Dear Chairman

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 communiques 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.

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
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
— 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 man
agement, both in Japan and with
UAW workers in the US.
— We are not closing the quality and
price gaps in spite of huge expen
ditures 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 rela
tionship 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 oppor
unity 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 rela
tionship with Smith. From that moment
forward, Smith focused his energy on get
ning 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 bil
lion for acquisitions of high-tech compa
nies 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 any
one 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 inves
tors, prompted by the Perot buyout in
1986, had an immediate impact on public
company governance. CEOs and direc
tors were targeted in ways that seemed
unthinkable just a few years earlier, as evi
denced 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 share
holders 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 share
holders to be pushovers. This helped end
the corporate raider era, while encourag
ing the kind of shareholder activism that
dominates markets today. $