CORPORATE GOVERNANCE: DOES IT MAKE A DIFFERENCE?*

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I. INTRODUCTION

I titled this speech "Corporate Governance: Does it Make a Difference?" I thought what I would do is try to sketch out four or five areas where the term corporate governance is applied and analyze whether it has or has not made a difference.

I think the best way to start is with a quote from the leading judicial corporate law scholar, William Allen, who is the Chancellor of the State of Delaware. Just five years ago, Chancellor Allen described the function of the board of directors of a public company this way:[1]

> The conventional perception is that boards should elect senior management, create incentive compensation schemes, and then step back and watch the organization prosper. In addition, board members should be available to act as advisers to the CEO when called upon, and they should be prepared to act during a crisis: an emergency succession problem, threatened insolvency, or a management buyout proposal, for example. This view of the responsibilities of membership on the board of directors of a public company is, in my opinion, badly deficient. . . .[2]
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> It ignores a most basic responsibility, the duty to monitor the performance of senior management in an informed way. Outside directors should function as active monitors of corporate management, not just in crisis, but continually. They should have an active role in the formulation of the long-term strategic financial and organizational goals of the corporation and should approve plans to achieve these goals. They should, as well, engage in the periodic review of short- and long-term performance according to plan and be prepared to press for correction when in their judgment there is need.[3]

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[1] Chancellor William T. Allen, Delaware Court of Chancery, *Redefining the Role of Outside Directors in an Age of Global Competition*, presented at the Ray Garrett, Jr., Corporate and Securities Law Institute, Northwestern University, Chicago (Apr. 1992).

[2] *Id.*

[3] *Id.*

I am not going to stop to parse through each element of that, but I think you can readily see that it is quite an expansive view of the role and the function of the board of directors. Without in any way detracting from the change in the SEC proxy rules[4] that have facilitated institutional shareholders exercising their ability to use their voices to influence management,[5] and the other things that Jon [Lukomnik][6] and Jamie [Heard][7] mentioned to you. I think that statement by Chancellor Allen as to his view of what the role and duties of directors are,[8] and the fear that that view will be enforced in the courts, has done more than anything else to change the perception of what a board of directors should do in the modern corporate world. As I mentioned, I will break this down into specific areas and try to illustrate where I think it has made a difference and where I think corporate governance has not made a difference.

In large measure it depends on how you define corporate governance. I am going to give corporate governance a fairly expansive definition.

II. PREVENTING MANAGEMENT MISCONDUCT

First, the prevention of management misconduct. In the United Kingdom, for example, the Cadbury Committee Report,[9] which took a major step in advancing corporate governance in the United Kingdom, essentially focused on what I would call management misconduct. In light of the *Maxwell*,[10] *Polly Peck*[11] and other serious defalcation situations, the focus of the Cadbury Committee Report was on improving

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[4] *See* Securities and Exchange Commission ("SEC") Rules 14(a)(1)-(15) and Rule 14(b)(1)-(2).

[5] *See, e.g., Medical Committee for Human Rights v. S.E.C.*, 432 F.2d 659 (D.C. Cir. 1970) (ruling that proposal submitted by proxy to Dow Chemical Corp. that would discontinue the manufacture of napalm must be included because of its political and social significance); *cf. e.g.*, NYCERS v. S.E.C., 843 F.Supp. 858 (S.D.N.Y. 1994), *rev'd*, 45 F.3d 7 (2d Cir. 1995); *ACTWU v. Wal-Mart Stores, Inc.*, 821 F.Supp. 877 (S.D.N.Y. 1993) (SEC decision to allow corporations to exclude proposals were approved since employment policies were not deemed to have sufficient political or social importance to mandate inclusion).

[6] Jon Lukomnik, *Why We Bother: A Primer in How Activism Enhances Returns*, 2 FORDHAM FIN. SEC. TAX L. F. 5 (1997).

[7] James E. Heard, *Agents of Change: Institutional Investors & Corporate Governance*, 2 FORDHAM FIN. SEC. TAX L. F. 19, (1997).

[8] Allen, *supra* note 1.

[9] Committee on the Financial Aspects of Corporate Governance ("Cadbury Committee"), *Report of the Committee on the Financial Aspects of Corporate Governance* 64 (Dec. 1, 1992) (known as the "Cadbury Committee Report").

[10] *In Re* Maxwell Communications Company, 93 F.3d 1036 (2d Cir. 1996).

[11] Linder Fund, Inc. v. Polly Peck Int'l PLC, 143 B.R. 807 (S.D.N.Y. 1992).

corporate governance or imposing on the board of directors a considerable responsibility for monitoring in order to prevent management misconduct.

We have had the same thing in the United States. This is illustrated in the *Caremark*[12] case, a recent opinion by, again, Chancellor Allen in Delaware. The question was whether the directors of a corporation could be held responsible for the losses suffered by the corporation when the corporation had violated the laws and had to pay a very large amount in fines and restitution.[13] Chancellor Allen said that in the particular case, the board did not have that responsibility. But, he went on to say, in dicta, that "one of the requirements of a board of directors is to monitor for compliance with the laws."[14] That is a very important point because what that has done is, not just *Caremark*[15] but the basic principle, has caused boards to focus on having audit committees that interact with the outside auditors, and that go even further to insist that the corporate officers present compliance programs to the audit committee and then to the board of directors.

Now, there is no compliance program, there is no audit committee that is going to totally prevent fraud or criminal acts by officers of a corporation. But I think it makes an enormous difference that there is a focus on compliance, that everyone in the corporate structure understands that the board of directors is concerned with compliance, and that there are actual directives from the board of directors to the management of the corporation with respect to compliance. I find that having a compliance program makes a difference. In many corporations, there is an avenue back to the board of directors that employees can follow if they believe that management is not being responsive.

In addition, the federal sentencing guidelines take into account whether a corporation has a compliance program.[16] The SEC and U.S. Attorneys take into account compliance programs in determining what to do when something has gone wrong. Frequently, if there is a compliance program that was put into place and is being followed in good faith, the enforcement authorities will not hold the corporation responsible for violations by individual employees or officers of the corporation.

So, in the area of monitoring for financial integrity and compliance with laws, I think corporate

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[12] Norton v. Caremark, Inc., 20 F.3d 330 (8th Cir. 1994).
[13] *Id.*
[14] *Id.*
[15] Caremark, 20 F.3d 330 (8th Cir. 1994).
[16] U.S. SENTENCING GUIDELINES MANUAL § 8 (1995).

governance has been extremely effective. There have been major advances in the last ten years, and this is a subject in the forefront of every major public corporation today.[17]

III. Corporate Strategy

The next area that I would like to talk about is participation in determining corporate strategy. This was not considered a function of the board of directors until very recently. Generally, management determined strategy, then the board of directors accepted the strategy. I think it is fair to say that, with respect to the strategic direction of the company, the board of directors felt that it should get involved only when there was a disaster.

In the last ten years, and really in the last five years, I think there has been a tremendous shift in the attitude of boards and managements with respect to strategy. Most major public companies today have two- or three-day retreats with the board of directors in order to discuss strategy. These retreats bring the board of directors into the dialogue with management, the key officers of the company, with respect to what the company's strategy is, where it is going, what may be expected of it, and so on. That, too, I think is a major shift.

I think that this has had a very significant impact on corporate performance and the prices of companies' stocks, the thing that Jon [Lukomnik] is so interested in as an investor.[18] Will the company change what it is doing? Sometimes it is called "will the company restructure in order to improve its performance?"

This shift in the attitudes of boards and managements toward strategy has also had an interesting side effect. Various activist investors, and this is usually not the New York City pension funds or California Public Employee's Retirement System ("CalPERS"), but more likely hedge funds or aggressive mutual fund managers (two that have been very prominent, Michael Price of the Mutual Shares Group[19] and

[17] *See, e.g.*, Terence J. Gallagher, *The Activist Board and Corporate Governance*, 2 FORDHAM FIN. SEC. TAX L.F. 59.

[18] Lukomnik, *supra* note 6.

[19] Jeahnee Kim, *The Legends' Pick: The Favorite Stocks of Five Famous Investors*, MONEY, Sept. 1997, at 70 (Price was found to be among the top five most admired money managers by investment professionals); Daniel Kadlec, *Going to Bat Against ITT: Two Heavy Hitters Play Hardball. Is This Fair?* TIME, Aug. 25, 1997, at 59 (discussing Price's success at managing over $26 billion for Franklin Mutual Advisors).

Alfred Kingsley of Greenway Partners[20]) have recognized the concern of directors with respect to the strategy of the company and the responsiveness of directors to criticism of the strategy that is being followed. Activists investors have recognized an opportunity for profit-making in light of the boards shift in attitude toward corporate strategy.

The activist investors have acquired positions in companies, not to take over the company, this is not the creeping tender offer where the entrepreneur is seeking to take over the company. Their objective is exactly the opposite. They do not want to take over the company. What they want to do is acquire a five, ten, or fifteen percent stake in the company in the open market and then they want to agitate for a change either in the strategy of the company or, more likely, have the company divide itself, spin off a major part of the company, or have the company merge with another company.

Mr. Price is generally credited with, or accused of causing the merger of Chase Manhattan with the Chemical Bank.[21] Clearly, he acquired a large stake in Chase Manhattan and agitated for its merger. He was also active with respect to the Michigan National Bank, which sold out to the Australian National Bank.[22] He urged a spinoff of the Dial Corporation, and in fact Dial did spin off. This occurred despite the fact that after having urged the Dial Corporation for about a year, in the last six weeks or so he changed his mind and said they should not do it, but at that point the Dial Corporation had set the pattern and it did happen. So Mr. Price has been very effective.

Mr. Kingsley is probably responsible for the takeover/ restructuring of the U.S. Shoe Company, and he has been active at Woolworth, Unisys, and a number of other companies, in urging either spin-offs or the sale of the company.[23]

The ability of institutions to communicate with each other has focused the board of directors on the

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[20] Dan Dorfman, *Tisch Sees Beauty in Ugly Bethlehem Steel*, FIN. WORLD, Feb. 18, 1997, at 14; Judy Temes, *CEO's Time Runs Low to Restore Woolworth: Crumbling Business, Spin-Off Push May Foil Farah's Three-Year Plan*, CRAINE'S N.Y. BUS., Feb. 12, 1996, at 3.

[21] Edward Wyatt, *Some Mutual Funds Found a Winner in Big Banking Merger*, N.Y. TIMES, Aug. 29, 1995, at D1 (discussing Michael Price's role as an agitator for the bank merger).

[22] Christine Williamson, *Mutual Funds: DC Consultants Purchased*, PENSIONS & INVESTMENTS, June 9, 1997, at 32 (noting Michael Price's dealings with Michigan National and its sale to Australian National Bank).

[23] Riva Atlas, *Unisys Watch*, FORBES, Sept. 3, 1996, at 236 (discussing Al Kingsley and Greenway Partners' dealings with Unisys and Woolworth).

strategy of the company, and the means to improve the price of the company has become a very significant thing.[24]

James [Heard] mentioned W.R. Grace & Co. ("W.R. Grace"), one of those fascinating situations.[25] Without going into the history of it, there was a change in management. Mr. Peter Grace, who had been the longtime chief executive officer and had passed the baton to a new chief executive officer, suddenly decided that the new chief executive officer ought to be removed. The board put in an interim chief executive officer, a man by the name of Thomas Holmes.[26] After having been installed as the interim chief executive officer, Mr. Holmes met with a group of institutional investors at one of the large investment institutions right here in New York City.[27]

After that meeting Mr. Holmes called me and he asked to meet. We met and he told me what had happened at this meeting, where there were about a dozen investors in W.R. Grace. He had with him the investor relations vice president who had the names of these shareholders, and the percentage of the shares they held, which added up to 47 percent. He told me what had happened and how unhappy they were and that they wanted, among other things, changes in the composition of the board and how the board would operate.

I said, "Well, you do not have a difficult problem at all."

He said, "What do you mean it is not difficult?"

I said, "Very simple. They have 47 percent. You have an annual meeting coming up in a short while. We have to call them up, find out exactly what they want, and give it to them." That is exactly what

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[24] SEC Rule 14a-8 ; *see also* Dennis J. Block and Jonathan M. Hoff, *Corporate Governance and Institutional Activism*, N.Y.L.J., Jan. 1, 1996, at 5 (noting that institutional investors have begun to work together to target under preforming companies).

[25] Heard, *supra* note 7, at 23.

[26] *W.R. Grace Considers Plan to Oust Chairman, CEO*, ORLANDO SENTINEL, Mar. 14, 1995, at B5 (commenting that the board was considering a mandatory retirement plan that would remove top executives); *see also* Robert W. Lear and Borid Yavitz, *Americas Best and Worst Boards*, CHIEF EXECUTIVE, Apr. 1, 1994, at 32 (listing W.R. Grace & Co. ("W.R. Grace") as one of the worst boards because it was controlled by the long-standing chairman, Peter Grace, and consisted of 25 members, 12 of whom were 72 or older).

[27] James P. Miller, Thomas M. Burton and Randall Smith, *Bad Chemistry: W.R.. Grace* Is *Roiled By Flap Over Spending And What To Disclose*, WALL ST. J., Mar. 10, 1995, at A1 (commenting that Thomas Holmes met with institutional investors who were concerned with financial waste at W.R. Grace).

we did. We contacted them, we negotiated, but essentially we changed the corporate governance structure of the company to satisfy the investors in the company because otherwise they would withhold their vote at the annual meeting and make effective management of the company impossible.

Subsequently, new directors were brought in, new management was brought in, the company restructured, spun off one of its major operations, the value of the stock almost doubled, and everybody turned out to be quite happy. The key issue, however, is the recognition on the part of a management and a board of directors of a company that has 70-80 percent institutional ownership, that if the institutions have communicated among themselves, as they're now permitted to do by the SEC rules,[28] and have a point of view, there is very little point in not responding to the institutional point of view; not necessarily accepting it, but at least effectively dealing with it.

Before I move on to the less dramatic areas, let me refer to the Disney situation. I guess it was three or four weeks ago that there was a front-page story in the *Wall Street Journal* about Disney.[29] It was an interesting headline: *The Plutocracy: If a Company Prospers, Should its Directors Behave by the Book? Disney's Eisner Shoots Back at Critics Who Say the Board Isn't Truly Independent. A Study in What Works.*[30]

That was the headline. I think most of you are familiar with the story. Mr. Eisner has done what I think everybody concedes is an absolutely magnificent job in the management of Disney. The value of the company has increased more than tenfold since he took over.[31] He has a board of directors that one would have to stretch far and wide to describe as having a majority of independent directors.[32] He considers them to be independent, but, by most standards, a majority is not independent. He insists that this is the board of directors that enables him to have created the success that Disney is, and a lot of institutions feel to the

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[28] *See*, SEC Rule 14a-8 (allowing shareholders to communicate with each other).

[29] *The Plutocracy: If a Company Prospers Should Its Directors Behave By the Book? Disney's Eisner Shoots Back at Critics Who Say the Board Isn't Truly Independent: A Study in What Works.* WALL ST. J., Feb. 19, 1997, at A1.

[30] *Id.*

[31] *Id.* ("Disney's market capitalization has soared to $53 billion from $2 billion under [Eisner's] leadership.").

[32] Bruce Orwall, *If a Company Prospers, Should It's Directors Behave By The Book?*, WALL ST. J., Feb. 27, 1997, at A1 (acknowledging the achievements and great success at Disney and questioning whether it matters that it's board is not independent).

contrary. When all is said and done, I think that one has to bow to the performance.

But it is interesting that a company performing as well as Disney, which is performing magnificently, will still draw criticism from a substantial body of shareholders. It is also interesting that the CEO will feel he is required to be responsive, if in no other way than to say, "No, you are wrong. This is the way we should operate."[33]

Some time ago I said that corporate governance, in the sense of guidelines, the independence of directors, committee structure, term limits and age of directors, and so on, is at best a safety valve for a poor performing situation. If you have all of what I will call the guideline elements, corporate governance facilitates dealing with a problem but does not really assure performance. I think the best performing companies in the United States and worldwide are those that are run by entrepreneurs and dynamic managers, like Mr. Eisner, who come in and really have an owner's view of what the company should do.

The great companies are generally those that have an entrepreneurial bend. By "entrepreneurial bend," I do not mean that each director owns 1,000 shares or 2,000 shares and so on, but that leadership is in the hands of someone who has a real stake in the company, not the directors, but the CEO, and top management have a real stake in the company. I think the studies show that those companies do far better than any other type of company.[34]

Now, let me turn to guidelines as such. I suspect I am responsible, or at least I am co-responsible, along with Jay Lorsch of the Harvard Business School, for guidelines. Some ten years ago, when the issue of competitiveness had reached a political crescendo, a Council on Competitiveness was created by Congress,[35] and then, a few years later, they created a Sub-Council on Corporate Governance.[36] The focus was on whether corporate governance would help in reviving or in creating competitiveness.

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[33] *The Plutocracy, supra* note 29 (commenting that twenty-four pension fund members of the Council of Institutional Investors decided to withhold votes for the re-election of five Disney directors).

[34] Christopher Farrell and John Hoerr, *ESOPs: Are They Good For You? They Can Deter Takeovers, Save Taxes, and Boost Productivity, But ...*, BUS. WK., May 15, 1989 (concluding companies where employees and management have an equity interest perform better).

[35] Helene Cooper and Rebecca Blumenstein, *Business Risk: As U.S. Firms Gain On Rivals, The Dollar Raises a Pesky Question; If Competitiveness is Due Mainly to Low Currency, Could It Fade Quickly? Many Nations Lift Efficiency.* WALL ST. J., Aug. 16, 1997, at A1 (competitiveness measures how productive, efficient and profitable a company is compared with its rivals).

[36] *See The 100 Most Influential Layers: Litigators, Dealmakers, Power Brokers, Masters of High Tech*, NAT'L. L.J., Apr. 28, 1997, at C4. (discussing Martin Lipton's active role in the Sub-Council on Corporate Governance).

As was mentioned, there was a feeling at the time that we had lost sight of how to manage corporate performance; that the Japanese were beating us in the marketplace; that General Motors had lost out to the Japanese automobile companies; and that something ought to be done.

The Council held hearings and commissioned studies. Jay Lorsch and I were members of the Council. We tried to think through what one could do without changing the laws at all. In other words, not look for either state or federal legislation, but rather look toward what changes in corporate governance one could make, regarding how a board operates, in order to improve performance.

We published an article five years ago in *The Business Lawyer*, called "A Modest Proposal for Improving Corporate Governance,"[37] in which we suggested first that boards be reduced in size: the ideal size of a board was not twenty-eight, but somewhere around ten or twelve. Second, that a clear majority of the board ought to be totally independent directors. By "totally independent," we meant not bankers, not lawyers, not others who were doing business with the company. Third, that there should be no interlocked boards, where two CEOs serve on each other's boards. Fourth, the boards ought to annually evaluate the performance of the CEO. Fifth, the boards ought to evaluate themselves. In addition, there ought to be a lead director who could mobilize the board in the event of a problem.[38]

About a year and a half later, General Motors changed its management and adopted the General Motors Guidelines, which have become sort of the touchstone for corporate governance procedures for a board of directors.[39] Indeed, CalPERS fell in love with the General Motors Guidelines and circulated to most of the largest companies of the United States a questionnaire as to whether they had guidelines like

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[37] Martin Lipton and Jay Lorsch, *A Modest Proposal for Improving Corporate Governance*, 48 BUS. L. 59 (1992) (suggesting that corporate governance in the U.S. would benefit from increased interaction between stockholders, Boards of Directors and management); *see also* Warner Raleigh, Jr., *The Lessons From American Express*, DIRECTORS & BOARDS, Mar. 22, 1994 (acknowledging the contributions of Martin Lipton and Jay Lorsch in the field of corporate governance).

[38] Lipton, *supra* note 37; Raleigh, *supra* note 37.

[39] Ronald Berenbeim, *Board and Directors' Assessment*, VITAL SPEECHES, Feb. 15, 1997, at 278 (citing General Motor's guidelines as signaling the growing awareness of concerns regarding board performance); Mark Kessel, *Manager's Journal: Boardroom Teamwork*, WALL ST. J., June 24, 1996, at A14 (stating that the General Motor's guidelines facilitate a better balance of power between the CEO and the board); *see also Guidelines on Guidelines*, INVESTOR RELATIONS, Dec. 1, 1996 (noting that General Motor's guidelines are widely lauded).

G.M.'s or whether they were about to adopt similar guidelines.[40]

Adoption of guidelines became a mark of compliance. With the best procedure in corporate America, you got an A+ from CalPERS, or at least an A.[41] Companies really were responsive to it, and many companies now have copies of the General Motors Guidelines - slightly modified for their individual use. The General Motors Guidelines have become more or less pervasive among the major public companies in the United States.[42]

Just a couple of months ago, the National Association of Corporate Directors published a paper[43] that was the product of a group of twenty-or-so people - some corporate directors, some academics, some corporate people, which more or less followed the General Motors Guidelines as to what companies should do: independence of the directors, what the directors should look at, and so on.[44] Bottom line: the paper is an amalgam of Chancellor Allen's view of what the function of a board is and what the General Motors Guidelines provide.

Whether or not that makes any difference, I really don't know. I do not know that it makes any difference whatsoever in the performance of a company if it has these guidelines and adheres to them.

What it does do, as I indicated, is provides a means of dealing with the problem. Otherwise, you run into the kind of situation that existed at Occidental Petroleum Company,[45] where Occidental had a board of directors who were all friends and colleagues, and in some way business related to Armand Hammer. This arrangement allowed Hammer to remain in office into his eighties in a declining performance situation.[46] So the one thing good corporate governance procedures does is focus attention on what the problems are

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[40] *"CalPERS Survey Finds Most Big Firms Adopt Governance Standards,"* WALL ST. J., June 1, 1995, at B6 (finding that over half of the nation's 300 largest companies have adopted corporate governance guidelines to strengthen their boards' independence).

[41] *Id.*

[42] Berenbeim, *supra* note 39 (noting that the General Motor's guidelines are now widely used); *see* Kessel, *supra* note 39; *see also Guidelines on Guidelines*, *supra* note 39.

[43] Joann S. Lublin, *Management: How to Keep Directors' Eyes On the CEO,* WALL ST. J., July 20, 1994, at B1.

[44] Berenbeim, *supra* note 39 (noting that the General Motor's guidelines call for independent directors); *see* Kessel, *supra* note 39; *see also Guidelines on Guidelines, supra* note 39.

[45] Lear, *supra* note 26 (identifying Occidental's board as one of the worst due to limited participation on board committees, lack of board meetings and the fact that the board consisted of friends and colleagues of the company's CEO, Armand Hammer).

[46] Amanda Bennett and Joann S. Lublin, *Management: Predecessor's Presence Clouds Power Transfer,* WALL ST. J., Mar. 17, 1992, at B1.

and provide the safety valve for dealing with them.

IV. TAKEOVERS

Next, let me move to takeovers, and look at what has happened. I am probably more responsible for the existence of the Council of Institutional Investors,[47] and maybe this whole corporate governance movement, than anybody else, because in defending Texaco against the Bass Brothers and Phillips Petroleum against Boone Pickens[48] and then Carl Icahn,[49] I provided the impetus to Jay Goldin and Jesse Unruh to create the Council of Institutional Investors.[50]

The Council was basically formed in response to Texaco's move to buy back Texaco shares from the Bass Brothers.[51] The Council's first major battle was in support of Carl Icahn's attack on the Phillips Petroleum Company. Together with Teacher's Insurance and Annuity Association - College Retirement Equities Fund ("TIAA-CREF") - this is now the early days, 1985-1986 - The Council became active in opposing what are frequently referred to as "shark repellents"[52] and devices to enable a board of directors to have more time to respond to a takeover, to be able to say, "Sorry, we are not for sale, we are not going to be taken over, and we are not going to redeem our poison pill,[53] and there is nothing you can do about it.

[47] Holman W. Jenkins, Jr., *Business World: The Rise of Public Pension Funds*, WALL ST. J.. Apr. 16, 1996, at A15.

[48] Richard A. Oppel, Jr., *In Shinning Armor: Rainwater Finds Profits in Rescues Such as Mesa*, DALLAS MORNING SUN, Mar. 1, 1996, at D1 (discussing Boone Picken's attempt to take over Phillips Petroleum in 1984, and how the tables have turned on him and he is defending his company, Mesa Petroleum, from hostile shareholders).

[49] Andrew Serwer, *Who is Afraid of Carl Icahn? Not RJR Nabisco*, FORBES, Feb. 17, 1997, at 104 (discussing Carl Icahn's attempt to take over Phillips Petroleum in 1985, and how he is no longer "makes runs" at companies like that); *see also* Dawn Blalock, *Phillips Petroleum Unburdens Itself Of Debt Load, Sways Wall Street*, WALL ST. J. EUR., Apr. 16, 1996, at 12 (discussing Phillips Petroleum's debt which was accumulated as a result of Carl Icahn's takeover attempt).

[50] Paul G. Barr, *Equities Bring a Dilemma: Indian Fund Wrestles with Touchy Brokerage Questions*, PENSIONS & INVESTMENTS, June 9, 1997, at 38 (noting the importance of the Council of Institutional Investors and it's "great reputation").

[51] Allana Sullivan, "*Judgment Day: Texaco and Icahn Hurl Last Gibes and Prepare to Meet Their Holders; Friday Vote Ends Proxy War of High Financial Drama and Immense Incivility; Slogans, Slurs and Solicitors*," WALL ST. J., June 13, 1988, at A1.

[52] *Shark Repellents* are various instruments used by entrenched managements to discourage hostile takeovers. BLACK'S LAW DICTIONARY 1376 (6th Ed. 1990); *see* Nancy L. Meade and Dan Davidson, "*The Use of Shark Repellents to Prevent Corporate Takeovers: An Ethical Perspective*," J. BUS. ETHICS (1993) 12:83-92.

[53] BLACK'S LAW DICTIONARY 1156 (6th Ed. 1990). A *poison pill* is "a defense tactic used by a company that is a target of an unwanted takeover to make its shares or financial condition less attractive to acquire. For instance, a firm may issue a new series of preferred shares that give shareholders the right to compel their redemption at a premium price after a takeover." *Id.*

Go home."

There ensued throughout the 1980s, and this was a period of very active hostile takeovers, junk bond financing and bank financing were readily available.[54] Despite the market decline in 1987, there was no real pause in takeover activity, and it continued increasing each year through 1989.[55]

Institutional investors, seeking a maximization of the value of their holdings, recognized that it was not in their interest, or at least they thought it was not in their interest, that companies be able to shield themselves behind poison pills or staggered boards. They believed that they really ought to be able to vote and not alienate the company on these issues. Accordingly, they would like to have confidential voting and they would like to be able to be sure that if a company was raided, it was taken over right away. If there was a high premium bid out there, why wait two or three months for it, or why even wait two or three months for another dollar or two, "today's dollar is worth more than tomorrow's dollar." So there was a real contest between these activist institutions and corporate management.

It played out in the state legislatures. Most of the states, those that have a significant corporate presence, essentially decided in favor of corporate management, and they passed statutes that said that the poison pill was valid.[56] They passed statutes that said you needed to get a shareholder vote if you wanted to acquire more than 20 percent of the stock of a company.[57] They passed statutes that said if you acquired control of a company in a hostile takeover, you could not merge the company for three years or five years after you acquired it.[58]

Ultimately, the grand daddy of all of these statutes was passed in the State of Pennsylvania,[59] be-

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[54] Dennis J. Block, Richard L. Levine, Dian Harvey and Alan Arkin, *Current Trends in the Market for Corporate Controls*, 972 PLI/CORP 7, at 14 (recounting the history of the 1980s and the active market for takeovers and the financing available).

[55] *Id.*

[56] *See, e.g.*, IND. CODE. § 23-1-25-1; NY Bus. Corp § 505; OHIO REV. CODE. ANN. § 1701.831; 15 PA CODE § 515; *see also* William A. Klein and John Coffee, Jr., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 101-6, 250 (4th ed. 1990) (providing a general review of how poison pills work).

[57] David C. McBride, *Revisiting Delaware Law and Mergers and Acquisitions: The Impact of QVC v. Paramount*, 876 PLI/CORP 9, at 53-54 (reviewing takeover and poison pill rules under Delaware law); *see also* Henry Lesser, Thomas F. Larkin and Ann E. Lederer, *Selected Recent Developments in Mergers and Acquisitions*, 751 PLI/CORP 171 (discussing changes in law related to takeovers).

[58] *See, e.g., id.*

[59] 15 PA CODE § 515.

cause a corporate raider group, the Belzbergs from Canada, decided that they would like to take over the Armstrong World Corporation.[60] Armstrong was a major Pennsylvania company. They fought very hard. They went to the Chamber of Commerce and the Manufacturers Association in Pennsylvania, and they retained a very good lawyer from Washington, by the name of Steve Wallman, who is now an SEC Commissioner, and he said, "I will look at New York's statute,[61] I will look at Indiana's statute,[62] I will look at Ohio's statute,[63] and they are all rather interesting, but I can improve those dramatically," and he created the Pennsylvania statute.[64] It's the Pennsylvania statute, of course, which came into play in the Conrail battle.[65]

I am not going to go into Conrail, but I do want to point out one thing with respect to the Pennsylvania statute. Now, everybody is saying the Pennsylvania statute enabled the Conrail board to ignore the will of the shareholders, frustrate what the shareholders wanted, and so on.[66] But if you think about it, it's the Pennsylvania statute that really enabled the shareholders to express their will.[67] Contrary to what the drafters of the Pennsylvania statute intended, it is not protective in situations like Conrail because even if the corporation wants you to acquire more than 20 percent of the stock of the company, you can not do it unless the shareholders vote in favor of your doing it.[68]

That is exactly what happened in Conrail. Conrail wanted CSX to be able to acquire 40 percent of

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[60] Richard Siklos, *Armstrong's Turf War Leaves Analysts Divided*, FIN. POST, Aug. 23, 1997, at 45 (discussing a current battle Armstrong is going through and reviewing it's successful fending off of the Belzberg family of Canada).

[61] NY BUS. CORP. § 505.

[62] IN CODE § 23-1-25-1.

[63] OHIO REV. CODE ANN. § 1701.831.

[64] 15 PA CODE § 515.

[65] For a summary of the Conrail situation, *see* Thomas G. Donlan, "*Editorial: The Long Detour,*" BARRON'S, May 26, 1997.

[66] Dennis J. Block and Jonathan M. Hoff, *Conrail/CSX: Pennsylvania Law on Different Track Than Delaware*, N.Y.L.J., Feb. 27, 1997 (discussing the difference between Pennsylvania and Delaware takeover laws and what parties the respective laws protect); *see also* David Faber, *Analysis: Conrail and CSX Extend Provision Preventing Conrail from Discussing an Offer for the Company with Norfolk Southern*, STREET TALK WITH DAVID FABER, Dec. 19, 1996 (discussing various developments and implications regarding Conrail battle); Tom Shean, *Mechanics of a Proxy Battle CENIT, Dissident Shareholders Hire Specialists to Round up Votes*, VIRGINIA-PILOT AND LEDGER-STAR, Apr. 6, 1997, at D1 (reviewing the proxy process and who the state statutes protect).

[67] *Id.*

[68] *See generally id.*

Conrail so as to lock up control of it and then do a merger for stock to acquire the rest of Conrail, but CSX could not do it. All they could acquire was 20 percent and then they needed a vote. Conrail went to its shareholders for a vote and the shareholders said, "No. We want a better deal from Norfolk Southern. We are not going to approve this." Basically, the statute frustrated the management of Conrail. The entire transaction ultimately changed, so that the Conrail shareholders will receive the price that Norfolk Southern was offering. Sometimes these devices for protecting management have another side, and they end up frustrating management rather than protecting them.

In Indiana and Ohio, there are opt-out provisions, so if the board of directors approves a transaction, the acquirer does not need the approval of shareholders to acquire more than 20 percent of the target's stock. But Pennsylvania thought it would go one step further than Ohio and Indiana. They denied the opt-out option to the board of directors and ended up in effect frustrating the will of the board.[69]

As I mentioned, institutions are continually coming forward with SEC Rule 14a-8 proxy resolutions, basically predatory resolutions asking companies to take action of one kind or another. Let me use the poison pill as an illustration.

Last year, fourteen poison pill resolutions went to a vote; eight passed.[70] I think 53.4 percent of the shares, on average, voted in favor of the resolution at the fourteen companies where the vote was held.[71] And generally today, I think, you would expect that about 50 percent of the vote will be against the poison pill,[72] not terribly meaningful, because lawyers like me say, "Ignore the vote. It is an issue for the board of directors." If a company is having bad performance and is otherwise worried about its shareholder relations, they will try to prevent the vote by redeeming that pill or otherwise satisfying the institutions.

But the ingenuity of people who want to remove these protections is unlimited. This year, at a

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[69] *Compare* 15 PA CODE § 515; OHIO REV CODE ANN. § 1701.831; IND. CODE § 23-1-25-1; and NY BUS. CORP. § 505

[70] Joann S. Lubin, *Poison Pills Are Giving Shareholders A Big Headache, Union Proposals Assert*, WALL ST. J., May 23, 1997 (discussing the large volume of poison pill resolutions in 1996 and how the trend has continued into 1997); *Proxy Hits of the Year*, INVESTOR RELATIONS, Apr. 1, 1996 (discussing the major proxy issues that were coming up for 1996).

[71] *Id.*

[72] Richard H. Koppes, *Prominent Shareholder Activists Over the Past Year Included Large Union Funds and Mutual Funds; Targets Included Poison Pills and Executive Pay Packages*, NAT'L L. J., Sept. 8, 1997, at B5 (stating that 20 anti-poison pill shareholder resolutions have been put up for consideration in 1997).

company called Fleming Companies in Oklahoma,[73] someone came up with an idea. They proposed, "Well, instead of a predatory resolution asking them to get rid of the pill, why don't we propose a by-law amendment which will have the impact of actually preventing the use of the pill?" They did that. Fleming went to court and said, "No, the pill was really a question of the board of directors, not the shareholders, and under Oklahoma law (Fleming is an Oklahoma corporation) this is a question for the board of directors, not the shareholders; therefore, it is not a proper subject for a [SEC Rule] 14a-8 resolution."[74] A federal district judge disagreed with that and said, "Yes, it is, and you have to include it in your proxy statement."[75] The case is on appeal.

What this illustrates is that activist shareholders will continually work to try and remove impediments to takeovers or the impediments to forcing corporate management to take steps that the institutions believe will increase shareholder value.

V. HAS THE PENDULUM SWUNG TOO FAR?

Let me turn to the last question, and that is obviously one of speculation, judgment. The question really is: Has the pendulum swung too far? Has too much power been put in the hands of shareholders?

I am using shareholders now in a much broader sense than just the shareholders of the company. Most of the shares are not really owned by the New York City Pension Fund, they are really owned by the beneficiaries of the New York City Pension Fund. The real beneficial owners of the portfolio are the people who expect their pensions to be paid out of those investments. That is true in the private pension funds as well.

Now, one can raise the issue as to whether the response of corporate America to the power of the institutional investor is going to stymie corporate management. The Business Judgment Rule was devel-

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[73] Bill May, *Fleming Officials Frustrated, But Expect Rebound*, J. RECORD, May 2, 1996.

[74] Brotherhood of Teamsters Gen. Fund v. Fleming Companies, 1997 U.S. Dist. LEXIS 2979 (W. Dist. Okla. 1997).

[75] *Fleming to Appeal Ruling on Vote*, COM. APPEAL (Memphis, TN) Jan. 16, 1997, at B5 (discussing the outcome of the *Fleming* case); Philip Scipio, *Binding Resolutions Are on the Way: Shareholders Are Taking Their Activist Agenda to the Next Level*, INVESTORS REL. BUS., May 19, 1997; *Judge Orders Fleming Vote; Shareholders Will Have Chance to Rescind 'Poison Pill,'* TULSA WORLD, Jan. 16, 1997; John C. Coffee, Jr., *Bylaw Barricades: Unions and Shareholder Rights*, N.Y.L.J., Mar. 27, 1997 at 5.

oped in the common law to assure boards of directors that they would not be second-guessed by courts if they made a business decision and it turned out to be wrong.[76]

One of the classic examples is the case of the Edsel, where the Ford Motor Company invested a billion dollars in developing the Edsel, and it sold twenty-three cars, or something like that, and resulted in a billion-dollar write-off. Would the board of directors of the Ford Motor Company be held liable for having made a really bad business decision and, in effect, losing a billion dollars of shareholder value? Clearly not. If they made a business decision and it turned out to be wrong, they were not going to be second-guessed.[77]

That gives a board the feeling that there is no real problem if they pay attention to what management is proposing and it seems reasonable. If the issues is esoteric or difficult and they have gotten the advice of an expert or two, they can go ahead and authorize the activity, even if it turns out to be a terrible blooper, like the Edsel. Because of the business judgment rule, they are not going to lose their homes, they are not going to lose their pensions, and so on.[78] That has stood us in great stead. That has been the law, well articulated now for close to a hundred years.[79]

The question is whether the potential power of the institutions to remove directors and to embarrass directors is changing the attitude in the board room so that the fear is not fear of liability for a bad decision, but fear of incurring the wrath of the institutions, and therefore in some way stultifying management action. It is not something you can prove and it is not something for which there are statistics. But, I get the feeling that there is an overreaction now and that what has happened is not that the directors themselves are specifically reacting to it in connection with transactions, but management is now much more attuned to the concern by directors of causing a problem with the institutional investors, and therefore management is adjusting its strategy so as to try to give the board the feeling that they recognize the board's concern.

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[76] Steven A. Ramirez, *The Chaos of 12 U.S.C. section 1821(k): Congressional Subsidizing of Negligent Bank Directors and Officers?*, 65 FORDHAM L. REV. 625, 646 (1996) (providing an overview of the business judgment rule).
[77] *Id.*
[78] *Id.*
[79] *Id.*

I think one of the examples of it is the tremendous increase in restructuring through either spinoff or the sale of assets of corporations in the last five years. I think a great deal of it is not that management thinks that specific divisions or specific subsidiaries do not hold a future for the company, but rather because analysts have said that the value of the company would be increased if it was in two or three pieces rather than in one piece. Knowing that the institutions would be responsive to the analysts' recommendations, management has preempted the situation and initiated it. Not that the board asked them to do it, not that the board said they were concerned about it, but that management, recognizing that it could become an issue, decided to preempt the issue and initiate the action.

Now, I am not saying it is bad that they do this in any specific situation. But I think it could create a very difficult problem if the general short-term focus of institutional investors caused management and the boards of directors to overcompensate, let the pendulum swing too far in the direction of maximization of shareholder value in the short term.

Now obviously, under our system we should leave that to the boards of directors to sort out. But if it appears that institutions are overpressuring in this area, I think we will see the same legislative reaction that we have seen in other areas, with restrictions being imposed on the institutions, including such things as passing through the vote to their beneficiaries, in order to ameliorate the problem.

If you look back over the last ten years, each time an abuse showed up, we have had legislation. Golden parachutes[80] appeared to be an abuse; the federal government passed a special tax on golden parachutes.[81] The size of executive compensation appeared to be an abuse; the federal government passed a tax provision that imposed a penalty tax on compensation in excess of a million dollars a year unless it was incentive compensation.[82] It has had the opposite effect. I think the executive compensation has mushroomed as a result of that rather than in any way been restricted, but we had a statute to deal with it.[83]

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[80] BLACK'S LAW DICTIONARY 476 (6th ed. 1990). A golden parachute is "a termination agreement which shelters executives from the effects of a corporate change in control. Such an agreement generally provides for substantial bonuses and other benefits for top management and certain directors who may be forced to leave the target company or otherwise voluntarily leave upon a change in control." *Id.*

[81] I.R.C. § 4999 (1986).

[82] I.R.C. § 162(m) (1986).

[83] Jennifer Reingold, *Tying Pay to Performance is a Great Idea. But Stock-Options Have Compensation Out of Control*, BUS. WK., Apr. 21, 1997 (discussing the explosion in executive pay).

Institutions complained that they were not being listened to; the proxy rules were amended to make it easier. You just go through item after item of concern in this area, we have had legislation.[84] There is no reason why the legislation will not go the other way if in fact the pendulum has swung too far.

I think on that note I should end.

[84] SEC Rules 14(a)(1)-(15) and Rule 14(b)(1)-(2); *see also* Corinna Arnolod and Kerry Breen, *Investor Activism Goes Worldwide*, CORP. BOARD, Mar. 1, 1997, at 7 (discussing how activism in the United States has changed as a result of the changes in the SEC rules).