The Daily Deal

The Activist Professor

By converting his academic work on takeover defenses and executive comp into bylaw proposals at major corporations, Harvard's Lucian Bebchuk has become an unlikely corporate governance star.

by Dan Slater,
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Andrea Ventura

At Home Depot Inc.'s 2006 shareholder meeting, its then-CEO, Robert Nardelli, wore his arrogance on his sleeve. Nardelli appeared at the meeting with two unidentified lackeys — presumably attorneys or public relations executives — and no board of directors. He ordered the erection of two digital timers and announced that questions would be limited to one person and one minute. The second speaker discussed his union's proposal that shareholders be allowed an advisory vote on executive compensation and then covered the litany of Nardelli's pay abuses: guaranteed bonuses, a $10 million loan that cost shareholders $21 million (after taxes) and so on. When the minute expired, Nardelli flatly recited the phrase he would use frequently that day. "The board recommends that you reject this proposal."

Seven months later, on Jan. 4, 2007, Nardelli resigned, taking an exit package valued at about $210 million. That day, the board adopted a bylaw, submitted by Home Depot shareholder and Harvard Law School professor Lucian Bebchuk, which required approval of executive compensation by at least two-thirds of the board's independent directors rather than a mere majority of the directors on the compensation committee.

The shareholder proposal at Home Depot is one of 14 that Bebchuk, a professor-cum-shareholder-activist, has made during the last two proxy seasons. While many law school professors agree that shareholder disenfranchisement in matters of corporate governance is a negative trend in need of a remedy, most are content to write law review articles and occasional op-eds that decry director primacy while extolling the virtues of a shareholder-first model. But Bebchuk is taking more direct action. Having converted his academic work on takeover defenses and executive compensation into specific (and binding) bylaw proposals, Bebchuk, much to the chagrin of such companies as American International Group Inc., Walt Disney Co., Exxon Mobil Corp. and Home Depot, is carrying his prescriptions directly to the boardroom — and demanding a vote.

"I thought there were a number of ways in which bylaws could be designed to address some of the concerns that investors and academics have been voicing," Bebchuk says. "One option would have been for me to write an article or two highlighting those possibilities. But I thought a better way would be to design several model bylaws, and then put them on the table at a number of companies."

So far, Bebchuk's experiment, begun in 2006, has brought encouraging results. Last year, Bristol-Myers Squibb Co. and AIG adopted bylaws based on Bebchuk's proposal to limit board power to maintain "poison pills," the legal mechanism that scares away hostile bidders with the threat of share dilution — literally rendering the company temporarily "sick." Also, at CA Inc., after Bebchuk sued, the board agreed to adopt a shareholder-friendly pill. This year, following on his book "Pay Without Performance: The Unfulfilled Promise of Executive Compensation," Bebchuk is taking on the hot-button issue of CEO pay.

At the most abstract level, corporate governance problems can be reduced to this issue: How to reconcile tensions between centralized management and dispersed shareholders? While Bebchuk believes that making boards and managers sensitive to shareholder input is critical to good corporate governance, Bebchuk's opponents — both practitioners and some academics — claim that the historical separation between ownership and control is the genius of American corporate law. But this latter camp has lost ground. Buttressed by a sympathetic press, angry shareholders and most of academia, Bebchuk's 25-year mission to reform corporate governance appears to be paying off — at least for now.

It was Bebchuk's interest in takeovers that, while still a student at Harvard, earned him a voice in the governance field. In 1982, Harvard Law School professor Victor Brudney encouraged Bebchuk, then 26, to write a response to a law review article authored by two well-known University of Chicago professors, Frank Easterbrook and Daniel Fischel. The issue was whether, following a tender offer — a time-limited offer to buy stockholders' shares at a specified price — there should be an auction during which the board solicits competing bids. In "The Case for Facilitating Competing Tender Offers," Bebchuk's response, which ran in the Harvard Law Review, an unusual occurrence for a student, argued that boards should be able to facilitate auctions. Later that year, the Stanford Law Review published a follow-up exchange on takeover policy among Easterbrook, Fischel, Stanford professor Ronald Gilson and Bebchuk. (Coincidentally enough, 1982 was also the year Wachtell, Lipton, Rosen & Katz's Martin Lipton invented the poison pill.)

After tacking on a doctorate in law, Bebchuk joined Harvard's law school faculty in 1986, receiving tenure two years later. Adding a master's and a Ph.D. in economics, he cemented his credibility as a major authority in law and economics, a burgeoning area that had been left largely clear by Easterbrook, whom President Reagan nominated to the 7th U.S. Circuit Court of Appeals bench in 1985, and Fischel, who, after serving as dean of Chicago's law school, became a legal consultant.

But it wasn't until the publication of Bebchuk's 2005 Harvard Law Review article, "The Case for Increasing Shareholder Power," which lays out the benefits of greater shareholder involvement in deciding governance arrangements, that Bebchuk began creating what he calls "synergies between academics and practice."

He hit his first roadblock in May 2006, with a pill proposal at New York-based CA. Just months before, CA had suffered several management debacles, not the least of which involved former CEO Sanjay Kumar and top salesman Stephen Richards pleading guilty to eight counts of securities fraud and obstruction of justice. At the time, CA, formerly Computer Associates International Inc., was also facing a resolution, filed by an institutional investor, seeking to oust two of CA's directors, former U.S. Sen. Alfonse D'Amato and Hyperion Partners LP founder Lewis Ranieri, of "Liar's Poker" fame.

Bebchuk, who owned 140 shares of CA stock, submitted a bylaw amendment aimed at tighter regulation of the board's poison pill. First, the proposal required that the board make periodic determinations that keeping a pill in place is desirable. Second, the decision to extend a pill must be approved by a unanimous board vote, rather than the simple majority required for most board decisions. "The CA bylaw was brilliant because it was a way to come very arguably within the bounds of Delaware law, and at the same time achieve a total defanging of the staggered board," concedes Wachtell Lipton's Ted Mirvis, whose belief in director primacy stands in opposition to Bebchuk's shareholder-dominated vision.

Adds Mirvis: "If a hostile bidder can get one director elected, and if that one director votes against the pill, then the pill can't last over one year. Therefore, there's no need to replace a majority of the board to make the company vulnerable to hostile takeovers."

Initially, CA barred Bebchuk's proposal from its voting materials, claiming it violated Delaware law. So on May 11, Bebchuk, represented by Michael Barry, a lawyer at plaintiffs' firm Grant & Eisenhofer LLP, filed a lawsuit in the Delaware Court of Chancery. Bebchuk won a decision that forced CA to put the proposal on the ballot. He went on to win 41% of the vote, an outcome good enough to induce the board to adopt a new pill whose terms allow shareholders to redeem it when a qualified offer is made.

Bebchuk's office, which faces Harvard-Epworth United Methodist Church, is large, lined with dark wood, and contains towering stacks of books, papers and annual reports. He wears wire-rimmed glasses low on his nose, requiring him to tilt back his head in conversation. Born in Poland and raised in Israel, Bebchuk speaks in heavily accented English — somehow, he sounds distinctly Belgian — and prefers not to be recorded. Yet he's relaxed, smiles often, and during thoughtful moments, sheepishly shoves his hands in his pockets, leans deeply in his swivel chair, and rests his feet on the table.

"What's most interesting to me about Lucian," says Wachtell's Mirvis, "is that here you have this guy who's the rock star of shareholder activism, and yet he's not an ideologue. He doesn't bang on tables, he doesn't stamp shoes on chairs, and he doesn't punch people in the face. He's actually extremely soft-spoken. But I'd be scared to argue against him. He's too smart. He's stupid smart. And he's taken this activism to another level."

Even Bebchuk is a bit baffled by his success. "The responses were both quicker and greater in magnitude than I expected," he says, "but they confirmed my belief that this is an effective route for investors. First, several of the companies to which I submitted proposals contacted me and worked out an agreement to reform in one way or another. Second, the percentage of shareholder support for the proposals was higher than I thought it would be."

While Bebchuk encountered resistance at CA, other 2006 proposals resulted in successes. Bristol-Myers adopted a pill bylaw similar to one proposed by Bebchuk. Also, at AIG, the board adopted a bylaw based on Bebchuk's proposal to reimburse costs and expenses for stockholders who submit proposals that get majority support.

Encouraged, Bebchuk came back this proxy season with bylaw proposals at 10 U.S. corporations, including Chevron Corp., Exxon, Halliburton Co., Home Depot and Disney. Though Bebchuck considers his greatest success to be his 2007 poison pill proposal at Disney (while it missed the total number of shareholder votes needed, it won 57% of votes cast), this year he's less preoccupied with the poison pill. Four of this year's proposals — those at AIG, Bristol-Myers, Exxon and Home Depot — focus instead on CEO comp, the subject of his 2004 book, "Pay Without Performance."

The book, based on two studies by Bebchuk and co-author Jesse Fried, a professor at Berkeley's Boalt Hall School of Law, argues that in setting executive comp, directors are conflicted due to a flawed governance structure that allows management to exert undue influence over boards. Directors' inability to negotiate with management at arm's length, Bebchuk and Fried argue, enables CEOs to brush aside supine directors and set their own pay, a phenomenon constrained, inadequately, by market forces and the potential for public outrage.

Bebchuk's gripe over runaway pay, however, is market-based, not moral. Yes, the authors state in the first paragraph of the book, in 2003 the average large-company CEO earned about 500 times the pay of the average worker. But comparative statistics like that, they say, aren't by themselves cause for concern. The problem is that pay has been "decoupled" from performance.

James Fanto, a former securities and M&A lawyer at Davis Polk & Wardwell who now teaches at Brooklyn Law School, explains, "Lucian says a lot of radical things, but it's not under some great political radicalism. I think he's very much a market person. There's not a problem with people getting paid a lot, but that assumes there's a market. His complaint is that there isn't one."

Bebchuk's solution calls for wider board approval for executive comp. "The underlying view," he says, "is that the compensation decision should be owned by all the independent directors, not just the subset of them who happen to be on the compensation committee."

AIG, Bristol-Myers and Home Depot agreed to adopt Bebchuk's proposal wholly or in part, while Exxon handed him his first executive comp defeat. When the board, which stirred controversy last year with a $98 milion retirement package for former CEO Lee Raymond, sent the proposal to a shareholder vote on May 30, it garnered only 7% support, reflecting a "vote against" recommendation by Institutional Shareholder Services Inc.

Shareholders' ability to rely on board members who conduct business with their interests in mind is, according to Bebchuk, the Archimedean point on which good corporate governance stands. But he denies conflating the economic and the political. Shareholder democracy, he declares, is not an end in itself. "The positions I've advocated are all grounded in value maximization," he insists.

Wachtell's Mirvis scoffs at Bebchuk's claim of crusading for market forces. "If he marches under the banner of value maximization, I'd like to see what clothes the emperor is wearing," Mirvis says. "He doesn't have empirical evidence that any of the proposals he's created would lead to one cent of shareholder value." (According to the Committee on Capital Markets Regulation, a bipartisan organization, a poison pill with staggered board does impair the market for corporate control.)

But empirical evidence, at least on the public stage, is a bit player in the governance drama. The policy debate tends to take place at the level of the theoretical, the rhetorical, even the philosophical.

When Martin Lipton, creator of Bebchuk's hated poison pill, caught wind of the professor's designs on the 2007 proxy season, he wrote a letter branding the efforts a "misguided campaign" by a "small band of academic malcontents to dismantle the director-focused approach to corporate governance that has, by and large, served U.S. corporations and shareholders remarkably well for more than a century." Lipton and partner Mark Gordon argue that, since shareholders lack both sophistication and commonality of interest (the objectives of a short-term hedge fund manager, for instance, diverge from those of a long-term individual investor), it's bad policy to "reduce the board to a mere conduit for shareholder referenda … at the very moments when active business judgment is most keenly needed." They conclude: "Turning these companies into the experimental playthings of a handful of special interest activists with an ideology to advance (or publicize) is not in the national interest."

Mirvis adds that Bebchuk, who's never worked outside academia, takes a "jaundiced view of how directors think, and why they act the way they do." He adds, "If anything, the self-interest of directors in a takeover case is to sell the company. It takes a gutsy director, even when there's a good premium, to say don't sell." And when it comes to attacks on boardroom entrenchment, Mirvis lobs one back. "Tenure is the most powerful form of entrenchment in America. In the face of any attack on tenure, professors will fight to the death on the grounds that it protects academic freedom. But how often does tenure really do that? Maybe one in a million times."

Wachtell being the paradigmatic (and literal) example of the defender of management, it's no surprise that Lipton and his cohorts come out strongly against Bebchuk's activism. Yet, there are dissenting academics — whose pocketbooks remain unaffected by the debate — who resist Bebchuk's theories on purely theoretical grounds.

Lynn Stout, a professor of corporate law at University of California, Los Angeles, says that Bebchuk's policies rely on a "1980s model of the corporation" that treats shareholders as principals and directors as shareholders' agents — the so-called principal-agent model that's become widely accepted among academics. Alternatively, Stout's vision of corporate governance casts shareholders not as company owners, but as holders of "a type of security called stock." They comprise only one constituency to whom the board owes fealty, Stout says. Directors are obligated to other groups, too, such as employees and communities. And since shareholders, consumed entirely with stock price, don't understand (or care) how these other constituencies figure in the company's future, they have no business controlling the firm.

"The place where people go wrong," Stout says, "is accepting the notions that shareholders are the best people to control the firm, that they're entitled to all of the profits and that everyone else just gets their contractual payments. This thinking has led to the wrongheaded view of directors as mindless functionaries whose sole role is to pay shareholders as much as possible."

She lays some of the blame on the media. "In academia," she says, "there's pressure to capture attention, and sometimes the ability to get your work cited in the newspapers means the difference between tenure and promotion. Unfortunately, because the media loves villains and simple stories — CEOs bad, shareholders good — some academics get pushed toward extreme positions."

Stout has staked out her own polar position. In March, when the Securities and Exchange Commission considered a rule that would make it easier for shareholders to elect dissident board candidates, she wrote a commentary in The Wall Street Journal predicting that such a rule "would dramatically accelerate an already dangerous trend: the flight of corporations away from public investors and into the arms of 'private equity.' " She wrote, "Instead of dealing with whiny public shareholders, [directors and management] can go to one of many rapidly growing private equity funds like [Kohlberg Kravis Roberts & Co.], BlackRock [sic] or Carlyle Group, and raise the capital they need to buy the company's stock back from its shareholders. Voila! A company once owned by the investing public is now owned by the private equity fund and the company's managers."

In a post-Enron era of options backdating, accounting mishaps and corporate looting, a champion of shareholder rights, especially a soft-spoken Harvard professor, makes a compelling hero. Even Delaware is catching on. Five recent decisions from the Delaware Court of Chancery reflect an impatience with the influence of executive comp on governance. And last summer, the SEC was shamed into changing its rules on disclosure of pay packages, requiring companies to provide, among other things, a bottom-line number and a detailed explanation of options grants. Many believe it's only a matter of time before shareholders may nominate directors on the proxy.

But as far as the press bolstering Bebchuk's cause, Stout is right. At a time when bosses are pulling down 500 times more than average workers, CEO pay provides just the kind of villain that Stout says leads to shoddy scholarship and tabloid-style journalism.

Bebchuk appears to have reflected on this. "The difficult part," he says, "given that there are only so many hours, is to continue doing your rigorous academic work at the same time you're reaching out to a nonacademic audience. My hope is that, over time, the benefits of governance reform, via bylaw amendments, will become clear, and investors-at-large will be doing these things instead."

In 1932, two New Dealers, Adolf Berle and Gardiner Means, published "The Modern Corporation and Private Property," which described a major trend in U.S. corporate governance: the separation between the ownership of a company — its shareholders — and those who control — the board of directors. (Berle was a mentor of Brudney, who mentored Bebchuk.) Berle and Means explained that this separation — what they called the "divorce" between ownership and control — resulted from a collective action problem among shareholders who were too dispersed to act in concert, and whose holdings were too negligible to justify the time and expense of costly proxy contests. If you disagreed with a company's strategy, or were appalled by the CEO's paycheck, your remedy was to flip your shares and invest elsewhere.

But 75 years later, shareholders like Carl Icahn, Kirk Kerkorian, activist hedge funds and other impatient institutional investors (who own two-thirds of the shares of corporate America) now have the financial interest and expertise to agitate for change. The question remains, however, whether Bebchuk's example will spark an activism interest among small investors — or restless professors. (In 2007, more than twice as many companies will face shareholder proposals to tie executive pay to performance, according to Institutional Shareholder Services, though unions and pension operators will submit the most.)

On the other hand, it may not matter. Since Bebchuk first advocated auctions in tender offers in 1982, shareholder rights has come into vogue as shareholder democracy has gradually supplanted the old corporate republic. "When changes come in this form, they have a kind of legitimacy that's hard to oppose," Bebchuk says. "It's the market imposing certain arrangements."

But the market, of course, can shift. Corporate governance is hardly a science, and there's little evidence to suggest that one set of beliefs or another is clearly superior. For now, however, Bebchuk and his arguments for shareholder rights have the momentum.