Shareholder Activism and the "Eclipse of the Public Corporation": Is the Current Wave of Activism Causing Another Tectonic Shift in the American Corporate World?

Keynote Address

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The 2008 Directors Forum

of

The University of Minnesota Law School

June 25, 2008

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About a year and a half ago, I gave a speech entitled "Shareholder Activism and the 'Eclipse of the Public Corporation.'" I borrowed the phrase "Eclipse of the Public Corporation" from Professor Michael Jensen, who used it as the title of a 1989 article in the Harvard Business Review. In large measure, my point was that increasingly burdensome corporate governance and compliance standards, combined with remarkable growth in both the size and number of leveraged buyout deals, might well change the corporate world along the lines that Professor Jensen had predicted 18 years earlier. That is, while the public corporation would continue, it would be eclipsed by a new corporate form: the privately owned corporation that uses public and private debt, rather than public equity, as the major source of capital. Since the time I gave that speech, however, the subprime and leveraged loan financial crisis has significantly altered the corporate landscape. Leveraged buyout activity, particularly for large companies, has shrunken dramatically as a result of new constraints on liquidity and risk, while at the same time, governance practices continue to be scrutinized and activists' efforts are invigorated. In short, this turn of events calls for a reassessment of where we are likely to go from here.

I. The Current Predicament of Boards of Directors

One can date modern shareholder activism from the watershed year of 1985. It was in 1985 that Bob Monks and Nell Minow started Institutional Shareholder Services (now a division of RiskMetrics Group) 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—confirming the business judgment rule and the primacy of the board of directors in managing the business of the corporation. First public pension funds and union pension funds, then mutual funds and now activist hedge funds joined the activist movement. The momentum built year after year, until five years ago it got an injection of steroids from the Enron and WorldCom scandals, Sarbanes-Oxley, the Department of Justice Corporate Fraud Task Force, and the new SEC and NYSE regulations.

Most recently, it has received another booster shot from the options backdating scandals, the Hewlett-Packard telephone tapping scandal, the populist attack on what is argued to be excessive executive compensation and especially the widespread criticism of boards of financial institutions in failing to prevent the subprime crisis. The fallout of the subprime crisis has not only sharpened the focus on risk management and audit committee practices, but has propelled a more general critique of the proper role and functioning of boards. By way of example, the House Committee on Oversight and Government Reform recently held a hearing to examine the link between executive pay and the subprime crisis, and obtained public testimony from the CEOs of Citigroup, Countrywide Financial and Merrill Lynch, as well as from the chairs of their compensation committees.

The pressures exerted by new and stronger governance and compliance duties have been pervasively eroding the centrality of the board and transforming its role in the governance structure of public companies, with the end game being a new conception of the corporate organization. The aggregate effect threatens to be "death by a thousand paper cuts" rather than just tinkering and experimentation at the margins. In short, the crux of the issue today is whether the institution of the corporate board, the members of which exercise their business judgment in the management of the corporation, can cope with shareholder activism and survive as the vital governing organ of the public corporation. Or, will a forced migration from director-centric governance to shareholder-centric governance, along with a concomitant transformation of the role of the board from guiding and advising management to ensuring compliance and performing due diligence, simply overwhelm American business corporations? It has become ever more uncertain whether public companies will continue to be able to attract the most qualified and dedicated people to serve as directors, and whether directors and the companies they serve will become so risk averse that they lose the entrepreneurial spirit that has made American business great.

II. The Evolving Role and Operations of the Board of Directors

It is beyond dispute that the shareholder activism movement has been fundamentally impacting the role, focus and collegiality of the board of directors. Proliferating lawsuits, "best practices" standards, certification requirements and governance rules, as well as the lurking 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 has noted that boards' traditional "trusted role as confidante has largely disappeared" because CEOs are wary of sharing concerns with investigative and defensive boards.

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. The parade of lawyers, accountants, consultants and auditors through board and committee meetings can have a demeaning effect. While it is salutary for boards to be well advised and outside experts may be necessary to deal with a crisis, 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.

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 audit, compensation and nominating committees consisting solely of independent directors, as well as the special Sarbanes-Oxley duties for the audit committee, have combined to separate 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. Survey results issued by the Business Roundtable last October indicate that 71% of respondents expected their non-management directors to meet in executive session at every board meeting, representing a 26% increase from four years ago. 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 proper functioning of the board. In today's charged environment, compliance and disclosure problems lead almost inexorably to independent investigations by a special committee (or by an audit committee), each with its own counsel and frequently forensic accountants and other advisors and investigators. 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 when there is no such legal or other requirement. These time-consuming undertakings further distract independent directors from their role as strategic advisors, sour relationships between independent directors and management, and in extreme cases may result in the lawyers for the special committee hijacking the company and monopolizing the attention of directors and senior management.

III. The Shift Towards a New Paradigm: The Shareholder-Centric Model of Governance

More dramatic than changes in the procedures and personality of the board, however, is the threat that the shareholder activist movement is shifting the locus of decision-making power from the board to activist shareholders and shareholder advisors. The pressures in this direction have been constant and increasing. Academics, activist shareholders and shareholder advisory organizations like the Council of Institutional Investors and RiskMetrics have been making substantial headway in legislative, regulatory, litigation and proxy efforts to supplant directorial judgment with shareholder prerogatives. Among other developments, many companies have now adopted majority voting for election of directors. In addition, the SEC's new e-proxy rules have increased the ability of shareholders to conduct a proxy fight or vote-no campaign. At the extreme end of the spectrum are proposals by Harvard Law School Professor Lucian Bebchuk that would result in a shareholder referendum on all material decisions.

As decision-making power shifts from boards to activists, boards are increasingly vulnerable to pressures to realize short-term share price gains and other agendas at the expense of long-term value creation. Activist hedge funds and other investors have been conducting high-profile, multi-pronged campaigns which utilize various tools including, proxy fights to elect directors, amend bylaws, or pass precatory resolutions; media outreach to publicly reprimand and embarrass directors and management; engagement of experts and consultants to conduct studies and draft white papers; consortiums with other activist shareholders; litigation and "bear hug" acquisition proposals. The measures advocated by these activists range from changes to corporate governance policies, board composition and corporate structure (e.g., Knight Vinke's campaign against Royal Dutch/Shell Group), to exploration of strategic alternatives, share buybacks and special dividends (e.g., Trian's campaign against H.J. Heinz Co.) and even the break-up, dissolution or sale of the company (e.g., Icahn's campaign against Yahoo Inc., and TCI's campaign against ABN Amro).

The de-coupling of voting power and economic ownership by means of borrowed stock, options, swaps and other derivatives is also helping activists to exert pressures on companies and manipulate shareholder voting dynamics. Hedge funds may use de-coupling arrangements to control many more votes than their real investment warrants. Conversely, activists may sometimes use derivatives to accumulate a substantial economic stake in a company's stock while arguably not triggering 13D disclosure requirements, as illustrated by the total return equity swaps entered into by The Children's Investment Master Fund (TCI) which, together with its 4.4% shareholding stake, gave TCI an economic upside on a position equivalent to more than 14% of the shares of CSX Corporation. The CSX situation resulted in a federal district group holding that TCI had formed an illegal group, had violated the disclosure requirements of the federal securities laws, and that the testimony of TCI was not credible. Amazingly, and to my mind inexplicably, RiskMetrics excused the violations and recommended a vote in favor of the TCI short slate of director nominees.

One example of direct shareholder pressure on directors is the demand by public and union pension funds for meetings with independent directors. These activists 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. For example, CtW Investment Group—an activist that works with various union-sponsored pension funds—recently sent letters to twenty-two board members at six of the major banks affected by the subprime crisis, and threatened to wage vote-no campaigns if the directors did not provide satisfactory explanations of the efforts they took to manage risk exposures. In response to the letters, several directors and other representatives of these banks agreed met with CtW to discuss its concerns.

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. However, if the board approves compensation packages necessary to attract and retain top-quality senior managers, the directors may be criticized for paying "excessive" compensation, as illustrated by the public hearings of the House Committee on Oversight and Government Reform to review the compensation packages of the CEOs of Citigroup, Countrywide Financial and Merrill Lynch. Even compensation based on superior performance is subject to criticism. In short, boards are increasingly faced with "heads you lose, tails I win" outcomes.

Along with the media spotlight on executive compensation, governance activists are promoting the use of voting campaigns in order to embarrass compensation committee members with whose decisions they disagree. For example, RiskMetrics recently recommended that shareholders vote against members of Citigroup's compensation committee, and CtW Investment Group urged shareholders to withhold votes from the compensation committee members of Ryland Group and to vote against the chair of Washington Mutual's compensation committee. In addition, efforts to require advisory shareholder votes on executive compensation have gained considerable traction. In April of 2007, Rep. Barney Frank introduced a say-on-pay bill that passed by a vote of 269 to 134 in the House of Representatives; the bill is currently awaiting action by the Senate. RiskMetrics recently reported that so far this year, say-on-pay proposals have received majority shareholder support at nine U.S. companies.

In short, it is clear that executive compensation will continue to be a high profile issue and a major focus of shareholder activism. Unless directors are particularly careful with respect to severance, perks, the relation of pay to performance, and reasonable clawback arrangements to provide for recoupment of past compensation in appropriate circumstances, the political pressures will continue to grow, including pressures for say-on-pay legislation.

IV. Attacks on Boards and Other Deterrents to Director Recruiting

To compound pressures on boards, shareholder litigation and other public attacks on board members have been undermining the willingness of some of the most qualified individuals to serve as directors. Although the number of shareholder claims brought each year eventually seemed to level off in the wake of Enron, the subprime financial crisis has spurred a new frenzy. A recent report issued by RiskMetrics indicates that as of early April 2008, there were at least 67 subprime related securities class actions, and the "litigation tsunami" has been spreading to engulf not only companies with relatively direct ties to subprime lending but also companies with more remote connections. 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. Shareholder litigation continues to be hugely profitable for plaintiffs' firms, without conferring real benefits on shareholders generally. The growth of shareholder litigation against directors coupled with the media attention and reputational damage to the directors who are sued, and to some extent to all directors, takes a toll on board recruiting efforts.

Director recruitment is also affected by the potential embarrassment directors face 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 of 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. In addition, the full boards of many companies impacted by the subprime fallout have been harshly criticized and, in large measure, blamed for losses precipitated by the convergence of broad economic trends over which they had no control. Directors risk public embarrassment for any misbehavior or other failures at their companies, however diligent they may have been.

In addition, director recruitment is being impacted 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 would be tagged as not independent by a governance advisory organization, even though the candidate meets the NYSE independence test.

The constantly increasing time demands of board service are a further deterrent to board service. John Castellani, President of the Business Roundtable, has suggested that the amount of time invested on board issues by directors of Business Roundtable companies now ranges from a minimum of 250 hours to up to an astonishing 800 hours per year. The subprime crisis has demonstrated the need for special tutorials and educational sessions in order to ensure directors are well versed in complicated business, financial, risk management and other aspects of the business of the companies they serve.

As a result, the reality is that many active CEOs and other senior business people now restrict themselves to only one outside board; indeed, they risk being publicly reprimanded by activists if they are perceived to be "overboarded." The inability to attract CEOs to a board discourages other qualified people from serving and essentially leads to boards where few members are CEOs or former CEOs, and too few members are fully qualified to provide the best possible business and strategic advice.

V. The Market for Shareholder Activism

Finally, besides looking at the effect of the current shareholder activist movement on the role, functioning and composition of boards, it is necessary 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. RiskMetrics and the Council of Institutional Investors, 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, then the separation of the CEO and the Chairman of the Board such as supported by the Rockefeller family at Exxon this year, and so on. 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.

As noted, corporations have to subscribe to a variety of corporate governance services in order to keep track of what currently constitutes "good corporate governance" and to make sure their ratings and report cards are satisfactory. These ratings are often based on one-size-fits-all governance metrics 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 the self-appointed watchdogs who publish them, rather than to advance the best interests of the company. Indeed, a recent study by professors Sanjai Bhagat, Brian Bolton and Roberto Romano reviewed the use of corporate governance ratings in predicting corporate performance and concluded:

> Our core conclusion is that there is no consistent relation between the … governance indices and measures of corporate performance. In short, there is no one "best" measure of corporate governance: the most effective governance institution appears to depend on context, and on firms' specific circumstances. It would therefore be difficult for an index, or any one variable, to capture critical nuances for making informed decisions. As a consequence, we also conclude that governance indices are highly imperfect and unsatisfactory screens for determining how to vote corporate proxies, and that investors and policymakers should exercise utmost caution in attempting to draw inferences regarding a firm's quality or future stock market performance from its ranking on any particular corporate governance measure. . . . Most important, the regulatory implication of our analysis is that corporate governance is an area where a regulatory regime of ample flexible variation across firms that eschews governance mandates is particularly desirable, because there is considerable variation in the relation between different governance indices and different measures of performance.

VI. Conclusion

Directors of large public corporations today 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. The astounding losses incurred as a result of the subprime meltdown are a vivid illustration. We cannot afford continuing attacks on the board of directors at a time when their full commitment and their most talented members are so acutely needed. It is time to recognize the threat to our economy and reverse the trend.

There are no easy solutions or magic checklists to resolve today's corporate governance issues. Directors must be vigilant, thorough and proactive in seeking to balance short-term pressures against long-term goals, navigating procedural and compliance requirements and critically evaluating reformist agendas to determine for themselves what will further the best interests of the company and its constituents. At its core, the board-centric model of governance is premised on the notion that boards merit the vote of confidence of shareholders and the public markets, and notwithstanding the strong current of distrust that runs through many corporate governance reforms, history has proven this vote of confidence to be well deserved. I believe it is the only way to assure that public corporations will be able to compete with the state corporatism that is transforming the economies of China, Russia and other rapidly industrializing countries, cope with the demands for short-term (and short-sighted) stock gains by activist hedge funds and make the long-term investments in the future of their businesses that are essential for future prosperity of our nation.