SEC Historical Society
Interview with Martin Lipton
Conducted on June 6, 2013, by Robert Colby

RC: This is an interview with Martin Lipton for the SEC Historical Society's virtual museum and archive of the history of financial regulation. I'm Robert Colby. Today is June 6th, 2013, and today's interview is being conducted at the offices of Watchtell, Lipton, Rosen & Katz in New York City. Mr. Lipton, thanks for being with us today.

ML: Thank you.

RC: So you said that your corporate governance experience began in 1960?

ML: No, my corporate governance experience began in 1955 after graduating from the New York University School of Law. I went to the Columbia University School of Law, where I did graduate study under Adolf Berle, the author of *The Modern Corporation and Private Property*, which is one of the bedrocks of corporate law, corporate governance, and indeed, he assigned a thesis topic to me of what the impact of the shift from private ownership to pension fund, and other institutional ownership of the shares of the major public companies, would have on corporate law and corporate governance. A thesis I never did complete, but that was the beginning of my exposure to corporate governance.

Then after an interregnum, while I clerked for a federal judge, I joined a law firm that had as one of its specialties representing clients involved in proxy fights, and that began a career-long exposure to corporate governance. I'll use corporate governance as allinclusive of both corporate governance in the legal sense, corporate governance in the regulatory sense, and corporate governance in the so-called best practices sense.

RC: Now, you founded Watchtell, Lipton in 1965, and from the beginning was mergers and acquisitions the focal point?

ML: Well, yes, from the beginning we had a significant merger and acquisition practice, and also, as one of the first matters that came to us as a new firm, proxy fights. During the 1960s, from '65 to 1970, we had Wall Street exposure and some proxy fight exposure and some merger and acquisition exposure. At the same time, from 1958 until 1978 I was teaching securities regulation as an adjunct professor at NYU Law School. So in large measure, much of my personal activity and a good part of the firm's activity was focused on securities regulation, on M&A activity, and on proxy activity, although the relative amount of proxy activity in that period was quite small compared to what it is today.

RC: Did the Williams Act have any effect on the nature of your business?

ML: It did not have an impact on the nature of our activity really until 1972. I'm straining for memory now, but I think we began to have some significant tender offer activity in '72. I know we did in '73, and then in '74, which you might call the threshold year for hostile tender offer activity, there was a bid by INCO for ESB. That was one of the first times that a major first-line investment house, Morgan Stanley in this case, made a hostile bid on behalf of a major establishment company, INCO, and that had considerable notoriety and attention.

And also in 1974, I was involved as the firm represented Loews Corporation in a hostile bid for the CNA Insurance Company. That became one of the cause célèbres and our success in that takeover led to a number of the investment banks seeking our services in connection with takeovers. And just to go back a bit, I wrote a review of a book on takeovers in the *Michigan Law Review* in 1973, in which I referred to Joe Flom of the Skadden law firm as the person that the arbitrageurs asked about at the very beginning of every deal: "which side has him?" And in large measure, Joe Flom of the Skadden firm dominated takeover activity through 1974.

Nineteen seventy-five was a very significant year in takeover activity, and we were involved in a number of transactions. All of these were basically a tender offer bid that was either resolved through the target by finding a more attractive home, or the target remaining independent either through successful litigation or some other means. But it began to be the major part of our practice to the point where in 1976 *New York Magazine* carried an article called, "Two Tough Lawyers in the Takeover Game," positing Flom in the Skadden firm against Watchtell and myself.

RC: Now, I just want to go back. What is causing this to all of a sudden become either more acceptable or just more common, is there a cultural shift happening?

ML: I think that are several cultural shifts. One was that the passage of the Williams Act itself made it more acceptable, because it was possible to then say look, this is an activity that's regulated by federal law. There's an SEC that regulates this, so there is clearly no real opprobrium to be attached to being involved in this. And of course, as is always the case, market conditions.

When entrepreneurs see an opportunity to make money they're going to pursue that opportunity. The availability of funds to engage in this kind of activity and the difference between market asset value and price with respect to some companies, that are being recognized as being worth far more if they were liquidated than if they continue as a conglomerate were major factors. Various reasons over the years, different factors have come together to either stimulate the activity or retard the activity and there are both internal and external factors.

Through the latter part of the 1970s the activity continued, and then from the standpoint of my connection with corporate governance, in 1979 the American Express Company made a hostile bid for McGraw-Hill. Up until that point there was no real agreement as to the legal ability of a board of directors to reject an all-cash premium bid for the shares of the company. Wachtell Lipton had been giving opinions that it was within the business judgment of the board of directors to reject a takeover bid, and in academia there was very substantial thought that the board didn't have that power.

In any event, the McGraw-Hill board asked us for a formal written opinion with respect to their ability to exercise their business judgment to reject an all-cash premium bid. We did a great deal of research and of course, found no direct precedents, and it ended up that ultimately we decided to give the opinion based on analogous precedents and I wrote an article called "Takeover Bids in the Target's Boardroom" which provoked a debate that continued until 1985, when it was decided by the Supreme Court of Delaware in the *Unocal* case, which cited that article for authority, that the board of directors had the ability to exercise their business judgment in connection with a takeover bid.

Meantime, in the period from '79 to '85, there was a great deal of activity, much of it fueled by junk bonds and the development by Drexel Burnham of the "highly confident letter" which facilitated making hostile takeover bids. And during this period, from say, '75 to '82-'83, there was a lot of activity and we were heavily involved in promoting state takeover statutes to make it easier for the target of a hostile bid to defend.

And there was what I would call substantial development in terms of litigation designed to stop takeover bid becoming more and more difficult, which led ultimately in 1982 to my coming up with the idea of what today is called the Poison Pill but was originally called the Warrant Dividend Plan. In September of 1982 I wrote a memo, one that circulated first in the firm and then generally, describing the Warrant Dividend Plan and how it could be used to stop a hostile takeover.

RC: Now, you had said that in the late seventies many of the hostile takeover attempts failed either because the companies found a white knight or they were able to defeat it. Are there developments that made them more successful?

ML: Less successful. Litigation became more and more difficult, because the courts began to feel that the litigation based on antitrust charges and on disclosure issues and so on that was designed to stop a takeover bid was not substantive, and courts felt somewhat imposed upon and it became more and more difficult, which led to my frustration at defending companies, and ultimately sparked the idea for the Warrant Dividend Plan, or Poison Pill.

And also during this period, corporate raiders would buy a position in a company and seek to extract greenmail from the company. The combination of activity resulted in 1985, which is clearly the seminal year, in ISS and the Council of Institutional Investors being formed and they began the twenty-eight year process of initiating new corporate governance ideas, petitioning the SEC for adoption of regulations, and publishing policy considerations and voting recommendations based on a view of best practices of corporate governance. That has continued to date.

There appears to be almost a symbiotic relationship between the Congressional committees that deal with this, the SEC, ISS, Council of Institutional Investors, and twenty-five other organizations, National Association of Corporate Directors, association of corporate secretaries, U.S. Chamber of Commerce. I mean there's what I frequently refer to as a Washington-centered corporate governance industry working both sides of the street, those who are trying to promote a shareholder-centric set of governance principles, and those who are trying to retain the director-centric set of corporate governance principles.

RC: One of the things that I was in interested in is you worked with the Tender Offer Advisory Committee and promoted legislation to curb abusive takeovers. Can you talk a little bit about that?

ML: Well, I don't know that the Committee really accomplished very much. Refresh my recollection as to the year.

RC: Eighty-three.

ML: Eighty-three, the change in the offer period from ten days to twenty business days became effective in '81, and I think in large measure nothing substantive came about. Subsequent to that, I don't think the Committee, which wrote a report, really had much impact on tender offer regulation or takeovers. The next thing that happened, was the 1985 period but almost immediately after that, by '87, the insider trading scandals came along, basically as a result of takeover activity, at least merger and acquisition activity, where leaking of the information or using the information that was improperly obtained resulted in a number of insider trading prosecutions and so on.

So there was this shift. The attention of the SEC shifted dramatically to enforcement and pursuing these insider-trading cases, and then there was what you would call almost a competition between the enforcement division and the U.S. Attorney, particularly here in New York, with respect to pursuing these matters.

I left out that the academic discussions continued apace, and during the period from '79 all the way through the eighties, there was almost a steady stream of considerations by the SEC of requests for regulatory changes, or requests for practice changes and how the staff dealt with hostile tender offers. There was very little proxy fight activity. It was just easier and to some extent less costly to do a tender offer than to run a proxy fight.

We had the collapse in '89, '90, '91, the collapse of the junk bond market, the Savings and Loan Association fiasco, and the creation of the Resolution Trust Company, a marked decline in M&A activity and a focus on the decline of the American corporation's competitiveness. The government created a council on competitiveness and that council had a committee or sub-council on corporate governance, and I was a member of that committee along with Professor Jay Lorsch of the Harvard Business School. He was clearly shareholder-centric at that point, and I was clearly director-centric at that point, but we shared a cab to National Airport one day and he proposed that we write an article, and at first I didn't think we could possibly find a middle ground but we did and we wrote "A Modest Proposal for Improved Corporate Governance" that was published in 1993.

RC: And that's based on the competitiveness issue?

ML: Well one of the things that was being raised was whether poor corporate governance was responsible for decline in American competitiveness. The General Motors situation sort of became dominant at that point; GM removed the CEO, and separated the role of CEO and Chairman. A number of companies adopted corporate governance guidelines which in large measure were based on the "Modest Proposal" article. Those guidelines, which came into play in 1993, started the best practices concept of corporate governance, and in large measure they've been added to each year since.

RC: What were the main issues that you and Professor Lorsch saw and thought most needed to be addressed?

ML: Independence of the directors, the focus of the agenda, having committees that focused on compensation, nominations, a truly independent and expert audit committee; the usual, nothing that today would appear out of the ordinary. To some extent, it reflected what the better-advised companies were doing at the time but tied it all together. And we also published a supplement to that article, recommending a lead director, and so from '93 to 2002, I don't know that there were any major developments other than a vast increase in the influence of ISS.

RC: They looked a little bit at executive compensation and proxy access at that time.

ML: Right. Now, the SEC was sharpening the disclosure requirements with respect to proxy statements and tender offer disclosure. And actually, in response to some of these things the SEC changed the forms to increase disclosure. But we had this increase in the stock market. Stock prices kept going up and up and up, and there was this great rush of hot IPOs in what was referred to as the TMT securities, telecom, media, and technology, and of course we had the "Millennium Bubble" collapse in the market. And as is always the case with the collapse of bubbles, scandals come about and so we had Enron, WorldCom, and all the scandals that broke in 2001, 2002, at which point the SEC required the stock exchanges to adopt corporate governance rules. I served as both counsel and a member of the NYSE Governance Committee, and I was concurrently the chair of the Legal Advisory Committee of the Stock Exchange. The proposed rules were published in 2002 and they were approved by the SEC in 2003.

In effect the SEC, through requiring the New York Stock Exchange and NASDAQ to adopt corporate governance rules that every listed company had to comply with federalized a major area of corporate governance. So the SEC, through that means, had for the first time moved from what was fundamental disclosure regulation to substantive regulation of corporate governance. Previously, to the extent the SEC had an impact on corporate governance it was through disclosure, and it could be a significant impact because if you're doing something that doesn’t look so good in the light of day you usually stop doing it.

So it did have an impact, but the real impact came about with the stock exchange rules, which were concurrent with Sarbanes-Oxley. What had happened actually, is that Sarbanes-Oxley was pending for a couple of years in Congress and getting no place when Enron and WorldCom came along, so the SEC's oversight of the stock exchanges with respect to their rules kind of paralleled Sarbanes-Oxley, and Sarbanes-Oxley actually was enacted before the stock exchange rules actually became effective. They had been published, but not effective. And then obviously Sarbanes-Oxley added to the power of the SEC with respect to substantive governance as distinguished from governance through disclosure.

RC: Now, before Sarbanes-Oxley the functional rules of corporate governance are almost entirely left to the states.

ML: That's right, yes.

RC: So this is really an unprecedented federal incursion into corporate governance.

ML: This was the first time that the federal government really started to regulate corporate governance, and it's almost coincidental that it was simultaneous or concurrent with Sarbanes-Oxley.

RC: Okay. Now, you mentioned earlier that since the late seventies academics have been talking about corporate governance in different forms, including some people who have proposed federal corporate governance standards.

ML: Well Nader, back in whatever year it was, proposed—and this was specifically aimed at the automobile companies—that the 100 largest companies would have to be federally incorporated and subject to federal law. I mean, their corporate governance would be the product of a federal corporation law.

RC: With the idea being that, because these companies were engaged in interstate commerce they were properly regulated by the government?

ML: Frankly, I don't remember the constitutional justifications. There's no doubt I think in anybody's mind that the activity of the major corporation was such that they could probably be subjected to federal legislation, but that obviously met with great objection on the part of the corporations that certainly did not want their governance to be regulated by the federal government; the classic states' rights versus federal.

But the other thing that really needs to be kind of layered into this whole period is, you start in 1932 with Berle's agency cost theory, that public companies presented that danger of management in effect profiting at the expense of shareholders juxtaposed against E. Merrick Dodd, the Harvard professor's stakeholder theory that the proper role of the corporation was not just to benefit shareholders but the community, employees, and so on, and that it was perfectly appropriate for the board of directors to take all of that into account.

Indeed, it was that approach that I put forward in "Takeover Bids in the Target's Boardroom" in 1979, the constituency theory, as a justification for the legal ability of the board to take this action. Then, through the thirties and forties there's not much development, the Depression period, the war, and then after the war you begin to have the creation of these conglomerates, but more important than anything else you have the financialization of the markets.

Prior to the end of the Second World War, corporations were generally controlled by individuals, principally families; the heirs of founders and so on. And after the war you begin to have the development of private pension plans, mutual funds, and the institutionalization of shareholdership, and concurrently, the development of the efficient market theory, the Chicago School of Economics, Milton Friedman; Fama; Michael Jensen at Harvard, and a combination of the agency cost theory with the efficient market theory, capital markets pricing theory, and to my mind maybe more significant than any of them, the total return investment theory. So that there's a shift to focus on quarterly prices of stock instead of long-term increase in dividends, which essentially fueled short-termism and provides an academic justification for activist hedge funds, hostile tender offers, and such.

And you had the Chicagoans, in response to my “Takeover Bids in the Target’s Boardroom” in '79, Frank Easterbrook, who is now Chief Judge of the Seventh Circuit, and Daniel Fischel, who later became dean of the Chicago Law School, writing an article that totally refuted it and put forward a passivity theory that directors had to remain absolutely passive in the face of a hostile tender offer and could not take any action to defeat it.

RC: Even including looking for better offers?

ML: Even including looking for better offers. That was their original position.

RC: But it seems like that would fly in the face of the purpose of a director.

ML: Also in the face of logic and reason and greed, but they put it forward. They wrote article after article, Ron Gilson, Reinier Kraakman, others jumped into it. This is when Bebchuk got his start.

RC: And so that idea provides the logical underpinnings for, not necessarily tender offers, but the movement that share value is primary.

ML: Milton Friedman was often quoted as, "The sole purpose of the corporation is to maximize value for the shareholders." And others would say the sole purpose of the corporation is to maximize immediate value for the shareholders.

RC: So is there a shift to the idea of the immediate value at a specific point?

ML: Yes, basically that came about with the development of the raids of the late 1960s and from then on. Remember, the Williams Act was enacted in response to dawn raids where people were accumulating shares in the open market, and so the primary purpose of the Williams Act was to eliminate dawn raids.

RC: To give companies warning that there was going to be an attempt, to give them a chance to defend themselves?

ML: Right, yes, and to require disclosure as to what was going on; it's arguable. It certainly wasn't to give them a chance to defend themselves, because you wouldn't have chosen a ten-day tender offer period if you were going to give a company an opportunity to defend. I think it's fair to say that the SEC, throughout the entire period, was basically shareholder-centric and justified that on the grounds that the fundamental purpose of the securities laws was to protect the shareholders and therefore it was the SEC's purpose and function to do that.

RC: Which makes it sort of interesting, that the progress of things like proxy access and shareholder proposals has progressed fairly slowly.

ML: Keep in mind these were put forward for a number of years. These were not new proposals last year or the year before, and these had been on the table for a long time. And you have to include the whole 14a-8 precatory resolution scheme and so on. These had been debated and argued over the years, what the purpose was and so on.

But I would say that from an SEC standpoint, the SEC has stood as the center of debate and lobbying by those who are pursuing shareholder-centric theories and trying to maximize immediate shareholder wealth, and those who have been trying to preserve the ability of management to manage for the long-term benefit of the shareholders in the corporation and the other stakeholders, and that debate is as hot today as it has been at any time in the past. And you have Lynn Stout and Margaret Blair and a number of people now who have abandoned the efficient market theory as no longer valid and have recognized that there is a serious problem.

And then you have the retrogrades like Bebchuk who still think the efficient market theory is valid and despite any logic to the contrary will argue endlessly that the whole purpose is to further immediate shareholder profit, and that's the best thing. So it continues today, and the SEC of course is in the center of this. We put in a petition to change—I guess it’s two years ago now, maybe a little more—Dodd-Frank gave the SEC the power to reduce the ten-day period under 13D by regulation. We put in a petition to reduce it to two days, and Bebchuk and his colleagues organized twenty or thirty academics to write a petition that would deter activist shareholders from coming in and stirring the pot and therefore the SEC should not do it, because it was beneficial to shareholders that activists come along and promote takeovers.

RC: So the extra time in the window would allow between two days and ten days.

ML: Just to enable them to secretly accumulate more shares, and obviously we argued that that's unfair to the shareholders whose shares are being purchased, not knowing that this accumulation is going on and what the intention is. The SEC has not taken action on it; it's still pending before the SEC. Whether they're ever going to take action, I don’t know. You're familiar with the proxy access situation and the litigation, and now it basically looks to me like the SEC will never try to reinstitute it and is just going to leave it to—if shareholders want it they can start a proxy fight to impose it and 14a-11 now permits shareholders to go ahead and do that, but the mandatory 14a-11 is gone.

And so I think the last point was Dodd-Frank basically enhanced the powers of the SEC with respect to a number of different things, say-on-pay and the 13D rules. Dodd-Frank subsumed Chuck Schumer's Shareholder Bill of Rights, so his Shareholder Bill of Rights was not enacted but parts of it subsumed within Dodd-Frank.

RC: I'm not familiar with Schumer's Shareholder Bill of Rights.

ML: Well, basically it was to pick up all of what's called good practices, best practices today.

RC: And these are the initiatives that are primarily promoted by activist shareholders?

ML: Yes.

RC: So the activist shareholders, you mentioned that 1985 was sort of the watershed year for them. Was there something about that time period?

ML: I think it was coincidental that we had the Delaware decisions that year. I think it came about because of the buildup of activity from '74 on. In other words, you had a steady buildup of activity and all that had really happened that was substantive was the change in the tender offer period and the Poison Pill, and the tax legislation with respect to greenmail. On the shareholder side, spurred by academics and so on, and the unions, union pension funds—have you interviewed Damon Silvers?

RC: I have not.

ML: You should. You should interview him. He's Deputy General Counsel of the AFL-CIO. You will find that he has been a major factor in this for a long time. And I think what happened was that the shareholder-centric people were frustrated, and the management-centric, director-centric people were frustrated, so they were coming up with things like the Poison Pill, and whenever you get that kind of clash of activity out in the market sooner or later litigation and legislation happens. It just so happened that in 1985 you have the four cases in Delaware, and you had the development of organizations to promote the policies of the opposing sides. Also, I left out that Boone Pickens at one point had organized the United Shareholders of America.

RC: It just is interesting to me that they would organize, even though these ideas of these tender offers is driving short-term gains, so I would think that the hostile takeovers would be in the same vein as what the shareholders wanted in terms of maximizing value.

ML: Well see, I think that the real question is what is the real fiduciary duty of all of these people and what is the duty of the SEC to shareholders? If you step back from the immediacy of stock market prices it's obvious that there's an enormous friction cost in all of this activity, and it's also obvious that what's truly in the interest of the beneficiaries of pension funds and the holders of mutual funds is the long-term increase in the value of their holdings.

And to the extent that almost the entire activity is focused on short-term, quarter-to-quarter stock market prices, you are deterring investment for the long term, you are deterring truly maximizing the value of the investment, but even more important you are causing gaps in employment, you're deterring investment that would increase the economic benefit for the entire population, and in fact you are putting a very significant limitation on growth in GDP.

And quite obvious, if you limit R&D, if you limit CAPEX, if you require companies to constantly lay off people in order to try and maintain quarterly earnings, you are having an impact on the economy as a whole. And if you look at it across the entire spectrum of business activity by public companies in America, it's quite obvious that you're impacting GDP to a real material extent. I actually think there's about a 50 percent restraint on increase in GDP.

RC: Because the long-term investment would have a growth factor.

ML: A growth factor, absolutely. I need to stop.

RC: Now?

ML: Yes, it's 12:00.

RC: Okay, great. Well, thank you for your time.

ML: Well, good luck with your project.

RC: Thank you.

[End of Interview]