SHAREHOLDER ACTIVISM AND THE "ECLIPSE OF THE PUBLIC CORPORATION"

KEYNOTE ADDRESS

BY

MARTIN LIPTON

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Martin Lipton

The phrase "Eclipse of the Public Corporation" is in quotes because I borrowed it from Professor Michael Jensen who used it as the title of a 1989 article in the Harvard Business Review. It was an article that, at the time it was published, I publicly disagreed with, but I now find that it has new vitality. I'll return to Professor Jensen in my conclusion.

One can date shareholder activism from the watershed year of 1985. It was in 1985 that Bob Monks and Nell Minow started Institutional Shareholder Services and City of New York and State of California pension fund officials, Jay Goldin and Jesse Unruh started the Council of Institutional Investors. It was also the year in which the Supreme Court of Delaware decided the four seminal cases of corporate governance jurisprudence, Unocal, Household, Van Gorkom, and Revlon. First public pension funds and union pension funds, then mutual funds and now activist hedge funds joined the movement. The momentum built year after year, until five years ago it got an injection of steroids from Enron and WorldCom, Sarbanes Oxley and the Department of Justice Corporate Fraud Task Force. Today shareholder activism is ripping through the boardrooms of public corporations and threatening the future of American business.

The key issue for American business is whether the institution of the corporate board of directors, as we know it today, can cope with shareholder activism and survive as the governing organ of the public corporation. Will the forced migration from director-centric governance to shareholder-centric governance overwhelm American business corporations? The fundamental questions are: (1) whether we will be able to attract qualified and dedicated people to serve as directors and (2) whether directors and the companies they serve will become so risk adverse that they lose the entrepreneurial spirit that has made American business great.

Destroying the Role, Focus and Collegiality of the Board

The shareholder activism movement is destroying the role, focus and collegiality of the board of directors. Activism and the corporate governance changes it has brought about has caused a shift in the board's role from guiding strategy and advising management to ensuring compliance and performing due diligence. Proliferating lawsuits, certification requirements, and governance rules, as well as the increased threat of personal liability, are forcing boards to spend more time and energy on compliance, due diligence and investigations, and less on the actual business of their companies. This shift in focus tends to create a wall between the board and the CEO. Professor Jeffrey Sonnenfeld of Yale recently noted that boards' traditional "trusted role as confidante has largely disappeared" because CEOs are wary of sharing concerns with investigative and defensive boards.

Similarly, even when the board is able to focus on the business of the corporation itself, activist investors create pressure on boards to manage for short-term share price performance rather than long-term value creation. The combination of activist hedge funds and investors who have no interest in long-term value creation puts tremendous pressure on a board to manage for the short-term at the expense of the company's relationships with its employees, customers, suppliers and communities and at the expense of the company's investment in research and development and capital projects, all of which are critical to a company's long-term success.

In addition to changes in the fundamental role of the board, the everyday functioning of the board has suffered as well. The demeaning effect of the parade of lawyers, accountants, consultants and auditors through board and committee meetings is one example. A corollary of the transformation of the role of the board from strategy and advice to investigation and compliance is an increased reliance on experts in the boardroom. While it is salutary for boards to be well advised, over-reliance on experts tends to reduce boardroom collegiality, distract from the board's role as strategic advisor, and call into question who is in control – the directors or their army of advisors. Recent suggestions that compensation consultants, rather than informed boards, are responsible for "excessive" executive pay is just one example of the perception that boards are ceding control of their companies to outside advisors.

Additionally, the balkanization of the board into powerful committees of independent directors and the overuse of executive sessions has had a corrosive impact on collegiality. Stock exchange requirements for executive sessions of the independent directors and that audit, compensation and nominating committees consist solely of independent directors and the special Sarbanes-Oxley duties for the audit committee have separated boards into distinct fiefdoms, each with a different mandate and a different information base. At too many companies, executive sessions have grown in number and length far beyond what was envisaged by the NYSE committee that mandated them in 2002. As CEOs and other management directors are excluded from executive sessions and forbidden from serving on key committees, and as these committees have increased in importance, it takes considerable effort to keep a board from becoming polarized and to maintain a shared sense of collegiality and a common understanding of all the issues facing the company.

The proliferation of special investigation committees of independent directors, with their own independent counsel, to look into compliance and disclosure issues has further hampered the board. In today's charged environment, compliance and disclosure problems lead almost inexorably to independent investigations by special committees (or by audit committees), each with its own counsel and perhaps forensic accountants and other advisors. Risk-averse auditors, spurred by the strict standards of the SEC, frequently demand investigations, while the media and many lawyers create the impression that best practices require independent investigations, even outside of the purview of the SEC requirements or none too subtle SEC "suggestions". These time-consuming investigations further distract independent directors from their role as strategic advisors, sour relationships between independent directors and management, and in extreme cases result in the lawyers for the special-committee hijacking the company and monopolizing the attention of directors and senior management.

Change of Control: From Boards to Shareholders

More dramatic than changes in the role and personality of the board, however, is the threat that the shareholder activist movement will wrest control from boards entirely. The pressure to shift control of the company from the board to shareholders has been constant and increasing. Academics, activist shareholders and shareholder advisory organizations like the Council of Institutional Investors and Institutional Shareholder Services are having increasing success in legislative, regulatory, litigation and proxy resolution efforts to limit the power of the board and increase the power of shareholders. New SEC and NYSE rules have increased the ability of shareholders to conduct a proxy fight or a withhold-the-vote campaign. The success of labor unions and ISS in promoting majority voting has provided an incentive for proxy fights and withhold-the-vote campaigns. At the extreme are proposals by Harvard Law School Professor Lucian Bebchuk that would require a shareholder referendum on all material decisions.

One example of the encroachment on board control is the demand by public pension funds for direct meetings with independent directors. Public pension funds have been demanding to meet not just with management but with independent directors to express their views with respect to performance, governance, social issues and "political" matters, including, for example, recent calls for meetings with Exxon Mobil's independent directors to discuss global warming.

Another example is evidenced by the executive compensation dilemma. If a board fails to recruit excellent senior managers, the directors are subject to criticism for the company's sub-par performance. If the board approves compensation packages necessary to attract and retain top-quality senior managers, the directors are criticized for paying "excessive" compensation. Even compensation based on superior performance is subject to criticism. In addition to the media frenzies of criticism of executive compensation, governance activists are promoting proxy campaigns to require advisory shareholder votes on executive compensation, and the use of withhold-the-vote campaigns to embarrass compensation committee members with whose decisions they disagree.

Although the number of cases brought each year seems to have leveled off after dramatic increases in the post-Enron period, shareholder litigation against directors has grown to be a big business and a type of extortion. While courts, commentators and legislators have long recognized the potential for abusive shareholder class actions, reforms aimed at reducing that potential have not had their intended effect. The recent Hubbard Committee report calls for further efforts to curb this type of litigation. Shareholder litigation continues to be hugely profitable for plaintiffs' firms, without conferring any real benefits on shareholders generally.

In addition, a number of politically motivated institutional shareholders have adopted policies of refusing to settle lawsuits against directors unless they contribute to the settlement from their personal funds. In the WorldCom shareholder litigation, for example, the lead plaintiff Alan Hevesi, trustee of the New York State Common Retirement Fund trumpeted the settlement as sending a "strong message" that directors will be held "personally liable if they allow management of the companies on whose boards they sit to commit fraud." Ironically, last month Mr. Hevesi was forced to resign his office for defrauding the State of New York.

The Effect on Director Recruitment

The growth of shareholder litigation against directors coupled with the media attention and reputational damage to the directors who are sued, and in part to all directors, affects the willingness of the most highly qualified people to serve as directors.

Director recruitment is also affected by the potential for embarrassment of directors from corporate scandals in which they had no active participation. Events like the Hewlett-Packard "leak" investigation and "option backdating" investigations at more than 150 companies, including blue-chip companies like Apple Computer and UnitedHealth Group, have led to criticism not only of those at fault but all directors of the companies involved. Media critics and governance watchdogs simplify scandals and assume that all directors are at fault when something goes wrong. Thus, directors risk public embarrassment for any misbehavior at their companies, however diligent the directors may have been.

Director recruitment is further affected by the continuing narrowing of the definition of director independence. As governance activists have stressed the importance of a board made up primarily of independent directors, they have also worked to categorize even minor connections to the company (including minor charitable contributions and relatives holding minor jobs) as impediments to independence. Frequently, a highly-qualified candidate for a board will withdraw from consideration if the candidate is tagged as not independent by a governance advisory organization, even though the candidate meets the NYSE independence test.

Beyond the independence issue, many director candidates are declining to serve on boards due to the unpleasantness of filling out extensive questionnaires to enable appropriate disclosures and qualification determinations. To meet legal requirements, corporations must require their directors to respond to lengthy, repetitive and intrusive questionnaires about their business background and relationships, their securities holdings, their charitable contributions, their employment backgrounds, their families, and anything else that may affect governance determinations or be required to be disclosed in a proxy statement or elsewhere.

Lastly, the constantly increasing time demands of board service restrict the ability of active senior business people to serve on boards. The increasing complexity of the board's role has led to greater time demands on directors, with the result that many active CEOs and other senior business people restrict themselves to only one outside board, if any. The inability to attract CEOs to a board discourages other CEOs to serve and essentially leads to boards where few members are CEOs or former CEOs and therefore may not be as qualified as they could be to provide business and strategic advice.

<u>The Market for Corporate Governance Watchdogs</u>

Finally, besides looking at the effect of the current shareholder activist movement on the role, functioning and makeup of boards, it is interesting to note both who is instigating this trend and how they are doing so. In the past several years we have seen a constant cycle of new corporate governance proposals. Shareholder advisory organizations like ISS and CII, as well as politically motivated institutional investors like public pension funds and labor union pension funds, justify their existence and satisfy political motivations, by finding new governance practices to propose each year. Once poison pills have been eliminated, classified boards must go; once classified boards are gone, majority voting becomes a requirement, and so on. Most recently ISS and Moody's have introduced the idea of a board secretary, a lawyer whose sole client is the independent directors of the company. The never-ending cycle creates a moving target for what these organizations consider "good" corporate governance, and every year places additional unproductive non-business burdens on boards.

In addition, the publication of corporate governance ratings and report cards intended to embarrass directors forces companies to pay attention to the ever-changing definition of good corporate governance. CalPERS's Focus List is one of several governance ratings, watch lists and report cards that are widely publicized; others are published by ISS and The Corporate Library. These ratings are often based on one-size-fits-all governance metrics, such as director independence, compensation practices and takeover defenses, rather than a careful analysis of the needs and interests of individual companies. They are designed to coerce a board into making governance changes to satisfy these self-appointed watchdogs rather than to advance the best interests of the company.

These days, corporations have to subscribe to a variety of corporate governance services in order to keep track of what "good corporate governance" is and to make sure their ratings and report cards are satisfactory. Essentially, ISS and its brethren have become successful businesses, continually able to create products to market to corporations and institutions. Indeed, the little advisory service started by Bob Monks and Nell Minow in 1985 was sold last year for a reported half a billion dollars. The questions are: Are shareholder advisory services truly an uninterested third party acting solely for the benefit of shareholders? Should they be regulated by the SEC?

Conclusion

Directors of large public corporations bear the weight of tremendous responsibility. The situations they face and the decisions they must make are complex and nuanced and require the willingness to take risk, all the while knowing that failure may have devastating consequences for shareholders, employees, retirees, communities and even the economy as a whole. We cannot afford continuing attacks on the board of directors. It is time to recognize the threat to our economy and reverse the trend.

Jack and Suzy Welch in the December 25, 2006 issue of Business Week summed up perfectly what is so troubling:

> [C]onstructive dialogue occurs only when a board comprised of savvy leaders and experienced entrepreneurs uses its wisdom, character, courage, common sense, and collective judgment to help the CEO and top team get to the right answer. Of course, the board must assess and challenge management. It must get out of headquarters to see if employees in the field are really carrying out the mission and hewing to the values that the brass espouses in the boardroom. But ultimately, a board and management must play on the same team, not operate at cross-purposes.
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> There's just not enough of that happening now. Directors are too paranoid. Which is why change — and change is imperative — must be led by CEOs themselves. Naturally, many of them are paranoid, too, in this era of tenuous tenures. But for the current impasse to break, CEOs must have the self-confidence to put themselves on the line with a commitment to their boards that controls are fully functioning. They must earn and demand board trust, and the board must give it, or put the right CEO in place. With that dynamic, boards can let go of their crippling fear. And together, the CEO and lead director can set a new tone and create a new agenda, where Item 1 deals with any financial (or other bumps) ahead, and Items 2 through 10 concern exciting strategic objectives.

Finally, I said I would return to Michael Jensen. In 1989 he said:

> The publicly held corporation, the main engine of economic progress in the United States for a century, has outlived its usefulness in many sectors of the economy and is being eclipsed. New organizations are emerging in its place — organizations that are corporate in form but have no public shareholders and are not listed or traded on organized exchanges. These organizations use public and private debt, rather than public equity, as their major source of capital. Their primary owners are not households but large institutions and entrepreneurs that designate agents to manage and monitor on their behalf and bind those agents with large equity interests and contracts governing the distribution of cash.

The current growing volume of going-private transactions is in large measure a response to the corporate governance changes, past and present and those being put forward for enactment in the future. I now find myself embracing Professor Jensen's 1989 article, less for the reasons he espoused in 1989 and more as the solution to the problems created by rampant, unrestrained and unregulated shareholder activism.