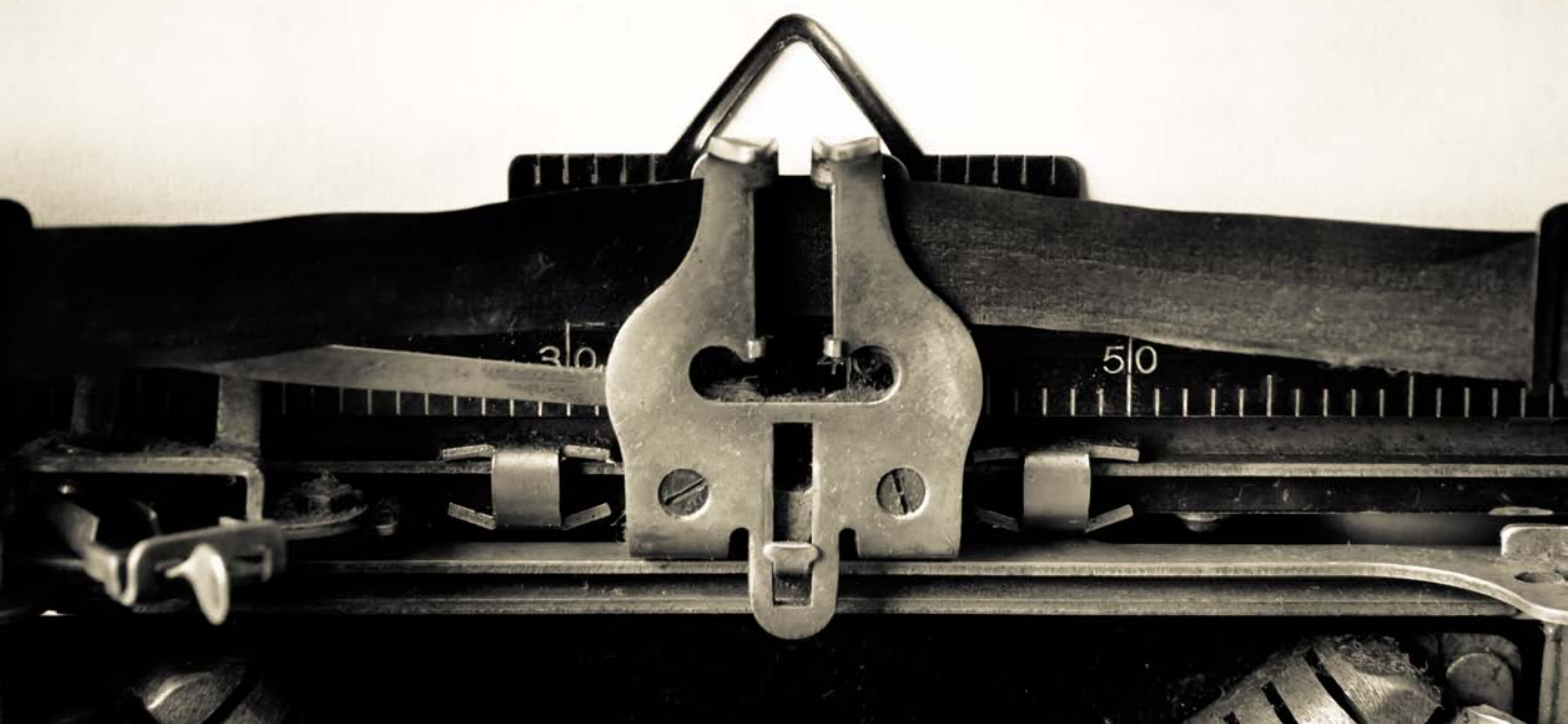
Dear Chairman



Boardroom Battles and the Rise of Shareholder Activism

By Jeff Gramm

Public companies are filled with contradiction and conflict of interest. The best place to study these peculiar institutions is at the fault line where shareholders and corporate managers and directors meet. I've always kept a collection of "Dear Chairman" letters on my desk. To me, each one is a fascinating example of capitalism at work; the critical point at which a shareholder decides to engage management, distilled into a letter. The business world can be a messy place, and there is perhaps no better way to understand it than to study its many conflicts. These letters teach us how American business really works, through the voices of its most interesting participants.

Robert R. Young and the Proxyteers

The proxy fight for the C&O Railway sent a warning shot through public company boardrooms across the country. Robert R. Young, whom the *Saturday Evening Post* would later call "The Daring Young Man of Wall Street," bested Guaranty Trust and, allegedly, J.P. Morgan, not with ample supplies of capital, but merely by lobbying public shareholders.

He also caught the attention of a handful of aggressive young men who were beginning to build their own business empires during the Great Depression. Young's campaign for the C&O Railway taught them a winning strategy for seeking control of public companies by proxy vote. When the US economy began to expand after the end of World War II, they worked from Young's playbook to target underperforming public companies, including major railroads and other household names such as Montgomery Ward, Decca Records, 20th Century–Fox and MGM-Loews. This group of feared raiders picked up a name in 1951, when the management of United Cigar–Whelan Stores Corporation labeled Charles Green a "Proxyteer."

The 1950s were bountiful for investors. The decade remains one of the Dow Jones Industrial Average's best ever, with a 240% gain. The '50s also saw significant changes in the ownership structures of public companies. Wall Street vigorously promoted broad share ownership with efforts such as the New York Stock Exchange's

"Own Your Share of American Business" campaign. The Proxyteers put this propaganda to the test. They bought large interests in public companies, often from vestigial holders liquidating their stakes, and they attacked management teams in the name of shareholders' rights. Managers were incredulous. Often the CEO's first response was simply a befuddled, "Who? I have never heard of this guy." But the Proxyteers were not easily dismissed. As Charlie Green said, "If owning stock doesn't make me a partner, then all that stuff they hand out about how if you own shares you're a partner in American business is a lot of baloney."

The New York Central Proxy Fight

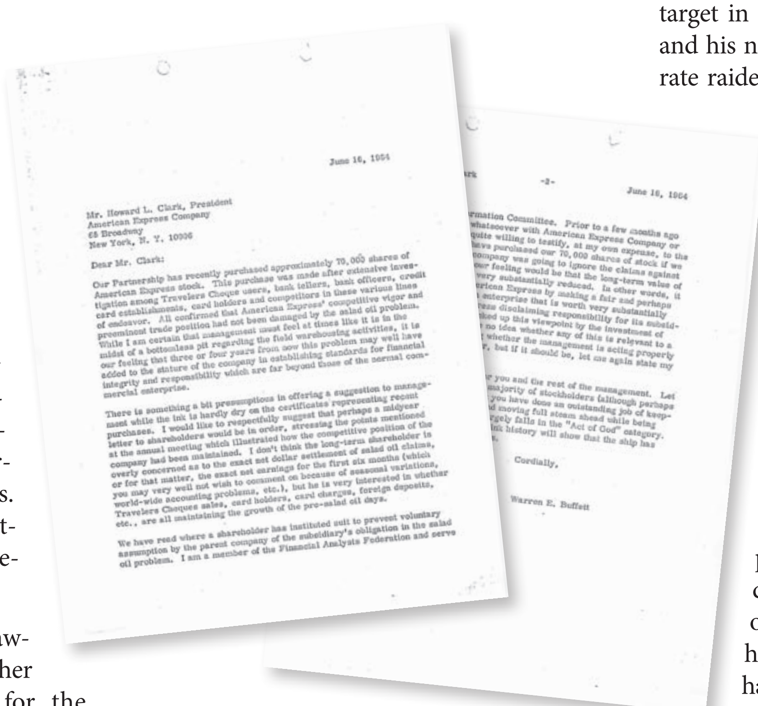
When "Commodore" Cornelius Vanderbilt won control of the New York Central in 1867, he did it via cutthroat competition and behind-the-scenes share purchases. Almost 90 years later, when Young began his own assault, he courted the common shareholder. He did so with a flair for the dramatic, turning shareholder communiqués from formal legal documents into entertaining and irreverent missives. One of his most provocative letters to New York Central shareholders read:

> WARNING: If any banker, lawyer, shipper, supplier or other person solicits your proxy for the present Board, ask him what his special interests are, or what your Company is paying for his services. Like the bankers now on your Board, he, too, may be hoping to receive special favors from your railroad or from the bankers.

Young was the elder statesman of the Proxyteers, and the New York Central fight was the culmination of his decades-long battle against the Wall Street establishment. He had already made his fortune and built his mansions in Palm Beach, Florida and Newport, Rhode Island. But the New York Central was the ultimate trophy — his chance to win the Vanderbilts' railroad at the expense of the Morgans and their ilk.

Warren Buffett and the Great Salad Oil Swindle

The Great Salad Oil Swindle was an audacious fraud that nearly toppled American Express in the 1960s. It is a complicated story filled with valuable lessons about the fallibility of businessmen and their capacity to ignore reality at critical junctures. While the saga exposes terrible behavior and a true villain, it features many more honest and capable people who unwittingly developed deadly blind spots. The fallout from the fraud also pitted Warren Buffett against a handful of shareholders who wanted American Express to maximize its short-term profits by ignoring salad oil claimants.



June 16, 1964

Mr. Howard L. Clark, President
American Express Company
65 Broadway
New York, N. Y. 10006

Dear Mr. Clark:

Our Partnership has recently purchased approximately 70,000 shares of American Express stock. This purchase was made after extensive investigation among Travelers Cheque users, bank tellers, bank officers, credit card establishments, card holders and competitors in these various lines of endeavor. All confirmed that American Express' competitive vigor and preeminent trade position had not been damaged by the salad oil problem. While I am certain that management must feel at times like it is in the midst of a bottomless pit regarding the field warehousing activities, it is our feeling that three or four years from now this problem may well have added to the stature of the company in establishing standards for financial integrity and responsibility which are far beyond those of the normal commercial enterprise.

There is something a bit presumptious in offering a suggestion to management while the ink is hardly dry on the certificates representing recent purchases. I would like to respectfully suggest that perhaps a midyear letter to shareholders would be in order, stressing the points mentioned at the annual meeting which illustrated how the competitive position of the company had been maintained. I don't think the long-term shareholder is overly concerned as to the exact net dollar settlement of salad oil claims, or for that matter, the exact net earnings for the first six months (which you may very well not wish to comment on because of seasonal variations, world-wide accounting problems, etc.), but he is very interested in whether Travelers Cheques sales, card holders, card charges, foreign deposits, etc., are all maintaining the growth of the pre-salad oil days.

We have read where a shareholder has instituted suit to prevent voluntary assumption by the parent company of the subsidiary's obligation in the salad oil problem. I am a member of the Financial Analysts Federation and serve

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June 16, 1964

...rmation Committee. Prior to a few months ago ... whatsoever with American Express Company or ... quite willing to testify, at my own expense, to the ... have purchased our 70,000 shares of stock if we ... company was going to ignore the claims against ... our feeling would be that the long-term value of ... very substantially reduced. In other words, it ... erican Express by making a fair and perhaps ... enterprise that is worth very substantially ... ress disclaiming responsibility for its subsid... ked up this viewpoint by the investment of ... no idea whether any of this is relevant to a ... whether the management is acting properly ... , but if it should be, let me again state my

... you and the rest of the management. Let ... majority of stockholders (although perhaps ... you have done an outstanding job of keep... d moving full steam ahead while being ... rgely falls in the "Act of God" category. ... nk history will show that the ship has ...

Cordially,

Warren E. Buffett

Letter from Warren Buffett to American Express President Howard Clark regarding the company's involvement in the 1960s Salad Oil Swindle.

Courtesy of Jeff Gramm

When Buffett intervened at American Express as a large shareholder, he didn't demand board representation or ask probing questions about the company's operating performance. He didn't call for a higher dividend or question the company's capital spending. Instead, he wanted American Express to use its capital liberally to recompense parties who were defrauded in the swindle. Buffett had done enough research on American Express to understand that it was a phenomenal business. He would later refer to companies like this as "compounding machines," because they generate huge returns on capital that can be reinvested at the same rate of return. Buffett knew that walking away from the salad oil claims would damage American Express's reputation and its substantial long-term value. He wanted to prevent short-term-oriented shareholders from jamming the compounding machine's gears just to save a few dollars.

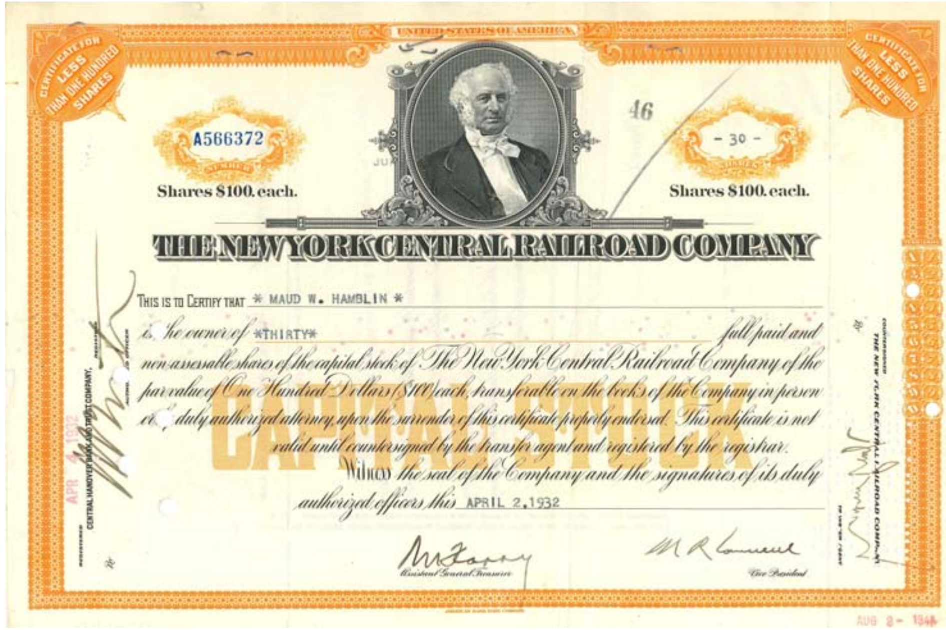
Carl Icahn's Bear Hug of Phillips

On February 4, 1985, Carl Icahn sent a letter to William Douce, chairman and CEO of Phillips Petroleum, offering to buy the company. He wrote that if Phillips did not accept his bid, he would launch a hostile tender offer for control. Phillips was Icahn's 15th target in his seven-year career as a raider, and his note to Douce was a classic corporate raider's "bear hug letter" — an offer to purchase the company, followed by threats should he be ignored. While Icahn had used the same playbook for his earlier battles, this showdown was markedly different: Phillips was one of the largest corporations in the world, many times bigger than any company he had ever pursued.

Icahn once said of his early corporate raids that he was merely "playing poker." He borrowed heavily to fund his stock purchases, and his threats to tender for controlling stakes were often bluffs. He explained, "I didn't have the money to fight for the long haul — to pay the interest on the shares I held." When Icahn threatened an $8.1 billion tender offer to take control of Phillips, few people took him seriously. Phillips's investment banker, Joe Fogg, told him, "That's preposterous. What the hell do you know about the oil business?" Phillips, which had just endured an intense fight with raider T. Boone Pickens, ran full-page newspaper ads asking, "Is Icahn for Real?" This time, he was. "Cash! We have cash," he responded to Fogg. "We'll hire people who know about the oil business."

The 1980s Deal Decade

America's fourth great merger wave proved to be much more substantial than its conglomerator-driven predecessor. The 22,000 mergers and acquisitions of the



New York Central Railroad stock certificate, dated April 2, 1932. The certificate bears the image of "Commodore" Cornelius Vanderbilt, who won control of the railroad in 1867 via cutthroat competition and behind-the-scenes share purchases.

Collection of the Museum of American Finance

1980s "deal decade" included leveraged buyouts by private equity firms, strategic acquisitions by corporations taking advantage of lax antitrust enforcement and expansion into the US market by international companies. But it was the hostile takeovers — though they made up only a small percentage of the decade's deals — that defined Wall Street in the '80s.

That the public was so taken by battles between such unsympathetic figures says something about the high stakes and drama of hostile takeovers of that decade. A few people may have looked on with disgust as vulture raiders pecked at fat cat CEOs, but for everyone else, these clashes at the top of our largest companies were Hollywood material.

Thirty years earlier, nobody really knew what to make of fledgling corporate raiders picking fights with company CEOs. By the 1980s, such men were known as "masters of the universe." In many ways, the corporate raiders of the '80s were not so different from the '50s Proxyteers. Both groups featured aggressive and motivated young businessmen operating on the fringes of Wall Street. But while the Proxyteers struck fear into the hearts of CEOs with their ability to harness the discontent of public shareholders, the corporate raiders had something much more powerful at their disposal: ready cash. It came from Michael Milken and the vast market he created for new-issue junk bonds. Milken used his network of high-yield buyers to create a liquidity boom for young takeover artists.

GM's Evolving Ownership Structure

General Motors is a good example of how ownership of America's corporations evolved over time. In 1920, most of GM's shares were held by a handful of "owner-capitalists," as Peter Drucker called them. This group included the DuPont Company and men, like Alfred Sloan, who sold their businesses to Billy Durant in exchange for stock. Over the next 30 years, most of the large individual owners retired from GM's board of directors and passed away. In 1957, the US government forced DuPont to dispose of its large stake in General Motors for antitrust reasons. By the 1960s, General Motors was a modern public company, run by professional managers and governed by a board of directors with little share ownership. From that point forward, institutions would dominate the company's shareholder base.

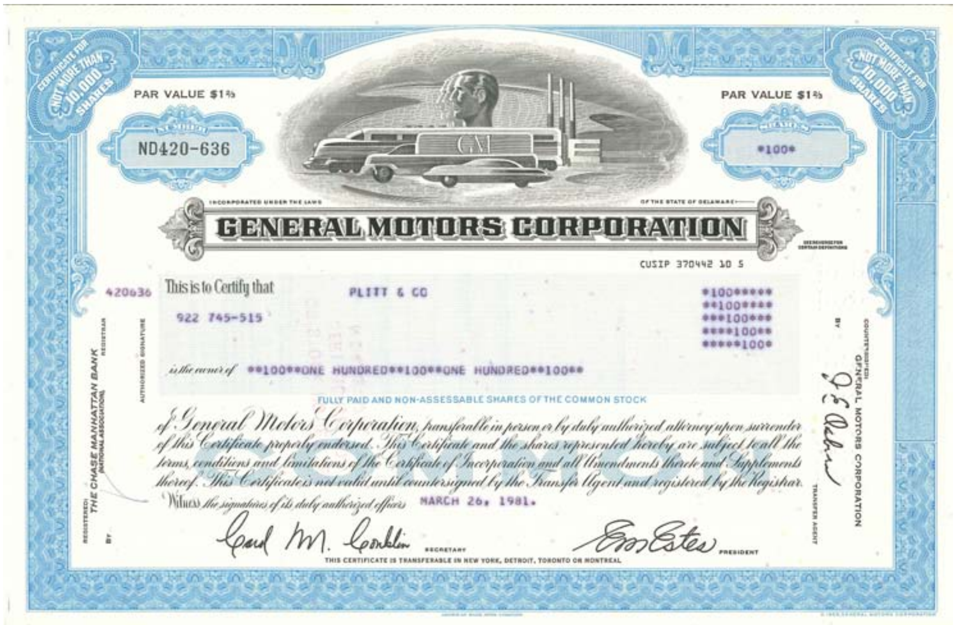
General Motors itself played a major role in this evolution. Employee pension funds, which form one of the largest groups of institutional investors, are essentially a GM creation. While some pension funds existed when GM President Charles Wilson launched the GM Pension Fund in 1950, they tended to be annuity plans holding fixed-income securities, or trusts invested entirely in the stock of the employer company. Wilson believed pension plans should have significant equity exposure, but he thought it was senselessly risky to bet workers' retirement money on the future of their employer. He mandated independent management of GM's pension funds, little or no investment in the employer company and a diversified portfolio with no large ownership stakes in other companies. Wilson's guidelines immediately caught on with other employers — 8,000 new plans were launched within a year of GM's — and were codified in the ERISA Act of 1974.

Corporate America's decision to broadly invest its employees' retirement funds in equities gave American workers a huge ownership stake in the country's economic assets. Drucker argued that this made the United States the world's first truly socialist country. But it also placed control of these investments in the hands of conservative, highly-regulated fiduciaries who limited their exposure to any single investment. Before Ross Perot pushed them to a breaking point, these kinds of investors were highly unlikely to intervene in the oversight of powerful companies like General Motors.

Ross Perot Sparks a Rebellion

On October 23, 1985, Perot penned a scathing five-page letter to Roger Smith, challenging his autocratic management style. He wrote:

> In the interest of GM, you are going to have to stop treating me as a problem and accept me as —
>
> — A large stockholder
>
> — An active board member



Collection of the Museum of American Finance

General Motors stock certificate, dated March 26, 1981. Ross Perot's battle with the company became a turning point in shareholder activism in the United States in the 1980s.

> — An experienced businessman
>
> You need to recognize that I am one of the few people who can and will disagree with you…
>
> I do not believe that GM can become world class and cost competitive by throwing technology and money at its problems.
>
> — The Japanese are not beating us with technology or money. They use old equipment, and build better, less expensive cars by better management, both in Japan and with UAW workers in the US.
>
> — We are not closing the quality and price gaps in spite of huge expenditures on automating plants. The fact that we have not set a date to have competitive prices indicates the prevalent attitudes about our will to win.
>
> The foundations for a future relationship are honesty, openness and candor — or simply put, mutual trust and respect. From this point forward, actions count — words do not. We must focus all our energies on helping GM win.

Perot's reason for tackling General Motors was simple: "It was the opportunity to save millions of American jobs. It was too exciting to pass up." This is a man who engaged in many difficult battles over his lifetime and fought to their end. But perhaps none of these was harder than making positive changes at a poorly-run public corporation. Perot's letter turned out to be the breaking point in his relationship with Smith. From that moment forward, Smith focused his energy on getting Perot off the board of directors.

General Motors ended up spending $80 billion on new plants and equipment through the course of Smith's nine-year tenure as chairman, plus another $10 billion for acquisitions of high-tech companies like Hughes Aircraft, whose purchase was approved over Perot's lone dissenting vote. Much of this money was wasted, as was more than $700 million used to buy out Perot in 1986 to make him walk away from GM. One of the world's greatest industrial companies — once a model of good management and governance — was on a path to insolvency.

When the buyout was made public, Perot, who was as astounded as anyone that GM's board of directors would approve such a large payment just to get rid of him, challenged shareholders to do something about it. He said, "I've alerted the stockholders that if they accept this, then they deserve what they get."

Perot's battle with General Motors became a turning point in shareholder activism and public company governance in the United States. Large pension funds that had held GM stock for years without making a peep were aghast that a company would spend $700 million to weaken its board of directors. Institutional investors were finally discovering their voice. Perot ultimately left General Motors without accomplishing any of his lofty goals for the company, but on his way out he stoked a fire under the country's largest institutional shareholders that remains burning today.

The awakening of institutional investors, prompted by the Perot buyout in 1986, had an immediate impact on public company governance. CEOs and directors were targeted in ways that seemed unthinkable just a few years earlier, as evidenced by the California Public Employees' Retirement System's campaign to dump Smith from the GM board. But the biggest effect was at first quite subtle — the stiffening resolve of institutional holders behind the scenes. Shortly after the Perot buyout, the head of the State of Wisconsin Investment Board (SWIB) said, "If shareholders continue to be passive, they will continue to be shorn like sheep."

He meant it. After Perot, you could no longer count on large institutional shareholders to be pushovers. This helped end the corporate raider era, while encouraging the kind of shareholder activism that dominates markets today. $

Jeff Gramm manages a hedge fund and teaches value investing at Columbia Business School. He has served on several public company boards of directors. This article was adapted from his book, Dear Chairman: Boardroom Battles and the Rise of Shareholder Activism *(HarperBusiness, 2016), with the permission of the publisher.*