, the Board of Directors has established procedures set forth in the Corporate Governance Guidelines under which in any non-contested election of directors, any incumbent director nominee who receives a greater number of votes cast against his or her election than in favor of his or her election shall tender his or her resignation, and the Board of Directors shall decide, through a process managed by the Committee (as defined in the Corporate Governance Guidelines) whether to accept or reject the resignation, or whether other action should be taken. If a director nominee who was not already serving as a director fails to receive a majority of votes cast at an annual meeting, Delaware law provides that such director nominee is not elected to the Board of Directors and does not serve on the Board of Directors as a ‘holdover director.’”40

On July 21, President Obama signed into law the Dodd–Frank Wall Street Reform and Consumer Protection Act, which *inter alia* removed doubts about the SEC’s authority to require shareholder access to proxy statements to nominate alternative slates of board members.41
On August 5, 2010, with Lead Director Inman, 79 years old, in his final year as a board member and Blankenship’s current term as a director expiring in May, 2011, Massey commenced a public relations offensive that included making Inman available, for the first time, for media interviews. Apparently rethinking its May creation of a committee to look into the Upper Big Branch disaster that had included Massey President Phillips, Massey announced that it would create a new safety committee made up entirely of independent directors. The Company said that, for the first time, the Company would permit shareholder-called special meetings of shareholders. However, the Company set the threshold support required in order to call such a meeting at a high 25 percent of shares outstanding. Continuing to reject calls by shareholder activists to separate the position of Chairman of the Board from that of CEO, the Company said it would expand the authority of the Lead Director, including a grant of explicit authority to determine the agendas for board meetings. In addition, the board adopted a new policy prohibiting outside CEOs from serving on more than two other boards and precluding all other Massey directors from accepting more than five directorships in addition to Massey. These changes were greeted with cautious approval by proxy advisory firms and members of the coalition of public pension funds that had urged the ouster of the three board members in May. However, Coalition to Win kept up the pressure, remaining highly critical of the Company’s failure to separate the Chair and CEO positions:

> By failing to name an independent chairman, the Massey board has once again demonstrated its unresponsiveness to shareholders and unwillingness to challenge Chairman and CEO Don Blankenship. Without fundamental changes to the board’s leadership and composition, shareholders will continue to bear the cost of Mr. Blankenship’s confrontational and counterproductive approach to shareholders and regulators alike.

On August 16, Massey announced the appointment of two new directors, Robert B. Holland and Linda J. Welty, to serve until 2012, and immediately designated those directors as a special litigation committee to review the shareholder derivative lawsuits arising out of the April 5 disaster. The Company published the following biographical information in its SEC filing:

> Mr. Holland has served in a variety of roles throughout his career. He is Executive Co-Chairman of Max Petroleum PLC, an oil exploration company which trades on the AIM division of the London Stock Exchange, where he serves on the compensation committee and as audit committee chairman. Since July 2009, Mr. Holland also has served as a member of the board of directors and the compensation committee of Financial Guaranty Insurance Corporation, a bond and mortgage insurer. He has served on the boards of directors of the following U.S. publicly-traded companies during the previous five years: Pier 1 Imports, Inc., a specialty retail company, and Affiliated Computer Services, Inc., a provider of business process outsourcing and information technology services. From 2002 until 2006, Mr. Holland represented the United States on the Board of Executive Directors of the World Bank. During that time, he served on the World Bank’s audit committee. He holds a law degree from the University of Texas Law School, having practiced corporate law at Jackson Walker LLP and as General Counsel of Triton Energy Limited, a New York Stock Exchange listed international exploration company that was sold to Amerada Hess.
Ms. Welty is an experienced global business executive with a record of redirecting and rejuvenating various business enterprises, initiating and leading change within large organizations. During a career spanning more than 30 years in the chemical industry, she served in executive roles with Celanese, Hoechst, H. B. Fuller and Flint Ink, a global printing ink supplier for publication and packaging, where she served as President and Chief Operating Officer from 2003–2005. Since 2005, Ms. Welty has served as an executive advisor to private equity firms in transactions involving specialty chemical companies, providing advice on business valuations, due diligence, and value creation strategies. Since 2007 she has served on the board of directors of Vertellus, a global specialty chemical manufacturer serving the agriculture, nutrition, health care, personal care, plastics, inks and coatings market, with over half of its sales derived outside North America. She serves on both the compensation and audit committees of Vertellus. Ms. Welty holds a degree in Chemical Engineering from the University of Kansas.45

Investor reaction to the appointments was mixed. The California Public Employees Retirement System, a member of the coalition that had attacked the three board candidates in May, praised the appointments, but Change to Win said “It’s going to take a lot more than two new directors to reassure shareholders that we have an effective board that’s exercising effective oversight of the CEO.” In response, Inman said Massey would add one or two additional board members “as early as November,” and claimed that it would consider names proposed by shareholders.46

On October 6, at a special meeting of shareholders, Massey’s certificate of incorporation was amended, inter alia, (1) to de-classify the board of directors and require all directors to stand for election annually; (2) to remove the requirement of a supermajority vote for shareholders to amend the bylaws; (3) to remove the provision that had prevented shareholders from calling special meetings of shareholders, although requiring a 25 percent vote. Each of those actions received the approval of more than 90 percent of shares voting.47 In the immediate aftermath of that special meeting, Massey’s stock price climbed above $35 and outperformed the S&P 500 index, for the first time since the May 2010 annual meeting.

NOTES

1. Adjunct Professor of Law, Rutgers School of Law, Camden; Chief Operating Officer, NCI Consulting LLC; Director of public and private companies. Formerly Senior Vice President, Law and Public Affairs, Campbell Soup Company; Adjunct Professor of Law, University of Pennsylvania; Partner and Department Chair, Dechert LLP; Law Clerk to Chief Justice Warren E. Burger, Supreme Court of the United States.
9. From January 1 to June 30, 2008, the S&P 500 Index gained 14.7 percent, while Massey Energy gained 162 percent.
10. From June 30 to December 31, 2008, the S&P 500 Index fell 29.5 percent, while Massey Energy fell 85.3 percent.
12. Ibid.
15. In the 2009 proxy season, 9.8 percent of directors received “withhold” votes of 20 percent or more, up from 5.5 percent in 2008 and 4.8 percent in 2007. “Shareholder Votes Opposing Director Nominees Show Sharp Increase in 2009 Proxy Season,” news release from Proxy Governance, Inc., September 19, 2009.
17. On May 7, the groups Earthjustice, Friends of the Earth, Greenpeace, and the Sierra Club sent a letter to Mr. Gee asking him to resign from the board, saying “Your association with Massey Energy undermines your own standing as an advocate for clean energy sources and confers undeserved credibility on Massey’s terrible environmental record.” Gretchen Mae Stone, “Gee to Leave Massey Energy Board of Directors,” WVNS-CBS59 TV, May 29, 2009.
18. Letter of March 31, 2010, from William Patterson, Executive Director of CtW Investment Group, to Bobby R. Inman, with copies to all other directors.
19. Ibid.
30. California Public Employees Retirement System, Office of Connecticut State Treasurer, Illinois State Board of Investment, Maryland State Pension and Retirement System, New York State


32. Similarly, the year before, then-Massey director Gordon Gee, President of Ohio State University, was the target of protests by environmentalists on campus. Gretchen Mae Stone, “Gee to Leave Massey Energy Board of Directors,” West Virginia Media Holdings WVNS-CBS59 Television, May 29, 2009.


39. See text at note 110 in GM case study, supra.


47. Massey Energy SEC Form 8K, filed October 6, 2010.
AIG

by Jennifer Taub, Senior Lecturer, Isenberg School of Management, University of Massachusetts

“In only a matter of months AIG’s worldwide empire had collapsed, brought down by the company’s insatiable appetite for risk and blindness to its own liabilities.”

Numerous actors helped deliver one of the world’s largest insurance firms, American International Group, Inc. (“AIG”) to the brink of failure. Efforts to assign blame resemble Murder on the Orient Express in which twelve individuals, each inflicting a separate wound with the same dagger, were individually and collectively responsible for the stabbing death of a fellow traveler. However, unlike the case of the fugitive-turned-murder victim in Agatha Christie’s mystery novel, many of AIG’s wounds were self-inflicted. Management and the board of directors weakened AIG over many years, well in advance of the financial crisis. As the firm showed early warning signs of trouble, some, including its shareholders, attempted to intervene to restore the firm’s health. Near the end, in addition to management and the board, professional gatekeepers, counterparties, and regulators each played a part in AIG’s collapse.

Fortunately for AIG, and those dependent upon its survival, life did not imitate art. On Tuesday, September 16, 2008, just one day after 158-year-old Lehman Brothers Holdings Inc. (“Lehman”) filed for bankruptcy protection, the Bush Administration revived AIG at great public expense. In exchange for $85 billion, AIG became a ward of the state, with the US government entitled to nearly 80 percent of its stock. The AIG bailout grew to a $182 billion commitment. Even with the taxpayer-funded rescue, AIG posted a gigantic $61.7 billion loss for the fourth quarter of 2008, an historical record for any US corporation. On the heels of the bailout and huge loss, in March 2009, it was revealed that $165 million in bonuses had been paid to employees of AIG Financial Products. This was the London-based business unit with approximately 400 employees that had accumulated massive risk that threatened the entire global financial system.

Instantly, AIG became a lightning rod for populist anger. Fueling the outrage was the added revelation that AIG’s counterparties were paid 100 cents on the dollar, about $62 billion of the bailout funds, when they should have and would have taken substantially less. In 2010, the Dodd–Frank Wall Street Reform and Consumer Protection Act (“Dodd–Frank”) became law. Many key provisions of this legislation were designed in response to AIG. Even if the government is ultimately paid back in full, the firm may remain a symbol for the worst corporate governance problems of the day, including pay-for-failure, imperial CEOs, inadequate board oversight of risk management systems, and the propensity of firms to privatize gains and socialize losses.
RISK MANAGEMENT EMPIRE FAILS TO MANAGE ITS OWN RISK

“We will ask how it came to be that AIG, a once respected company that Americans looked to for traditional insurance needs, found itself on the losing side of many derivatives transactions with Goldman and other companies and had to be bailed out with a commitment of $182 billion in taxpayers’ assistance.”12

It is with great irony that an empire built on protecting others from risk was brought down by the inability to manage its own risk. Cornelius Vander Starr founded American Asiatic Underwriters, the insurance firm that would become AIG, in 1919 in Shanghai, China. Initially Starr sold fire and maritime insurance. By its fiftieth year, AIG was still a private firm, with a market value of just $300 million and approximately $1 billion in insurance policies.13 At nearly ninety years old, the business was complex and multifaceted, including, among other lines of business, life insurance, aircraft leasing, and retirement plans. In 2007, the firm had nearly 120,000 employees worldwide,14 a market capitalization of $173 billion,15 $1 trillion in assets, and 76 million customers in more than 130 different countries.16 This included insurance policies held by businesses and municipalities. The firm also either managed or sold insurance to retirement plans affecting thirty million Americans.17

Once a “pillar of the American financial establishment,”18 ultimately it became “a sprawling set of profitable insurance businesses trapped beneath a parent company that had become a giant hedge fund that had massive losses.”19

GREENBERG BLAMES “THAT” BOARD

Did corporate governance weakness substantially contribute to AIG’s near collapse? Many observers say “yes” and cast blame upon the board of directors. Somewhat surprisingly, one of the biggest critics of the AIG board was Maurice R. “Hank” Greenberg, the former Chairman and CEO of AIG. This may seem counterintuitive. Greenberg controlled “his” board members during much of his tenure as the CEO and Chairman. Moreover, Greenberg himself was accused of mismanaging the firm. Ultimately, he was pushed out in 2005 amid allegations of improper accounting20 and related investigations of AIG by the New York Attorney General, the Securities and Exchange Commission and the Department of Justice.

However, from Greenberg’s perspective, all was well in terms of risk management at AIG until his departure. On television, Greenberg insisted that “After I left the company, all the risk management procedures that we had in place were obviously dismantled. I can’t explain that. There was a new board of directors. One should be asking that board of directors what they did and why.”21 (emphasis added).

As the firm began its death spiral in the fall of 2008, Greenberg, the largest AIG shareholder who then directly and indirectly owned about 12 percent of the firm, sent a letter to the board in which he wrote: “I am as concerned as millions of other investors as I watch the deterioration of a great company.” He declared that the current board had “presided over the virtual destruction of shareholder value built up over 35 years. It is not my intention to try to point fingers or be critical…. I am truly bewildered at the unwillingness of you and the Board to accept my help.”22 In addition, apparently Greenberg planned a proxy fight for control over AIG. His last-ditch efforts
were ineffective. “In the matter of a weekend…. Greenberg watched the company he built over a lifetime collapse and, with it, his personal fortune and greatest legacy.” He lost about $3 billion, or roughly 95 percent of his personal assets.

It is clear that Greenberg did not wish to lose $3 billion. It is also clear that fault can be found with “that” board that was in place during the crisis. However, it does not follow that both Greenberg and “his” board were blameless. His board, when he was chairman, also created the conditions for the collapse. He also in his role as chief executive was culpable. Many, including one of his successors, Ed Liddy, agree that Greenberg was responsible for the company’s troubles.

These early signs of corporate governance weakness appeared during Greenberg’s reign, at least five years before the AIG bailout. Surface problems of earnings management and manipulation revealed deeper structural vulnerabilities including complex conflicts of interest, inadequate risk management reporting, and cultural problems including an imperial CEO and corresponding weak board. Even Greenberg’s board, the one he claimed had strong risk management controls in place, upon his departure faced “a barrage of shareholder lawsuits claiming they didn’t do enough to prevent mounting regulatory problems at the insurer.”

GREENBERG LEAVES A “COMPANY IN CRISIS”

In 2005, when Greenberg was forced out, Martin Sullivan who stepped up the CEO role remembered that the “company was in crisis.” Due to concerns raised by outside auditors, AIG had just admitted in February that it had made its reserves appear larger than they truly were by improperly accounting for some reinsurance transactions. The firm had treated loan proceeds as if they were insurance premium revenues. This accounting trick and other shenanigans were later thought to have inflated the firm’s net worth by $2.7 billion.

The market reacted quickly. The stock price dropped nearly 19 percent. The rating agency Fitch quickly downgraded AIG from AAA to AA and Standard and Poor’s from AAA rating to AA+. Regulators also responded. Investigators pored over approximately 60 improperly recorded transactions. Civil actions were brought by the NY Attorney General with the support of the New York State Insurance Department and the Justice Department. In 2006, AIG eventually settled the civil claims with New York and the SEC, paying $1.6 billion, a record fine, without admitting wrongdoing. Criminal charges were also brought by the NY AG resulted in criminal convictions of five individuals, with Greenberg referenced as an “unindicted co-conspirator.”

Greenberg would later contend that these restatements, issued after he left, were not necessary. However, there is other earlier evidence of AIG problems that were either found or settled on his watch. For example, in 2003, AIG settled a lawsuit with the SEC for $10 million. AIG had allegedly helped another firm (a distributor of cellphones) hide $11.9 million in losses. Apparently, “AIG had attempted to withhold key documents” and may have provided misinformation to the SEC.

Then, in 2004, also during Greenberg’s reign, AIG paid $126 million in fines to the Justice Department and SEC. Allegedly AIG had helped PNC Financial in 2001 hide $762 million in losses. Some $80 million of this settlement related to the cellphone company matter. As part of this settlement the AIG Financial Products Unit was subject to a deferred prosecution agreement and placed on probation for just over a year. Given the central role it would play in the financial crisis four years later, one has to wonder what might have happened if this unit had been shut down entirely.
In addition, in February of 2005, two of AIG’s executives pleaded guilty to bid rigging charges. They had been accused of rigging corporate insurance policy bids as far back as 1999. AIG had allegedly worked with broker Marsh & McLennan & Co. For example, M&M employees would allegedly submit fake high bids on behalf of an AIG competitor and then a lower bid from AIG so that AIG would land the policy. The allegations involved Greenberg’s son Jeffrey Greenberg who had been CEO of insurance broker Marsh & McLennan Co. Jeffrey Greenberg left M&M in October of 2004 so the firm itself could avoid criminal charges. These bid rigging allegations also led to civil litigation which began in 2004 and dragged out for six years. One has to wonder whether this was the sort of “unfair advantage” that Greenberg perpetually sought.

Additional examples abound. In 2009, Greenberg paid $15 million to settle a claim with the SEC related to the alleged manipulation of earnings between 2000 and 2005, and in July of 2010, AIG paid $725 million to settle with three Ohio pension funds.

**A HISTORY OF CULTURAL AND STRUCTURAL PROBLEMS**

Greenberg joined AIG in 1960 and quickly became Starr’s heir apparent. In 1968, he was elevated to President. From the beginning, he displayed a “headstrong and combative” personality. He is also credited with aggressively expanding the firm. Some observe that Greenberg briddled at attempts to rein in his authority. Though he would later chide the AIG board for its failings, he showed resistance to allowing his board to fulfill its role in overseeing his actions. At one early meeting, Greenberg instructed the Chairman of the firm, Gordon B. Tweedy, “Sit down, Gordon, and shut up. I’m in charge now.”

Greenberg’s control over his board was of concern to some large shareholders. In 2001, the AFL–CIO Office of Investment, who advised roughly 1,500 union pension plans with a total of $400 billion in assets, wanted AIG’s board to adopt a policy that allowed shareholders to nominate a majority of independent directors. In an unusual move, Greenberg contacted the Office of Investment directly, providing his assurance that his board would approve such a policy. This surprised the Office of Investment, who was happy with the outcome, but concerned that it demonstrated that Greenberg had too much power over his board. In 2005, after the board was “praised by regulators for moving quickly to force out its chairman and chief executive, Maurice R. Greenberg, it has also been criticized for not being vigilant and independent enough for years under Mr. Greenberg.”

During his nearly half a century in control, Greenberg fostered a “secretive and ingrained” culture. He inspired respect through fear and by rewarding his most loyal inner circle. Greenberg used complex affiliated entities to both reward this inner circle and undermine the role of the board of directors to oversee executive compensation and other matters.

Greenberg may have used his positional power to help ensure director loyalty. One avenue was through his role as Chairman of the Starr Foundation; the Foundation held 2 percent of AIG.
The Foundation gave millions of dollars to causes with which his directors were closely associated. This included a gift of $36.5 million to the American Museum of Natural History after the Museum’s President, Ellen Futter, joined the AIG board in 1999. That same year the C.V. Starr Natural Science Building opened. This was a cavernous space in the New York museum used to store the dinosaur collection. Other donations included $1 million to an international policy center named after William Cohen, one of the directors prior to his joining the board, and $675,000 to a business school at Hofstra named after Frank Zarb, another director. The Foundation also gave $3 million to the National Bureau of Economic Research, where another director, Martin Feldstein, served as President and CEO. Without challenging the notion that these were deserving organizations, the question is whether the donations bought too much loyalty, making the board compliant. Of course, it was this board who did force his resignation, but the damage to the firm was already done. Also, did they truly have an adequate succession plan or risk management system in place?

Greenberg also established some affiliated companies that became embroiled in conflicts-of-interest related investigations and litigation. For example, lawsuits were brought against Starr International Co. (“SICO”) for allegedly taking more than $4 billion from an employee stock plan. SICO, a holding company that owned roughly 12 percent of AIG outstanding shares, was AIG’s largest shareholder. Initially created around the time AIG went public, SICO may have been sold these shares at a discount to help fend off hostile takeovers. Apparently, SICO was also used as a vehicle to provide deferred shares to compensate “an elite group of AIG managers” in the form of stock. While SICO prevailed in the civil action, regulators have expressed concern that the interconnected firms subverted board governance. “Greenberg and other AIG directors sit on the board, have large personal stakes, and decide who gets paid what. Regulators believe SICO hides executive pay and takes away powers that should rightly lie with the compensation committee of the board.”

Another similar conflicted affiliate was C.V. Starr & Co (“Starr Co.”). Starr was also owned and controlled by AIG executives and controlled about 1.8 percent of AIG shares. In 2002, while Greenberg was still the CEO of AIG, the Teachers’ Retirement System of Louisiana initiated a shareholder derivative lawsuit against certain AIG directors. After the complaint was amended, the suit alleged that Greenberg and three other AIG executives had breached their fiduciary duties by engaging in self-dealing. They had allegedly diverted insurance business that should have gone to AIG, to Starr Co., and also used resources from AIG to perform work and then paid millions in compensation to AIG executives. In 2005, the AIG withdrew its motion to dismiss the case. In 2008, a settlement of $115 million was made, of which the four defendants were personally required to contribute $29.5 million, with the remaining $85.5 million paid by AIG’s director’s and officer’s liability insurance policy. This represented, according to plaintiff’s lead counsel, Grant and Eisenhofer, “the largest settlement of a derivative suit in Delaware Court of Chancery.”

Regulators suspected that Starr Co. was a “convenient tool for managing earnings at AIG, which has been a model of earnings consistency in a notoriously volatile industry. The arrangement also creates endless possibilities for conflicts of interest.” In addition, one institutional investor with $300 million at stake, Richard Moore, the State Treasury for North Carolina State, noted that this structure was suspect. “I don’t think you can have a publicly traded company that allows board members to own a private entity that does business with the publicly traded company. [It’s] impossible to know if shareholders are being taken advantage of.”
RISK MANAGEMENT REPORTING PROBLEMS

In 2010, the Congressional Oversight Panel issued a comprehensive report on AIG in which it concluded that AIG did not have a risk management structure to match its extensive, complex operations. “This poor management structure, combined with a lack of regulatory oversight, led AIG to accumulate staggering amounts of risk, especially in its Financial Products subsidiary, AIG Financial Products (AIGFP).” The second area of substantial risk, which was a proximate cause of AIG’s implosion, was the securities lending business.

While Greenberg claims he had a strong risk management system in place prior to his departure in 2005, the first chief risk officer position had only just been created in 2004. Greenberg hand-picked that first CRO, Robert Lewis. Lewis, who had been at the firm for more than a decade, remained in that role through the 2008 crisis.

One can see at the outset problems in the entire risk management reporting structure. To begin, Lewis first reported to the Chief Financial Officer, not to the board. Then in early 2008, Lewis began reporting to the CEO, Sullivan. Moreover, the individual business units also had their own “risk control units.” While senior management was supposed to approve “all strategic decisions,” the individual business units were given autonomy to make decisions. Lewis also revealed to the FCIC panel that neither the CEO of the most troubled unit AIGFP nor its risk personnel reported to him. To whom did the risk personnel at AIGFP report, one wonders? More importantly, as described in more detail below, whatever the chain of reporting, something was amiss given that AIG tripled its exposure to credit derivatives on asset-backed securities in 2005 and Sullivan did not learn of the extent of this exposure until 2007.

ATTEMPTED INTERVENTIONS

Anonymous sources involved in the 2005 investigation expressed confidence that AIG was not another Enron. By this they meant that unlike Enron whose profits were largely illusory, AIG sold “real products and produce[d] real earnings.” Others were not as sanguine and acted upon even earlier warning signs. Institutional shareholders targeted the firm for a board shake-up.

In December, 2004, during Greenberg’s tenure, the American Federation of State, County & Municipal Employees (“AFSCME”) employee pension fund (the “Plan”), a large shareholder of AIG, requested that the firm include a proposal in the 2005 proxy statement. If approved by shareholders at the May 2005 meeting it would amend AIG’s bylaws to allow for shareholder director nominees, in certain circumstances, to be included on future ballots. The hope was that this might help to replace at least some of the board members who were beholden to Greenberg with some who would act as the shareholders’ watchdogs.

The SEC’s Division of Corporate Finance assured AIG that it could exclude the Plan’s proposal. In February 2005, the Plan sued AIG in the Federal District Court for the Southern District of New York. The court sided with AIG, agreeing that the Plan’s proposal could be excluded. In September of 2006, the US Court of Appeals for the Second Circuit overturned the court below, holding that under the current securities laws and related SEC rules, the proposal should be included.

In November of 2007, the SEC under Christopher Cox’s leadership, amended its rules to make clear that this type of proposal could be excluded. This would help other corporate managers fight off shareholder director nominees. While the AIG shareholder activists were not successful,
the efforts had a broader impact. Under Dodd–Frank, the SEC was given the authority to give shareholders access to the ballot to actually nominate directors. The SEC acted upon this authority and approved new rules in 2010, which became the subject of federal litigation brought by the US Chamber of Commerce and the Business Roundtable, lobbyists for corporate managers.

Another intervention occurred in 2005. A proxy advisory service, Glass Lewis & Co., recommended that investors withhold votes from 10 of the 15 AIG board members. Glass Lewis expressed concern that "members of the current board profited from arrangements from a number of privately-held companies controlled by Greenberg and other former and current executives."66 When a majority of AIG shareholders withheld votes from one director nominee, that director did not resign immediately.67

RESERVOIR OF RISK IS RICH SOURCE OF INCOME

Major risks metastasized inside AIG Financial Products during and after Greenberg’s reign. The London-based unit was launched around 1987. Alumni from the ill-fated Drexel Burnham Lambert formed the group.68 Drexel was the engine behind the leveraged-buyout craze of the 1980s. It helped corporate raiders amass the cash needed to take over target companies. Drexel had a well-developed network of big investors. Through this network, Drexel was able to swiftly finance private buyouts of publicly listed firms, transactions through the creation and sale of below-investment grade “junk” bonds. Drexel was led by the brilliant Michael Milken who “took a decidedly mediocre securities company to the pinnacle of financial power, developing a cultlike following in the process.”69 Drexel ultimately sank when Milken pleaded guilty to a number of felonies and served nearly two years in federal prison.70

The Drexel alumni team lived by similar values and practices. This included an incentive structure that encouraged short-term risk taking. The traders were given 38 percent of profits.71 The first FP leader, Howard Sosin, departed in 1993 or 1994 with $200 million.72

While the FP unit had initially focused on interest rate swaps,73 in about 1998 AIG FP entered the fledgling credit default swap market. Credit default swaps were similar to insurance. In the case of credit protection, however, the buyer pays premiums to cover losses that would occur if the bond issuer defaults. AIG FP took the role of seller of CDS protection, accepting premiums from buyers of protection.

AIG became involved in the CDS market when credit derivatives were in their infancy. In this early phase, the firm earned only 0.02 cents (2 basis points) for each dollar of risk it “insured”74 – as little as $20,000 per year in premiums to insure $100 million in loans.75 By 1999, the rate was about 0.11 cents (11 basis points) per dollar of risk,76 or $110,000 to insure $100 million in loans. Counter-parties buying protection thought this was low risk given AIG’s AAA rating. They expected a firm of AIG’s stature could pay up. AIG thought this was “free money,” given the AAA rating on the tranches of the bonds it was insuring. At that time, in the 1990s, there were very few players in the market.77 Yet, the market expanded from less than $1 trillion in 2000 to nearly $60 trillion by 2007.78

Unlike a real insurance business, AIG did not set aside reserves to cover future losses. In part this was because CDS, though economically equivalent to insurance, were not regulated like insurance. In addition, had AIG been regulated like a bank, it would have been subject to capital reserve requirements in this part of its business. Thus, in the words of Fed Chair Ben Bernanke, the firm “exploited a huge gap in the regulatory system.”79
It also failed at its own self-regulation. This was because employees believed there was no chance whatsoever that it would need to pay out on every claim. If AIG believed there was no chance of paying out, why was anyone buying this “insurance”? The early buyers of protection were often banks, seeking to transfer some of the risk of the loans (assets) on their books to someone else. This risk transfer would reduce their required regulatory capital.80

In the early years, the loans being insured were fairly transparent. Investors knew the names of each of the companies whose loans were in the deals.81 However, when Wall Street began to try to sell protection on mortgage debt, the clarity vanished. The names and credit histories of the borrowers were not shared with investors. While there had never been nationwide downturn in housing prices since World War II, some analysts were still nervous. They were concerned that there was not sufficient data available to see whether defaults on mortgage loans could be correlated.82

Joseph Cassano, a Drexel alum who became head of the unit in January of 2002,83 considered the premiums from CDS contracts “free money.”84 Under his leadership, it initially made $300 million annually, accounting for 15 percent of AIG’s profits.85

By 2005, however, the mortgage securitization market and CDS market substantially changed. Private mortgage firms like Countrywide offered new and exotic loan structures that made increasingly expensive homes seem temporarily more affordable to borrowers. Whereas in 2003, 95 percent of Countrywide loans were conforming at a plain vanilla fixed rate, in 2004, there was a huge shift. For example, adjustable rate mortgages that reset after two years, loans that require little income verification, and loans to borrowers with little ability to repay increased. The “pay-option” adjustable rate mortgage that allowed borrowers to make very small payments, resulting in their principal balance growing instead of shrinking over time, also proliferated. At Countrywide alone, these grew from 6 percent of loans originated to 21 percent by 2006. As a result, the amount the borrower would have to pay upon the reset would be even larger. Indeed, CEO Angelo Mozilo confessed in an email that it was not possible to know “how these loans will perform in a stressed environment of higher unemployment, reduced values and slowing home sales.”86 Somehow, due to a failure of risk management or blissful ignorance, the AIGFP unit did not perceive the shift.

While AIGFP may have been slow to see the true risk in the mortgage markets, others who saw it ended up buying credit protection from AIG. Many of these shorts were purely speculating both on subprime mortgages and also other risky types that would reset and lead to unprecedented defaults. Many did not actually own any of the CDOs for which they were purchasing protection. It was as if they were buying insurance on an entire neighborhood of waterfront homes as a massive hurricane approached. They had no insurable interest in the homes. Their only investment was the premiums. If there was no storm, they would be out those payments. If it arrived and washed away the neighborhood, they would be entitled to the full value of the buildings. Ultimately, AIG ended up on the other side of these bets.

Many see such activities in 2005 as the fatal blow to AIG. According to one expert, “Over the several years, AIG had generated large profits by writing protection against credit defaults on collateralized debt obligations, but its fatal mistake was to write CDS protection in 2005 and early 2006 on $60 billion of collateralized obligations based mainly on subprime loans.”87 AIG did not realize there was a change in the nature of CDOs. Loans inside of the pools against which AIG was writing protection were of lower quality. AIG had provided $50 billion in protection against “triple-B-rated subprime mortgage bonds.”88
SILENCING DISSENT AND PERVERSE INCENTIVES

There were those inside AIGFP who spoke up but were initially silenced. Cassano was an intimidating boss fostering a culture of fear. He was “a guy with a crude feel for financial risk but a real talent for bullying people who doubted him.”

One trader remembered, “If you were critical of the organization all hell would break loose.”

At least one employee recognized the risk in CDS coverage of riskier loan pools. He understood that if US homeowners began to default then AIG did not have enough money to cover losses. When he raised this topic, he was “hauled into a separate room by Joe Cassano, who screamed at him that he didn’t know what he was talking about.”

The skeptical employee studied the loans and “the magnitude of misinformation shocked him.” They were supposed to be diversified loans, but they were “almost entirely” US subprime mortgages. Another trader remarked that “none of them knew it was 95 percent.”

One reason Cassano and others dismissed concerns was that data showed that in 60 years real estate prices had not fallen all at once on a nationwide basis. Some did not stop to consider that the securitization market spurred on by the ability to buy protection against losses helped to drive up housing prices and that the nature of the mortgages they were originating would actually create massive defaults. However, there is evidence that many others were admitting that “things [were] going to blow up.”

By early 2006, when Cassano began to come around, all AIG did was stop initiating new transactions. Between 2005 and 2008, “credit default swaps on subprime mortgage bonds would... precipitate hundreds of billions of dollars’ worth of losses inside big Wall Street firms.” It became clear that AIG was on the other side of many subprime bets.

Though they may have been blind to risk, they were not blind to bonuses. “In the short term, this willingness to wager huge amounts of money insuring against catastrophes yielded large revenues, profits, and bonuses for traders and banks. In the long term, the inevitable happened and, when it did, companies like AIG collapsed.”

COLLATERAL CALLS AND COVER-UPS

In the summer of 2007, in the face of the subprime crisis, Cassano remained steadfast defending the risk AIGFP had swallowed. As has been oft-repeated, he said, “It is hard for us, without being flippant, to even see a scenario within any kind of realm of reason that would see us losing one dollar in any of those transactions.” AIG CEO Martin Sullivan echoed that assurance adding, “That’s why I am sleeping a little bit easier at night.”

What little sleep Sullivan got that summer would soon be awakened by news that less than one dollar of risk turned into many billions, due to Sullivan’s failure to know about or understand the collateral calls associated with the CDS.

What few people understood is that the contracts required AIG to part with cash even if the underlying loans did not default. In other words, by analogy, there were certain conditions short of the fire burning down the house that would require the insurance firm to give the homeowner cash. These conditions might be a very long dry spell in a fire-prone area or a lowering of the insurance firm’s own credit rating. In the AIG case, AIG had sold protection on the “super senior triple-A” tranche. These were the bonds that were the least vulnerable to the failures of homeowners to make
payments on underlying mortgages. However, at the beginning of 2007, the price of these bonds “declined sharply.” Even though they had not gone into default, cash payments by AIG were required.

After rating agencies lowered ratings on “tens of billions” in CDOs (including AAA tranches) in July 2007, Goldman Sachs began asking for and then demanding billions of dollars in cash from AIG. According to Financial Crisis Inquiry Commissioner, Byron Georgiou,

“AIG’s leadership testified that they didn’t know that there were collateral calls associated with the credit default swaps that they sold, that their Financial Products Division sold, that required, when those tranches were downgraded, collateral to be put up. Which of course led to the demise, or would have been the demise, of the oldest and best-capitalized insurance company in the history of the world.”

The amounts of these collateral calls were unfortunately unclear, and subject to negotiation, as the contracts allowed for AIG and the protection buyer (such as Goldman Sachs) to seek market pricing. Given the lack of market liquidity, AIG and Goldman argued strenuously about values. Cassano apparently said at a board meeting during fall of 2007, “Just because Goldman says this is the right valuation, you shouldn’t assume it’s correct because Goldman said it. My brother works at Goldman and he’s an idiot.”

Only in November 2007 did AIG reveal the disputes. Merrill Lynch was also seeking collateral. In December of 2007 Sullivan attempted to assure investors that AIG would weather the then merely subprime storm. His comments were cryptic and in retrospect highly misleading. He told investors that because the “business is carefully underwritten and structured with very high attachment points in the multiples of expected losses, we believe the probability that it will sustain an economic loss is close to zero.” He also said the firm “does not rely on asset-backed commercial paper or the securitization markets responding, and importantly, we have the ability to hold devalued investments to recovery.” While this was in part true, he failed to mention two important points.

First, as noted above under the contracts AIGFP had entered, the firm had promised to make cash payments to protection buyers in the event of a slide in the fair market value of the “insured” mortgage securities. Such cash collateral payments were also triggered by any downgrade in AIG’s credit rating. Therefore, while AIG would not need to pay out on the contract itself until a much higher level of defaults than they were seeing at that time, it would have to post cash collateral.

Second, he did not disclose that due to the securities lending program, the firm did not actually have the ability to hold devalued investments to recovery. AIG was taking great risks through its securities lending programs. The life insurance subsidiaries of AIG took in premiums and invested them in [relatively] safe securities. Because such low-risk instruments provided little return, AIG would lend them out to other investors in exchange for an interest payment. As part of this lending transaction, the securities borrowers were required to give AIG cash collateral. Instead of simply holding on to the cash collateral, AIG then took that cash and invested it in a variety of instruments. This included about $45 billion in mortgaged-backed securities (MBS). In the summer of 2007, it became difficult to sell these MBS. If the counterparties who had initially borrowed the “safe” securities from AIG wanted to return them and get back their cash collateral, AIG would have a serious problem if it needed to liquidate the MBS and there were no buyers. Indeed, in the fall of 2008, such counterparties would request $24 billion in cash.
In early 2008, AIG Chairman Robert Willumstad was concerned about AIG’s CDS on subprime mortgages held by European banks. He contacted the outside auditors. In February they said every single CDS contract had to be revalued. This revealed a “material weakness” and required a restatement of losses for November and December of 2007, up to $5 billion. AIG had agreed to post collateral, but had not set aside funds to meet that promise in the event the debt it was insuring deteriorated.

Even with these huge losses, CEO Martin Sullivan resisted firing Joseph Cassano. He wanted to keep him on at least as a consultant so he wouldn’t go to the competition and because he needed his expertise. So, in perhaps one of the most memorable examples of pay for failure, Cassano left AIG with $300 million and a $1 million per month, post-employment consulting agreement.

THE DEATH SPIRAL

In May of 2008, AIG reported first quarter results, showing a $7.8 billion loss. The firm’s rating dropped to an AA minus from an AA. At the board meeting, there was more pressure from Goldman and other counterparties to make collateral payments (of $10 billion). “Then this resulted in credit rating lowering, more calls and a death spiral. By August 2008, AIG had made $16.5 billion in cash payments to back its CDS.”

Sullivan was asked by the board to resign in June 2008 and was replaced by Robert Willumstad, given Sullivan’s own failure to monitor and manage the firm’s risk. At that point there was about $560 billion in risk on the “super-senior” supposedly safest tranches of CDOs. Yet “AIG was ill equipped to handle that risk.”

By the weekend beginning September 11, it was clear that AIG would be insolvent within a week if it did not raise more capital. It simply would owe more to creditors and other counterparties than the assets it held. Willumstad met with Timothy Geithner to inform him that AIG was having trouble borrowing in the short-term lending markets. According to one source “Geithner was stunned.” However, “Tim had said he couldn’t loan to a nonbank like AIG.” Over that weekend, he met with Henry Paulson explaining that AIG had attempted to raise $40 billion by selling “healthy insurance subsidiaries to private-equity investors.”

With AIG’s credit rating lowered to single A on September 15, additional demands for cash/collateral were $18 billion. “A sinkhole had opened up beneath the firm, and it lacked the liquidity to meet collateral demands from its customers.” In the end, it may have been only a small fraction of CDS contracts that nearly finished off AIG. According to the COP report, “losses were driven by just 125 of the roughly 44,000 contracts entered into by AIGFP.”

September 15 truly looked like the end for AIG. Lehman had filed for bankruptcy protection that morning and the markets were in turmoil. The Dow Jones Industrial average dropped over 500 points. Allowing Lehman to fail sent a new signal. This was a change in how the US government had previously responded to the building financial crisis. In March, Bear Stearns had been bailed out by JP Morgan with $30 billion in government assistance. Over the summer, the government-sponsored mortgage giants Fannie and Freddie had been put into receivership.

THE BAILOUT AND THE BONUSES

In a plot twist worthy of the Queen of Crime, AIG was suddenly and surprisingly brought back to life. On Tuesday, September 16, 2008, the Federal Reserve Bank of New York with the approval...
of Treasury loaned AIG $85 billion. This was done through the Revolving Credit Facility under the Federal Reserve’s emergency lending authority. In exchange for this loan, Treasury received preferred stock and warrants in AIG that were convertible into a 79.9 percent ownership interest. In October, the New York Fed extended another $37.8 billion to AIG.

In the days following the November Presidential election, AIG was still in poor shape. The firm was expected to post a third quarter loss of $24.5 billion. Thereafter, AIG also received $49.1 billion from the Treasury through the TARP. About $182 billion was committed. As part of the bailout, “AIG’s worst mortgage-related assets and credit default swaps” were moved into new vehicles run by the Fed, called Maiden Lane II and Maiden Lane III. “With AIG, the Federal Reserve and Treasury broke new ground. They put the U.S. taxpayers on the line for the full cost and the full risk of rescuing a failed company.”

Though it was not made public until March of 2009, “The Fed later arranged for AIG to make payments of about $80 billion to more than twenty major U.S. and European financial institutions in order to satisfy the full amount of AIG’s obligations to those institutions under CDS and securities lending transactions.” Of the six largest recipients, four were foreign banks. Many question whether it was seemly for the US to rescue foreign banks. In addition, many wondered why it was that the government was providing a backdoor bailout to Goldman Sachs who received $12.9 billion, given that Goldman has repeatedly claimed that its exposure to AIG was “fully protected, collateralized or hedged.” Put well by one expert, allowing AIG to pass this money to counterparties “constituted unjustified gifts by the U.S. government to the most sophisticated investors in the world, who had made bad judgments about whether this AIG subsidiary could deliver on its promised credit protection.”

Critics decry the fact that these pass-through payments to parties who bought credit protection from AIG were 100 cents on the dollar. In other words, there were “no shared sacrifices.” Many believe that the counterparties “would have been thrilled to accept 70 or 80 cents on the dollar if AIG had threatened to put this subsidiary into bankruptcy since it would then be allowed to renege on its CDS contracts.” In fact, some reveal that AIG had been working toward having its counterparties “accept as little as 60 cents on the dollar. Secretary Geithner later testified that he believed that payment in full to all AIG counterparties was necessary to stop a panic. In short, the government chose not to exercise its substantial negotiating leverage to protect taxpayers or to maintain basic market discipline.”

The COP found that the binary choice to either rescue AIG with government funding and fully pay counterparties versus let it fail through bankruptcy was a false choice. “The Panel rejects this all-or-nothing reasoning. The government had additional options at its disposal leading into the crisis, although those options narrowed sharply in the final hours before it committed $85 billion in taxpayer dollars.”

Many at the time and subsequently have questioned why Lehman was allowed to fail but AIG was rescued and nearly nationalized. Somejustifications have included that “AIG had profitable operating businesses that were pledged as collateral for the Fed Loan.” In addition, timing played a big role. The Fed and Treasury worried that the system could not absorb another failure so quickly. A third reason provided is that AIG was just too interconnected to fail. Fed Chairman Ben Bernanke justified this decision, “The impact of AIG’s failure would have been enormous. AIG was bigger than Lehman and was involved in an enormous range of both retail and wholesale markets. For example, they wrote hundreds of billions of dollars of credit protection to banks, and the company’s failure would have led to the immediate write-downs of tens of billions of dollars by banks.” Apparently, “every major financial institution in the world had bought
financial insurance of some sort or placed huge bets with AIG.” Paulson explained that “If any company defined systemic risk, it was AIG, with its $1 trillion balance sheet and massive derivatives business connecting it to hundreds of financial institutions, governments, and companies around the world. Were the giant insurance company to go under, the process of unwinding its contracts alone would take years – and along the way, millions of people would be devastated financially.”

As the COP AIG Report notes, “The result was that the government backed up the entire derivatives market, as if these trades deserved the same taxpayer backstop as savings deposits and checking accounts.” In so doing, the government indiscriminately saved the innocent bystanders such as “pension funds for retired workers and individual insurance policy holders,” and also saved players “who had profited handsomely from playing a risky game and who had no reason to expect that they would be paid in full in the event of AIG’s failure.” Also rescued were “foreign banks that were dependent upon contracts with AIG to maintain required regulatory capital reserves.”

In the wake of the rescues, AIG joined the ranks of bailed out banks and used government funds to provide hefty bonuses to its employees. It was revealed in March 2009, around the time that AIG had announced a $61.7 billion quarterly loss, that the firm planned to pay $165 million in bonuses to employees at AIGFP. The new AIG CEO, Edward Liddy, who had replaced Willumstad back in September, justified the payouts based on contractual obligations.

Apparently, a year earlier, concerned that the employees of AIGFP would depart, the board of directors had “approved a plan that would pay out $165 million in 2009 and $235 million in 2010.” Sullivan justified this action at the time because AIG was already troubled. He worried that the AIGFP employees would quit, as they were compensated based on a percentage of profits. No profit was in sight and if they left, he reasoned, the firm would be in worse shape.

Though President Obama was not in office at the time of the AIG rescue, he was by the time the bonuses were announced. He asked, “How do they justify this outrage to the taxpayers who are keeping the company afloat?” Secretary Paulson wrote that “People were outraged that banks that had received government aid were still planning to dole out lavish pay packages. I empathized with their anger. People had seen the values of their homes and their 401(k)s plunge. We were in a deep recession, and many had lost jobs. Frankly, I felt the real problem ran deeper than CEO pay levels – to the skewed systems banks used that rewarded short-term profits in calculating bonuses. These had contributed to the excessive risk taking that had put the economy on the edge. I was convinced, for policy reasons and to quell public anger that regulators needed to devise a comprehensive solution.”

Some employees gave back some or all of their bonuses, after tremendous public pressure and the threat of a 90 percent tax. Yet some refused and were quite vocal, and Robert Benmosche, the CEO who replaced Liddy in August of 2009, had their backing.

AIG endures as a symbol of pay for failure. Without AIG recklessly selling credit protection on poorly underwritten mortgage-backed securities, many homeowners would not have been put into refinancing loans they could not pay back, the housing bubble would not have grown so large, and the crisis would not have been so devastating. Had AIG employees shown some humility, had their counterparties shared some sacrifice, the public may have accepted the rescue without as much resentment. Yet, the stance by AIG insiders that contractual rights (for contracts that would have had little to no value in bankruptcy) trump fairness arguments will have lasting repercussions in public discourse. When after more than 2 million foreclosures, homeowners would begin to use their black letter legal rights to insist all paperwork be provided, even if they had defaulted months if not years earlier, few could blame them.
In a broader sense, though, what AIG emblemizes is “a broader implicit guarantee of ‘too big to fail’ firms. That is, the AIG rescue demonstrated that Treasury and the Federal Reserve would commit taxpayers to pay any price and bear any burden to prevent the collapse of America’s largest financial institutions, and to assure repayment to the creditors doing business with them. So long as this remains the case, the worst effects of AIG’s rescue on the marketplace will linger.”

NOTES

2. Agatha Christie, Murder on the Orient Express (Collins, London, 1934). (Upon arriving at this conclusion, the fictional detective Hercule Poirot explained, “I saw it as the perfect mosaic, each person playing his or her allotted part.”)
3. There were many players dependent upon AIG’s survival. These included the innocent bystanders, such as consumers who had insurance policies with AIG or its subsidiaries as well as the sophisticated bank and investment bank counterparties who had expectations that AIG would cover these firms’ losses on mortgage-backed securities and related collateralized debt obligations.
19. Ibid., p. 192.
28. Gretchen Morgenson, “A.I.G. to Restate its Earnings for 3rd Time This Year,” *New York Times*, Nov. 10, 2005 (note that a correction to the story indicated that this was just the second restatement).
34. Ibid.
39. Son, Campbell, and Voreacos, “AIG Sets Greenberg Disputes.”
40. Ibid.
43. Barr, “High-Profile AIG Directors May be Liable.”
46. Ibid.
47. Ibid.
49. Barr, “High-Profile AIG Directors May be Liable.”
50. Son, Campbell, and Voreacos, “AIG Settles Greenberg.”
53. Ibid.
57. COP AIG Report, p. 7.
60. Testimony of Robert Lewis, FCIC Derivatives Hearing Official Transcript, p. 143.
65. See AFMSCME Pension Plan v. AIG, 462 F.3d 121 (2d Cir., 2006).
73. Ibid., p. 69.
76. Tett, Fool’s Gold, p. 66.
82. Ibid., p. 68.
89. Ibid., p. 86.
90. Ibid., p. 87.
91. Ibid., p. 86.
92. Ibid., p. 88.
93. Ibid.
94. Ibid., p. 89.
95. Ibid., p. 31.
96. Ibid., p. 68.
100. Ibid., p. 78.
103. Ibid., p. 159.
104. Ibid., p. 158.
107. COP AIG Report.
111. COP AIG Report, p. 7 and Sorkin, p. 164.
112. Pozen, *Too Big to Save?*, p. 78.
117. Ibid., p. 204.
118. Pozen, *Too Big to Save?*, p. 78.
120. Ibid., p. 30.
121. Ibid.
122. Ibid.
123. Ibid., p. 7.
124. Ibid.
127. FCIC TBTF Report, p. 27.
128. Pozen, *Too Big to Save*, p. 78.
129. COP AIG Report, p. 10.
132. Ibid., p. 8.
133. Wessel, *In Fed We Trust*, p. 25.
136. Ibid., p. 192.
140. Ibid., p. 532.
143. COP AIG Report, p. 10.
Sperian Protection

by Paola Perotti, Governance for Owners (GO)

Sperian Protection is a leader in personal protection equipment (PPE) design and manufacturing. Operating on all continents, it had sales of €660 million in the year ended December 31, 2009. At that time it employed almost 6,000 employees. The company is headquartered in Paris and, prior to its acquisition by Honeywell International Inc., was listed on the Premier Marché on the Euronext in Paris. Its market capitalization on October 20, 2009 was €908 million.

Governance for Owners (GO) first invested in Sperian Protection in November 2005, having identified it as a fundamentally strong company in spite of years of under-performance relative to the market.

Sperian Protection operates in the PPE market, which encompasses all articles of equipment and clothing worn for the purpose of protecting against bodily injury, including safety eyewear and goggles, earmuffs and earplugs, respirators, hard hats, fall protection equipment, gloves, safety clothing, and safety shoes.

Historically, overall demand for PPE has been relatively stable due to government and industry regulations, the diverse end-user customer base and the nondiscretionary and consumable nature of the products. Most analysts expect its strong secular growth to continue, driven by a continual and increasing focus on workers’ health and safety issues.

Our investment in Sperian Protection was predicated on our view that the company’s sustainable business model and a supportive cash-flow yield would provide the basis for future growth, while our engagement would help the company achieve margins in line with the sector.

Bacou-Dalloz (as the company was called at the time we invested) was formed in 2001 through the merger of US-based Henri Bacou Group and French-based Christian Dalloz. In the words of Philippe Alfroid, then Chairman of Christian Dalloz SA, the transaction would

“... create an industry leader, headquartered in France. Both groups were founded by visionary French entrepreneurs whose companies have continued to flourish after their untimely deaths. The similarity of our two corporate histories and cultures is a strong foundation for the future success of the combined business. This is an important event in the history of our group that will build value for all of our shareholders...”

Since the merger, however, the company had underperformed the French market, the European market, and the Industrial Goods and Services sector, due to unpredictable earnings, weakening sales, and questions over the sustainability of margins.

Sperian Protection’s operating margins had continued to be depressed after the merger. This had been caused by a declining top-line as management at the time had focused on industrial restructuring...
and integration and not on customers and products. There had also been concerns that the company had not maximized the disposal value of Abrium, a wholesaler of protective equipment.

In April 2004 Claude Balleyguier, the company CEO, was dismissed. We had high hopes that the new CEO, Henri-Dominique Petit, would reverse the trend. We wanted to engage with management to persuade them to conduct a thorough portfolio review, using returns on capital as the metric for the review, and have the company focus the portfolio on the areas where they had strong positions (and thus strong returns).

GO had a pivotal meeting with the CEO and CFO in November 2006, which was the culmination of a series of meetings, during which we presented our analysis of the returns per subdivision. Sperian Protection did not disclose profitability by subdivision in its accounts. However, by means of a detailed forensic analysis, we were able to infer from public information that two divisions were loss making. The range of EBIT profitability varied from loss making to over 20 percent. The CEO did not dispute our findings, but told us that he had already implemented a number of restructuring steps that would result in a significant increase in profitability. However, he agreed to present separately from Sperian Protection’s core activities those businesses that were either non-core or needed to improve their margins. He also moved the CFO to head up these “turnaround” businesses.

In 2007 we met Essilor, the company’s largest shareholder with 15.0 percent of the shares, and took them through our concerns and aspirations for the company. We also met Mme. Dalloz, the second largest shareholder (holding directly and indirectly 13.2 percent of the capital) and the widow of the founder of the original Dalloz, and a number of other board directors. Founded in 1972, Essilor International is one of the world leaders in ophthalmic optics. It had acquired a 20 percent stake in the company in 1987 when it was working together with the then Christian Dalloz to develop shatter-proof spectacles, using a polycarbonate coating. While, by this stage, Essilor’s investment in Sperian Protection was by no means strategic, its management had developed strong ties with the management of Sperian.

By this time we had been invested for some two years. We had achieved some moderate success, but, overall, we felt that management had paid lip service to most of our proposals and the pace of change was too slow. We decided it was time to intensify the pressure. In 2008 we made a presentation to the CEO and IR highlighting the issues that Sperian Protection should address, in particular the need for an acceleration of the organic growth, increased focus on high value-added products and better financial disclosure. This was followed by a letter and a conference call with the executive board. Subsequently, in Sperian’s communication of the 2007 results, we were pleased to see that the CEO had taken our points very seriously and directly addressed the issues we had raised as the company made a number of additional disclosures as a result of our presentation.

During 2009, given the clear value case, we also discussed for the first time the possibility that we could increase our position. We told the company that for this to happen we would need board representation. We spent most of 2009 discussing whether we could get a board seat and the likely candidates for this position, but we could see that there was a strong desire for the company not to add a third reference shareholder. By this stage M. Petit had handed over the CEO role to Brice de la Morandiere, the previous CFO. This did not result in any acceleration in efforts to address the strategic issues at the company.

We met Essilor again, but M. Alfroid, the Essilor’s representative, was adamant that he did not want to increase the pace of change. M. Alfroid had personally known the husband of Mme. Dalloz. However, he was due to retire soon and we felt that a new Essilor’s representative would
perhaps take a different tack and insist that the board of Essilor justifies its investment in Sperian solely on financial metrics.

At this time, as the markets recovered and Sperian continued to generate cash, we felt that Sperian would be an attractive opportunity for a financial investor and met with four private equity players to discuss the opportunity.

On March 31, 2010, Sperian announced that it had received a “friendly” offer from Cinven at €70 per share, a premium of 16 percent over the previous close and 31 percent on the 3 month average. We saw this move as an opportunistic attempt to acquire Sperian at a price that significantly undervalued the company and its future prospects as the offer was timed when the profitability of Sperian was at a historical low point.

We therefore felt strongly that the level of the offer did not reflect its intrinsic value, which we estimated at over €90 per share. We were also concerned by the structure of the offer, requiring Cinven to only achieve 29 percent of nonrelated shareholders’ acceptances to assume control, as the shareholdings of Essilor and Mme. Dalloz would be rolled into Menelas, a new vehicle that would be controlled by Cinven. This left a possible divergence of interests between Essilor and Mme. Dalloz and the remaining minority shareholders.

We immediately appointed lawyers, valuers, and PR advisers. We also convinced Colette Neuville, the doyenne of protecting minority shareholders in France, to join us in the fight against this inequitable offer.

Sperian had given a 30 days’ exclusivity bid period to Cinven for it to continue its due diligence process. The French press and the financial community regarded it as a “done deal” – there was little appetite for resisting the offer. Just finding Paris-based professionals prepared to work independently for us was difficult enough – they all knew Cinven would have a future deal flow that would generate large fees and they did not want to offend them.

We used every possible means to thwart Cinven’s low-ball offer. We contacted the French market regulator (AMF). We and our appointed valuer met with the official independent valuer who had been appointed by the company to provide a fairness opinion on the offer (so that the board could recommend it, as required under French law). We wrote to Sperian’s auditors, Ernst & Young, pointing out that they had only very recently signed off the accounts with a book value of €77 – 10 percent higher than the bid price!

We were aided in these actions by our advisors and internal governance team, who provided us with an intimate knowledge of the French regulatory system. This allowed us to make some critical interventions, which resulted in the deal coming under additional scrutiny and delayed the process. The independent valuer should have come up with his report after 15 days, but that deadline was missed. This was our first indication that our efforts were having a tangible impact.

We also spoke to a number of other large nonrelated shareholders and shared with them the routes they could use to help increase the scrutiny the Cinven bid would come under. This resulted in increasing the public and private pressure on the company. We ourselves let it be known publicly that we had concerns around the level and structure of the Cinven bid, which attracted much press interest and led the share price in the market to start trading above €70. This was the first indication that there was some hope of a higher offer.

During this period we were in regular contact with both the CEO and the Chairman of the company but, as our work progressed, we believed we had unearthed a number of corporate governance irregularities. As a result, we wrote to each board member individually at their home address to highlight the irregularities. We intensified the pressure on the board to the extent that some board members may well have become concerned that the management of Sperian
Protection had not followed the proper legal procedure or adhered to the terms and the spirit of the French Corporate Governance Code (a voluntary code that becomes binding on a company when it decides to abide by it) as Sperian had. So the exclusive bid period expired on April 30 without a formal bid being forthcoming.

During this period we decided to contact a number of potential trade buyers, including Honeywell. These players were under the impression that the Cinven offer was a “done deal,” but now they realised they had time to prepare a competing bid. We indicated to the advisors of these players that we would be prepared to publicly support a counter-offer. An auction of trade buyers followed and Honeywell became the favourite bidder with an offer price of €117 per share, far above the Cinven offer of €70. At the company’s AGM on May 19, 2010, the management of the company announced the Honeywell deal, which had been unanimously approved by the whole of the Sperian Board.

Again, in the words of Henri-Dominique Petit, Chairman of the Board

“Sperian Protection’s Board of Directors has unanimously approved the tender offer agreement and intends to recommend Honeywell’s offer upon receipt of a fairness opinion. I'm pleased about the outcome of this process and believe with the Board that the transaction is in the best interests of Sperian, its employees, customers and shareholders, subject to conclusion of fairness opinion from an independent expert.”

On June 22, 2010, the proposed takeover was declared compliant by the AMF. This was the key regulatory approval for Honeywell to be able to launch the offer formally. The offer was then launched and remained open until September 2. Settlement followed some two weeks later.

We had 752,524 shares – 9.8 percent of Sperian’s equity across all funds. The Cinven “done deal” was worth €52.7 m to our clients; Honeywell’s offer was worth €88 m. This represented an uplift on our clients’ investment of €35.3 m.

For Governance for Owners, the process demonstrated that, despite the French market environment where a minority foreign shareholder may be at a disadvantage, more so in this case because the bidder was a large private equity firm, a well-constructed and sustained campaign can result in a favourable outcome. There were, however, costs associated with this approach that we had to bear on behalf of all the minority shareholders – who were, in effect, “free-riders.”

Nevertheless, this is a clear example that, unless long-term owners accept the fact that good stewardship costs money, they will miss out on such opportunities to unlock value.

The French press was supportive of us throughout. They recognized us as long-term shareholders objecting to an under-priced offer that should never have been approved by the Sperian board.

Shareholders, employees, and customers all welcomed the combination of Sperian Protection and Honeywell’s Life Safety division, as it would establish a leading global provider of personal protection equipment with a full range of safety products in the attractive, high-growth PPE industry.
The following case study is reproduced by permission of Rolf H. Carlsson, CR’RC AB.

This is a brief introduction to the Swedish Corporate Governance system and the role of the Nomination Committee. The purpose of this introduction is to give a brief orientation of the role of nomination committees in the overall context of Swedish corporate governance. This will include some key provisions by the Swedish Company Act and by the Swedish Corporate Governance Code (SCGC), as well as a brief review of the established practice of board nomination and its historical roots.

THE CORPORATE GOVERNANCE HIERARCHY

The Swedish Company Act defines the institutions, the different roles and responsibilities of the three main levels of the top hierarchy of a Swedish incorporated company:

1. The AGM elects the Chairman of the board separately as well as all the other Directors of the board. The AGM approves the accounts of the preceding year including the profit and loss statement and balance sheet of the company as well as deciding upon the dividend. It discharges the board and the CEO of liability after having received the annual report of the statutory auditors.
2. The Board is fully responsible for the management of the company. In a listed company the majority of the board should be elected by the AGM. (The only other way of appointment is by the employees.) The board appoints and dismisses the CEO to whom the board delegates the day-to-day management of the company. The board must monitor the performance of the CEO on a continuous basis.
3. The role and responsibilities of the CEO are provided by the Swedish Company Act. All listed companies are obliged to have a CEO. The chairman cannot be CEO of a listed company. The CEO reports to the board but he is also accountable to the AGM. However, the CEO can also be a director of the board, although many companies have chosen not to include the CEO as a director.

THE NOMINATION COMMITTEE (NomCom)

The Nomination Committee of Swedish corporations distinguishes itself from the Anglo-Saxon and many other countries (Norway is similar to the Swedish one) by being fully controlled by the owners of the company and being composed mainly of owner representatives. Hence, it reports to the AGM. Furthermore, any shareholder is entitled to propose additional candidates to the
NomCom or directly at the AGM. However, the NomCom is not subject to the Swedish Company Act, but has been defined and regulated by the Swedish Code of Corporate Governance.

Swedish industry – not least the large corporations – has been dominated by strong and long-term committed owners since the early phases of the industrialization when many of the large corporations of today were established. On the whole, owners have managed to remain in control ever since. There are several explanations for this, which cannot be fully explained in this context, but three key features should be highlighted:

(a) The global success of many of the Swedish corporations, e.g., Atlas Copco, Ericsson, Sandvik, and SKF – all of them global leaders in their respective markets. Early internationalization and incessant renewal are common denominators – very much due to the committed and competent ownership exercised by the leading owners seeing to it that the corporations have been led by competent boards as well as by adequate executive management being properly financed, etc.

(b) Although Sweden for a large part of the twentieth century was dominated politically by the Swedish Labour party and the trade unions based on a socialist ideology, the leading owners of Swedish industry were respected by most other stakeholders. There were some attempts to initiate heavy socialization after World War II and later in the early 1980s, but the first attempt was soon abandoned when the economic growth took off after the war and the latest attempt was rejected – with a vengeance – by all other stakeholders and by the public at large. Therefore, a culture of private ownership has prevailed as a distinctive feature of the Swedish society and industry. The prerogatives of ownership, e.g., that of control of assets, including shares of corporations, of deciding upon the nomination and election of boards, have prevailed as well.3

(c) Dual shares (A and B shares, usually with voting rights 10:1) have been a helpful tool to facilitate control by the leading owners in many cases.

The current practice of the Swedish NomCom has evolved over the last two–three decades when share ownership started to spread among the general public, when institutional investors – pension funds and mutual funds – emerged as important actors in the capital market, together with an increasing presence of foreign institutional investors after financial deregulation during the 1980s.

The increasing dynamic of the Swedish financial market opened up opportunities for new owners to enter into the battle for corporate control. The old ownership structures started to rattle by bold and innovative moves by young and aggressive risk capitalists. They both copied and challenged the old leading owners, particularly the most powerful of all, the Wallenbergs, and the so–called Wallenberg sphere.4

Earlier, the leading owner/owners of a corporation decided upon the nomination of possible new members of the board, usually after consultation with the chairman of the board, to be proposed at the upcoming AGM (as provided by the Swedish Company Act, the incumbent board stands for re-election every year).

With the increasing importance of the new actors, particularly the institutional investors, in the capital markets, not least as providers of risk capital and significant shareholders (albeit mostly B shares with lower voting power), old owners such as the Wallenbergs started to consult with the larger institutional investors holding significant portfolios of shares of the corporations of the Wallenberg sphere on board nomination issues. Successively, this became more formalized and, eventually, when what preceded the Swedish Corporate Governance Board was set up, the evolved practice was codified as part of the Swedish Corporate Governance Code (SCGC) in 2005, revised in 2008 to be applicable to all listed companies.
SCGC, based on the principle of “comply or explain,” provides that the AGM should set up a Nomination Committee to prepare nominations for the next AGM. In addition to nominations for the board it should also nominate the external auditors and proposals for board and auditor fees. The SCGC states that:

“The sole task of the nomination committee is to propose decisions to the shareholders’ meeting on electoral and remuneration issues and, where applicable, procedural issues for the appointment of the following year’s nomination committee. Regardless of how they are appointed, members of the nomination committee are to promote the interests of all shareholders. Members are not to reveal the content and details of nominations discussions unduly.”

TWO WAYS TO SET UP THE NOMINATION COMMITTEE (NomCom)

The SCGC states that

“The nomination committee has to have at least three members, one of whom is to be appointed committee chair.”

The NomCom can include members of the board but they must not make up a majority. At least one member of the NomCom should be independent of the largest owner. Usually, the chairman of the board is included in the NomCom, either as a full member or just as a co-opted participant. The chairman of the board cannot be chairman of the NomCom. The CEO or other members of executive management of the company cannot be on the NomCom.

The AGM has two options for how to set up the NomCom:

1. The AGM can elect the actual persons to be members of the NomCom in a two-stage process:
   (a) Identifying the owners to be represented – usually the largest in order of voting power. However, some owners, particularly many foreign institutional ones, prefer to stay out of the participation. Then the next in rank (by size of voting power) will be offered the chance to participate.
   (b) The AGM elects the persons to be on the NomCom as proposed by each respective owner.

2. Alternatively, the AGM can decide on the process of setting up the NomCom, e.g., by stating that the NomCom should consist of representatives of the largest owners based on the reported owner structure at, for example, the end of the third quarter. However, the members of the NomCom should be announced on the company’s website no later than six months before the next AGM.

The nomination work process of the NomCom is much the same independently of how it has been set up, possibly with one difference. The NomCom elected directly at the AGM can hold its start-up meeting shortly after the AGM to elect its chairman and prepare its work plan (cf. the GSI
case below). The NomCom will report its work at the next AGM but will remain on duty until a new NomCom has been appointed.

EVALUATION OF THE SWEDISH NOMINATION COMMITTEES

The Swedish Corporate Governance Board recently presented and commented upon a report on an evaluation of the functioning of Swedish nomination committees it had commissioned during 2010. The study was based on interviews with some sixty NomComs of listed Swedish companies (interviews were made with the NomCom chairman or the chairman of the board, about half of each).

The overwhelming majority (9 of 10) said the current NomCom system works well or very well. None of the respondents thought that the current NomCom system should be replaced by the Anglo-Saxon model (NomCom as part of the board of the company).

A few weaknesses/improvement needs were identified. For example, there were some concerns about the major owners tending to dominate the NomComs. Another concern pointed at a need to widen the recruitment of NomCom members to include people with more experience of board work and knowledge of the company concerned.

GSI – A SWEDISH NOMINATION COMMITTEE AND NOMINATION PROCESS: A BRIEF CASE STUDY

INTRODUCTION

This case study of a Swedish nomination committee (NomCom) is not a blueprint of an actual one but emulates typical characteristics of NomComs of major Swedish listed companies. Although all Swedish NomComs are subject to what the SCGC provides, there are quite a lot of differences from one to the other as to how they work and how ambitious they are. This case illustrates a rather ambitious and conscientious approach to the tasks of a NomCom. It is based on interviews with experienced members of actual NomComs and my own experience as a consultant carrying out board evaluations of large Nordic, particularly Swedish, listed companies, over the last seven years. Such evaluations are commonly reported to the NomCom concerned. In addition, there is quite a lot of information available concerning NomComs and the nomination process – both of a generic nature and specific ones on the websites of various companies (see list of references at the end).

THE NomCom OF GSI AND ITS PROCESS OF NOMINATION

As a matter of convenience, let us call the fictive company GSI – General Services Inc. Let us also assume that GSI appoints the NomCom and all its members at the AGM.

We will follow the work process during its five meetings and see what happens in between – from the AGM of 2009, when it is elected, until it delivers its report to the AGM of 2010.
AGM 2009: agenda item Election of NomCom

At the AGM of GSI in April 2009 it was resolved that the NomCom should have five members, four of which should represent the four largest shareholders of GSI. Two of the owners were major industrial holding companies each controlling more than 10 percent of the votes. The two others were institutional investors, one pension fund and one mutual fund, each controlling around 5 percent each. The fifth member elected was the chairman of the GSI board. The persons named by the respective owner were elected to form the NomCom until the next AGM. However, the NomCom should work as one body, representing all owners and only proposing what is in the best interest for the company as a whole.

First meeting of the GSI NomCom in June 2009

Present at the meeting were all the members of the NomCom and the NomCom secretary, a legal officer from the legal department of GSI who had been assigned to take the minutes of the NomCom proceedings. The meeting covered the following agenda:

1. Election of chairman – the representative of the largest owner is elected.
2. Review of what the SCGC says about the tasks and responsibilities of the NomCom.
3. Review of the GSI instructions for the NomCom of GSI.
4. The NomCom chairman summarizes the main work agenda ahead of the NomCom:
   - An evaluation of the GSI board and whether it needs renewal, replacements, etc.
   - Nomination of the board for decision by the next AGM, possibly including recruitment and nomination of new board members.
   - Proposals concerning board remuneration and auditor fees (nomination of new auditors are not due until the following AGM).
5. The chairman of GSI gives his views of the overall situation of GSI and challenges facing the company and its board in the near future; he comments also on the board work of the past year and the performance of all the board members.
6. A plan and meeting schedule for the work ahead of the NomCom is outlined and agreed upon. The next meeting is scheduled for early September. The NomCom chairman takes on the task of calling the CEO of GSI to be present at the next meeting for a thorough interview about GSI challenges, with comments regarding the competence profile of the board, etc. The NomCom chairman also urges everyone to be well prepared for the next meeting and to see to it that they have all the relevant information they need from GSI. The secretary will coordinate such requests.

Second meeting of GSI NomCom in early September

Initially, the NomCom gathered without the participation of the chairman of the board and the secretary to interview the CEO of GSI. She, one of the few female CEOs of listed Swedish companies, was asked to answer three main questions:

1. Her views on the challenges facing GSI as regards its ability to sustain and grow its value creation capability in its immediate as well as somewhat longer term perspective.
2. Her views on the incumbent board – how did the current competence profile match the challenges ahead? What changes did she see that might enhance the competence of the board as well as its ability to make value creating contributions? Additionally, what were her views on the chairman?
3. How would she like to comment on the dialogue and collaboration between the board, on the one hand, and her and the executive management, on the other, as well as the collaboration between her and the chairman of the board?

The CEO left and the chairman of the NomCom took a few minutes to summarize the main points of interest that the CEO had communicated. Some discussion followed before the NomCom members agreed on a tentative list of critical challenges that GSI was facing. On the whole, it very much overlapped what the chairman of the board had highlighted already at the first meeting of the NomCom back in June.

After a brief recess the meeting continued, now with the whole NomCom, covering the following agenda items:

- The chairman of GSI presented drafts of the questionnaires for board evaluation (of the board as a whole and for individual board members respectively), which he had prepared in collaboration with the external consultant hired to carry out the evaluation. The NomCom suggested a few amendments and requested a full report with particular and detailed emphasis on the individual evaluations at its late November meeting. The institutional investor representatives remarked that the evaluation reports should try to avoid making them insiders.
- It was decided that the NomCom, individual members or collectively (only the owner representatives), should aim to meet all the board members individually. This needed to take place before the next meeting of the NomCom. The chairman of the board offered to see to it that his assistant, which he shared with the CEO of GSI, took care of the practicalities of arranging the meetings.

The NomCom work between the September and November meetings
All in all the NomCom owner representatives managed to interview all eight AGM-elected members of the board, but all did not meet all board members as had been the ambition. Fortunately, from a practical standpoint, all NomCom members were based in Stockholm, which facilitated the meeting arrangements. However, only half the board members were. Some of the meetings could be arranged in connection with the late September board meeting and some in connection with an extra meeting of the auditing committee in October. Finally, two of the AGM-elected board members could be met in connection with their board meetings in two other companies based in Stockholm.

The employee-appointed board members, together with their deputies, were divided into two groups, each group being interviewed by a couple of NomCom members.

All along there were quite a few telephone contacts between the NomCom members. Successively, a realization emerged pointing towards the necessity of making some changes in the board.

Although the final conclusion was still pending the reporting and deliberations of the next meeting, the NomCom chairman urged the NomCom members, inventorying their own networks, to come up with candidates for new board members matching the competence requirements they had already started to see.

NomCom’s third meeting in November
The NomCom was visited by the board evaluation consultant who presented two reports:

- A summary of the evaluation of the board as a whole, which included an overview of strengths, weaknesses, and improvement suggestions regarding the overall challenges facing GSI, its
competence profile and performance. The key conclusion and recommendation to the NomCom was that the board should be strengthened as regards its competence and experience to support GS’s rapid expansion in the BRIC regions, most urgently for China and Brazil/Latin America. GSI could also benefit from more board competence as regards industry restructuring and M&A.

- A full report regarding the individual evaluation of the GSI board members, which revealed how the individual competence profiles and value-creating contributions summed up the total profile of the board. The summary of the individual evaluations allowed for a ranking of how valuable each board member was considering all evaluation aspects (some 15 criteria). However, it was also possible to see how each board member matched the aspects that were now most critical for GSI as well as how much overlap there was regarding less critical competence.

After the consultant had answered follow-up questions he left and the NomCom went on with its agenda:

1. First on the agenda was to draw the final conclusions of the need for board renewal considering both the NomCom’s own analysis and the findings as recently presented by the evaluation consultant. Two board members should be replaced and two new ones should be recruited with competence and experience corresponding to what the consultant had recommended. The recommendation came as no surprise to the NomCom members. The board members to be replaced included the one at the bottom rank of the individual evaluation and one of a higher rank. However, the latter had taken on new demanding assignments in other companies during the previous year, which showed a lower commitment to the GSI board by missed meetings, leaving meetings before they were finished, etc.

2. The NomCom chairman had prepared a list of all the candidates that the individual NomCom members had generated since the last meeting. He had made a first ranking of the candidates based on CVs and other available documentation. Four of the candidates stood out as regards the critical competence criteria they had agreed upon. A discussion followed resulting in the decision by the NomCom to support the shortlist of the four candidates. However, it was also concluded that in case some or all candidates were not available for a board assignment in GSI or a closer scrutiny should reveal flaws in their perceived strengths, the list should include two additional candidates from the gross list. To be sure to have identified the very best candidates, the NomCom decided this time to hire a reputable recruitment consultant.

3. The chairman of the NomCom had already anticipated such a decision and after consultation with the other major owner and the chairman of the board asked the recruitment consultant, who had been used before by the GSI NomCom, to be prepared to present a plan for his assistance at the meeting, which now took place.

It was decided that the recruitment consultant should be assigned to identify two more suitable candidates in addition to the list of the six generated by the NomCom. Preferably, such candidates should be of Swedish/Nordic origin while having the international competence and experience required. This gross list should be reduced to a shortlist of four candidates matching the competence criteria as well as being available for a board assignment. The consultant should work in close cooperation with the chairman of the NomCom as well as with the GSI chairman. The four shortlisted candidates should be interviewed by the NomCom for final selection. The whole process needed to be finished and the new nominations be decided upon at the fourth meeting of the NomCom in late January 2010.
The recruitment process and the NomCom work between the November and January meetings

The first stages of recruitment were finished by Christmas. The consultant had kept a close liaison with the GSI chairman as well as the NomCom one. The shortlist of four potential nominees was sent to all members of the NomCom together with a schedule of meetings with all the candidates for individual interviews, starting after the holidays in early January. The NomCom chairman urged the other members to try to take part in as many of the four interviews as possible.

About a week before the late January meeting of the whole NomCom, the interviews of all four candidates were completed. The consultant documented the interviews and collected the feedback from the NomCom members who participated. Based on that, the consultant could outline elaborate profiles as well as a ranking list of the four candidates.

The NomCom chairman managed to get agreement among the NomCom members – by means of email and phone communication – that two of the candidates should be chosen in the first place and that he should try to get their acceptance to stand for election at the AGM.

Fourth meeting of the NomCom in late January 2010

The fourth meeting marked the end of the substantial work of the NomCom and where its final decisions on nominations and proposals to the AGM should be concluded. The meeting covered the following agenda:

1. Nomination of chairman of the AGM in April. The NomCom chairman informed the meeting that the same lawyer who had been chairman at the last AGM was willing to take on the assignment once again. The NomCom so decided.

2. The NomCom chairman reported that the two nominees for the board had accepted to stand for election. For the minutes, the NomCom now confirmed this by its formal decision.

3. The chairman of GSI reported that he, as part of the feedback of the individual evaluation of the board to each of the board members, had made it clear to the board member who ended up at the bottom of the ranking list as well as to the one whose commitment had slipped, that the NomCom might not renew their nominations for the board at the coming AGM. Receiving this feedback, the latter one immediately withdrew his candidacy for re-election. This was noted by the NomCom and, following common practice, the NomCom chairman was going to communicate the decision to the one with the lowest rank that she would not be nominated for re-election. He should also confirm to the one who had withdrawn his candidacy that it had been noted by the NomCom.

4. The NomCom concluded that the full nomination proposal to the AGM should say: (a) the board should have the same number of members as now; (b) re-election of the incumbent chairman for chairman of the board; (c) re-election of all other incumbent members of the board except the two mentioned above; (d) nomination of the two new candidates.

5. The next item on the agenda was to prepare the proposal concerning remuneration of the board. The NomCom decided to propose the same board fees as the year before, the whole of which should be paid in cash:

- The chairman: €140,000
- Board members: €55,000 each
- Audit Committee chairman: €25,000
• Audit Committee members: €12,000 each
• Compensation Committee chairman: €4,000
• Compensation Committee members: €2,000 each

6. Regarding the auditor fees, the NomCom decided on the same principles as the year before (the auditor to be paid for work performed according to the approved invoice).
7. Regarding the proposal for the next NomCom, the decision was to follow the same principles as the year before.
8. The NomCom approved the NomCom report draft that the NomCom chairman had prepared and circulated in advance.
9. The NomCom chairman presented a draft of the NomCom statement to be presented on the GSI website explaining its proposal for the nomination of the board with regard to the requirements concerning the composition of the board as provided by the SCGC (article 4.1). The NomCom approved the draft.

Fifth meeting of the NomCom in late February 2010
This was the last meeting of the NomCom, which took place about a week before the notice for the AGM 2010 was to be published – no later than six weeks before the AGM (as provided by the statutes of the company)\(^8\) – in two newspapers as well as on the website of GSI. The full proposal of the NomCom, as well as its report, was to be published at the same time.

The NomCom concluded that no changes had taken place that would require any changes of the report and decisions taken at the last meeting.

AGM 2010
The AGM 2010 took place in mid-April. All the proposals of the NomCom were approved and decided upon by the majority of the shareholders.

ACKNOWLEDGMENTS
I owe a lot of people a great deal, at least indirectly, for having been able to write this case – a host of chairmen of Swedish corporations as well as Nomination Committee chairmen and members, through having worked with them on board evaluation assignments – but also many other people in the corporate governance community at large, with whom I have had the privilege of discussing corporate governance issues and the particulars of the Swedish Nomination Committees. They are too many to mention in this context – and most of them are unaware of the existence of this case study – thank you, anyway. Case study copyright Rolf H. Carlsson, all rights reserved, used with permission.

However, there are three people to whom I am deeply indebted in this particular case:

• Mr. K.G. Lindvall, Chairman of Swedbank Robur Fonder AB, who has shared with me his vast experience of sitting on numerous Nomination Committees – some ten NomComs every year since a long time back. He has also provided valuable feedback on my first drafts of the GSI case.
• Mr. Per Lekvall, Executive Director of the Swedish Corporate Governance Board, who generously supplied me with valuable information and most helpfully corrected and sharpened my interpretation of some of the provisions by the Swedish Corporate Governance Code.

• Mr. Magnus Hallberg, my partner and strategic corporate governance advisor colleague in Active Owner Partners (AOP), “comrade in arms” for almost forty years in the management consulting business and co-author of some joint publications. Much of what I know and have experienced in the field of corporate governance, board evaluations, and board nomination assignments is attributable to our close collaboration and Magnus’ sharp eye for crucial aspects and his incisive reflections.

NOTES

1. For a more elaborate account of the Swedish system, please see my article “Swedish Corporate Governance – Owners Still in the Driver’s Seat,” Corporate Governance, An International Review, 15, 6 (Nov. 2007). References for the present study include books, articles, and other documents and sources:
   • The Swedish Corporate Governance Code (The Swedish Corporate Governance Board, Stockholm, Feb. 2010), available on: www.corporategovernanceboard.se.
   • The Swedish Company Act of 2006 (with some later amendments); not available in English.

2. In addition, the Swedish Company Act provides that the employees – depending on the size of the company – can appoint two or three ordinary directors (and their deputies), who carry the same legal accountability as the directors elected by the AGM.

3. However, to give a more complete picture of prevailing private ownership, it should be mentioned that the Social-Democratic Party dominated governments created a huge government-owned service sector, e.g., including health care, schools, and other social services. Beginning in the early 1980s – about the same time as the last big socialization attempt was thwarted – private ownership started to make inroads into the government service sector. This was highly controversial and still meets a lot of resistance from left wing politicians and their supporters. Although the earlier government monopoly of health care and schools has been abolished, private ownership still accounts for the minor share of these service sectors.

4. The Wallenberg dynasty, now in its fifth generation since its founding father started SEB, a leading Swedish bank, in 1856, has been the leading owner of and supporting the growth of many Swedish large corporations, e.g., ABB, AstraZeneca, Atlas Copco, Ericsson, Saab, Scania, and SKF. Still the leading owner of these companies (except Scania) and a portfolio of other companies, the whole phenomenon is often referred to as the Wallenberg sphere. (A case study of the Wallenberg sphere is included in my book Ownership and Value Creation, John Wiley & Sons, Ltd., Chichester, 2001.)
5. The auditors can be elected for a term of four years and re-elected for another three years.
6. See the website of the Swedish Corporate Governance Board (www.corporategovernanceboard.se).
7. Those elected by the AGM; the employee representatives, who are not due for individual
evaluation could be interviewed as a group to get their views on the board as a whole.
8. The Swedish Company Act provides that the notice should be announced between four and
eight weeks before the AGM.

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Examples of Non-GAAP Material

For examples of non-GAAP material please use the below links:
http://www.endesa.cl/Endesa_Chile/gobierno_corporativo/Sostenibilidad_2010.pdf
http://www.cloroxcsr.com/