Corporate defender

Legal guru and champion of board power MARTY LIPTON tells Brunswick's STEVE LIPIN why he has battled for half a century against the ills of shareholder activism

Marty Lipton remembers the first time he noticed a contest for the control of a corporate board: a newspaper "fight" ad he saw while still a student at law school at New York University. Robert Young, from a Texas family, was waging a proxy fight for control of New York Central, a major East Coast railroad, against its establishment board, and pulled out the stops with a big PR campaign in the leading New York City newspapers.

"The ad said, 'A hog can cross the country without changing trains – but you can't!'" Lipton recalls. "After law school, I was actually intending to teach. I got sidetracked."

That sidetrack led to a career as a legal protagonist and corporate adviser on board rights. Lipton is the inventor of the "poison pill" strategy used to thwart hostile takeovers, and the author of a seminal 1979 article on board responsibility to other stakeholders besides shareholders. In 1992, he co-authored the paper, "A modest proposal for improved corporate governance," which became the template for basic corporate governance principles that were adopted in the 1990s.

He remains committed to the idea that boards should not be hostage to a "shareholder-centric" model that forces short-term thinking, results in layoffs instead of investments, and does tremendous harm to the US economy.

In a conference room at the firm he co-founded, the 84-year-old adviser to boards, CEOs and management teams is smartly dressed in dark pants, a crisp white shirt and red tie. He makes clear he is not slowing down either in his law practice or his advocacy work.

"I still work 24/7," he says.

How does activism now compare to the early days?

To the extent you'd call it activism in the 1950s and '60s, it was very different. Successful entrepreneurs, successful operators of businesses, decided that they could run an existing enterprise better than whoever was in charge. They staged proxy fights for control.

These were the early days of conglomeratization, so you also had attempts to acquire companies forcefully by buying stock in the market and threatening to take control in order to build a larger company. By the end of the 1970s, you had a large collection of conglomerates formed.

What you might call activist entrepreneurs started to show up on the scene around the same

MARTY LIPTON

A founder in 1965 of Wachtell, Lipton, Rosen & Katz, Martin Lipton is an important shaper of US corporate defense legal practice and is considered one of the deans of mergers and acquisitions law. He is most famous as the creator of the "poison pill" shareholder rights tactic in the 1980s to defend companies against hostile takeover bids. *The National Law Journal* has included Lipton on its "100 Most Influential Lawyers" list consistently for the past 30 years. According to *American Lawyer*, his firm has remained the "runaway leader in profits per partner" since 2000.

PORTRAIT: PETER FIELD

time. They typically had one of three objectives: to force targets to be acquired, to gain control of the company and liquidate it at a profit, or to be greenmailed out of their position. The quintessential example is T. Boone Pickens, who decided he could explore for oil on Wall Street – buy it for less than it cost to drill for it.

When did it become acceptable for an established company to make hostile bids?

Probably the threshold was 1979, with the hostile bid by American Express for McGraw-Hill: well-established companies on both sides, with Morgan Stanley defending McGraw-Hill and Lazard's Felix Rohatyn representing American Express. That shone a spotlight on this activity. It drew more attention than any other hostile bid up to that date and started the dispute about the economic effects of hostile activity – and what the legal rules should be. Up to 1979, and even after, there was great doubt about the legal rules around a hostile bid.

I wrote an article in 1979 called "Takeover bids in the target's boardroom," to argue that the law permitted boards of directors to defend against hostile takeover bids. The Chicago school of economics thought – at most – that all a company ought to be able to do is auction itself off to the highest bidder. A company should not be able to defend itself. Until 1985 [in the court cases of Unocal v. Mesa Petroleum and Moran v. Household], it was not established legally that a company was able to defend itself.

What has happened since then?

We have had a raft of activity supporting shareholder-centric governance. ISS and the Council of Institutional Investors started in 1985. We had Sarbanes-Oxley, Dodd-Frank, and a series of Securities and Exchange Commission and Department of Labor regulations. You could say I have been losing steadily since 1985 until a few years ago, never having given up, and continuing to write articles and make speeches.

Where are we now?

A few years ago people began to recognize that activism was having a serious adverse impact on the economy as a whole, that the accretion of shareholder power was a direct cause of the financial crisis in 2008, and that the pressure on companies to meet Wall Street expectations on

Greenmail, a play on the word blackmail, refers to stopping a hostile investor's campaign by paying a large premium to buy back his stake in the company

The Chicago school refers to followers of Milton Friedman (1912-2006), who advocate for freer markets and minimal government intervention

Institutional Shareholder Services, or ISS, advises hedge funds on the use of proxy votes to increase the value of the shares they own

The Council of Institutional Investors is an advocate for corporate governance to enhance the rights of shareholders

Sarbanes-Oxley and Dodd-Frank increased transparency requirements of corporate boards. Sarbanes-Oxley forces companies, among other things, to put non-executive directors on corporate audit and compensation committees. Dodd-Frank subjects executive compensation to a shareholder vote

The Department of Labor introduced the Employee Retirement Income Security Act (ERISA) in 1974, which requires pension funds to vote their proxies in the best interest of their employee members

earnings was encouraging corporations to take on very high risk, to go to the line, and in some cases over the line. There was a beginning of recognition that there was something wrong here. In 2008, there was a general recognition, particularly by bank regulators, that shareholder-centric governance created problems.

After that, there were the beginnings of support, some of it in academia, for the stakeholder concept: that the board's obligation was to consider the long-term interests of investors and the interests of other stakeholders, including customers, suppliers, employees, the community and the economy as a whole.

Is there a backlash brewing?

The first Wall Street recognition was from Larry Fink at BlackRock, who saw that activism restrains investment for long-term growth of profits and market price. Now he's been joined by Bill McNabb at Vanguard, by State Street, by Roger Ferguson at TIAA-CREF, so there is a significant Wall Street awareness of the adverse effects.

A series of economic studies, two of which have come from Europe, showed that activism – short-termism, shareholder-centric governance – is responsible for a very material drag on GDP growth in the US, UK, Netherlands, France and Germany. If companies don't invest you're not going to get an increase in productivity, you're not going to create employment – you're not adding to the economy. It doesn't take statistics to show that. It's plain, ordinary common sense. And people are beginning to have common sense.

You have seen some votes where the institutions have voted against the activists?

If it wasn't for BlackRock, State Street and Vanguard, the DuPont case [where shareholders sided with management against Nelson Peltz's attempt to split up the company,] could have gone the other way. The index funds clearly are recognizing that it's not in the long-term interests of their ultimate beneficiaries. You may get a profit in one stock, but in a thousand-stock portfolio, you have to worry about the other 999. In the long run, you may hurt your portfolio overall by supporting an activist in one stock.

Democratic presidential candidate Hillary Clinton proposed a higher capital gains tax rate

for short-term investments. Her views seem similar to yours, don't they?
They do, but I'm somewhat doubtful. Taxes cannot stop activism. Taxes don't mean anything to them, there's so much money to be made. The activists are not going to stop because they're paying 50 percent instead of 25 percent. It's good in that it sends a signal and it may help to moderate this activity – but it's not enough to stop it.

So what can be done?
We need to rethink corporate governance. The board of directors should determine the strategy of a company. We've taken that away and put the power into the hands of shareholders.

The best way of dealing with that is for institutional investors to stop outsourcing the monitoring of their investments and take it in-house. There are some companies that are not well managed. They should change management or change business strategy. I don't think we should leave that to activist hedge funds. I think that is an obligation of the major shareholders. Twenty-five institutions control most public companies. They need to step up.

How should a board deal with the potential for activism in this environment?
What these activists are trying to do is drive a wedge between the board and management. Boards need to be prepared to back the management. A board that knows what it's doing – is willing to help management tell the institutions, "We're on top of this" – they will get the support of institutions to win proxy fights. They can do what DuPont did.

Boards need to be on top of shareholder relations, to be ready to meet with institutional investors. They need to be responsive to investors and be attuned to the needs of the moment.

That means, with regard to the potential for activism, the single most important thing for a CEO is to maintain a relationship with the board of directors so the board doesn't feel pressured to seek a solution that's not in the best interests of the long-term shareholder.

It sounds like you have not slowed your advocacy?
You can say just the opposite. I feel more and more strongly about it, and I am more and more active.

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An early example of shareholder activism made an impression on the young Marty Lipton while still a student at law school. Railroad tycoon Robert Young ran an advertisement criticizing the New York Central line in his fight for control of the company. It concludes, "we invite the support of the public, of railroad people and railroad investors – for this vitally needed improvement in rail transportation!"

I have one message: activism is a disaster for the economy. And unless that gets played back, we are condemning ourselves to low growth – or no growth.

What really annoys me, what I get angry about, is that the unions don't try to do something about this. Activism is the cause of these great layoffs. The Council of Institutional Investors is the breeding ground for a lot of this [activism], and that's basically a union pension fund organization. This is bad for working people, it's bad for shareholders and it's bad for the economy.

But there are times to play for peace?
You have to be realistic. Day to day, fighting these people, sometimes you just have to compromise. Sometimes it makes sense to put someone on your board, rather than go through a proxy fight. Proxy fights have a very adverse impact on a company. Sometimes it makes sense to spin something off. In many cases, the strategies urged by an activist were already under consideration. If they make sense, why not do it? I even tell my clients sometimes, let [the activist] take credit for it.

From Robert Young's proxy fight more than 60 years ago, to now, do you see a line that connects all these things we've talked about?
Businesses make mistakes. You don't have a market economy without risks and mistakes. Nobody is perfect in management. And there are people who will always take advantage of mistakes.

STEVE LIPIN is Senior Partner for Brunswick's US practice.

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