Tyco's betrayal of board governance

From this tangled web of related-party transactions, intra-board lawsuits, personal tax evasion indictments, and other value- and trust-destroying exploits, some recommendations for director accountability readily suggest themselves. **BY PASCAL N. LEVENSOHN**

SERIAL REVELATIONS of self-dealing by Tyco International's former CEO, its former general counsel, and individual members of the board of directors paint a shameful canvas of derelict corporate governance in the Tyco boardroom. Under scrutiny from investors and regulators alike, the Tyco board has adopted a finger-pointing and blame-shifting approach in response to the charges leveled against management and the company. This may help some board members save face, but there is no denying that something was seriously awry in the Tyco boardroom for many years.

With powerful rights come equally powerful responsibilities. If public company directors have the right to attractive cash and stock option compensation packages, to the prestige associated with their positions, and to exercise the power corporate strategy, they also have the responsibility to be proactive in their oversight and to ask the hard questions of the CEO before trouble is irreversible. In my opinion, the Tyco board of directors has failed to acknowledge that it abdicated its responsibilities to the owners of the company — the shareholders — thereby compromising the board's rights to the benefits of directing the future of this company.

In examining the Tyco governance record, we draw three conclusions that may be helpful to other companies so that they may avoid breeding governance cultures that allow conflicts of interest to flourish: first, that boards must be proactive in their oversight of company management; second, that a board with a majority of independent directors should also include a diversity of skills, favoring directors with operating experience; and third, that aligning director interests with shareholder interests through stock ownership should be balanced by establishing a reserve system for realizing gains that is long-term in its construction.

Even in the context of the acquisitive 1990s, Tyco was one of the most acquisitive, having amassed a collection of companies for a total of over $60 billion in cash and stock over the past decade. Until January of this year, Tyco had brought the conglomerate concept to levels of investor acceptance not seen since the glory days of Gulf & Western, and its management made a science of creating accounting and tax loophole exploitation. Along the way, the company's growth under CEO Dennis Kozlowski generated both controversy and, for some, great success. From January 1996 to December 2001, Tyco's common stock appreciated at a compound rate of 37%, compared to 11% for the S&P 500. Tyco's market capitalization as of December 31, 2001, was $116.3 billion, making it one of the top 20-valued public companies listed on the New York Stock Exchange.

But the Tyco edifice crumbled in 2002. In the six months since December 31, the actions, inactions, and reversals of actions by the Tyco board have cost common equity owners approximately $88 billion in lost shareholder value (through June 24), which is roughly three-times the $33 billion in equity losses triggered by the Enron implosion and almost twice the equity losses in WorldCom year to date.

Pascal N. Levensohn is the president and CEO of Levensohn Capital Management LLC, a San Francisco-based firm that since 1996 has specialized in public and private technology investing and risk management of concentrated equity positions. He is currently a director of LiDCO Group PLC, a publicly traded medical device company listed in the United Kingdom, and of three venture-backed emerging technology companies based in California's Silicon Valley — TeraLogic Inc, Covigo, and NexVerse Networks.

Accident avoidance

How can a company avoid this type of accident-waiting-to-happen in the boardroom? Three years ago I wrote an article for DIRECTORS & BOARDS ["The Problem of Emotion in the Boardroom," Spring 1999] that analyzed, in the context of the takeover battle for AMP Inc., the disproportionate influence of former AMP CEOs on the AMP board. I expressed the view that former CEOs of companies do not make very good independent-minded directors because "It is naturally very difficult to move a CEO aside, have him remain a voting board member, and proceed to undo major projects that this person has previously done with the board's blessing. When more than one former CEO remains on the board, this problem is magnified. Retired senior executives have a natural tendency to glorify their exploits and to treasure past contributions as well as to protect one another and their reputations. It is therefore extremely risky to keep them at the table."

It would be healthy to establish a cap on the maximum realizable cash value of stock options to directors in any one year.

Again, the pattern is repeated at Tyco. The 11-member Tyco board of 2000 consisted of three insiders, one former Tyco CEO, one CEO of a manufacturing company, and six investment company professionals (one of whom passed away in 2001). Five of these six investment professionals were either chairman or president of their respective firms and three had investment banking backgrounds. Tyco's board thus included four CEOs, three of them with direct Tyco or predecessor company backgrounds, and a concentration of finance professionals rather than managers/operators. Such a board composition raises questions about the ability of these independent directors to be proactive and to adequately oversee the vast and complex operating companies that comprise Tyco.

I believe that board members must be accountable for the actions of their CEO. This means that the board must be proactive in discharging the responsibility of CEO oversight and fully understand what tools management utilizes to achieve business plan objectives. At a minimum, it would appear that the loyalty of the board to Dennis Kozlowski led to an absence of oversight. Perhaps, while everyone was making plenty of money, the board wasn't asking Kozlowski a lot of questions. Clearly, if we are to accept the board's statements that they had no knowledge of questionable payments until months after they had been made, the board cannot be held responsible for improper acts by a member of the management team. But the fact is that the board should have been aware of significant payments to one of their own, and they should not have been so complacent as to simply rubber-stamp the CEO's actions.

An action step

What can be done? It would be healthy, for example, to establish a cap on the maximum realizable cash value of stock options to directors in any one year, with future payments of the value to be held in reserve based on some kind of multiyear performance standard or high water mark, similar to that imposed on many investment fund managers. Specifically, many investment managers, hedge funds, and venture capitalists in particular, who receive an allocation of the profits of their portfolio appreciation, must measure that profitability over a multiyear period. For instance, suppose a portfolio gains 50% in one year and they are entitled to an allocation of 20% of those profits. In the following year, if the portfolio loses 20%, the manager may not receive another profit sharing allocation until the portfolio has recouped the 20% in depreciation and exceeds the original 50% high water mark.

Directors commonly receive annual options awards, and, at Tyco, they have a history of converting their cash compensation into stock. Currently directors can sell during open market windows for insiders, and they can reload the next year and start all over again. Companies should revisit this policy and create a longer-term, multiyear program that requires directors to become long-term shareholders who cannot lower the bar when the company fails to deliver value to shareholders over a multiyear compounding period.

Where does Tyco go from here?

The $10 billion CIT acquisition and its public divestiture within a 12-month period culminate Tyco's failure to create a GE clone. While we believe that IPO proceeds of $4.6 billion, added to over $4 billion in existing cash and forecasted operating cash flow of $3 billion for 2002, legitimately meet the $7.7 billion in refinancing obligations that Tyco faces between now and February 2003, investors' concerns continue to linger and Tyco's stock has not materially appreciated since the closing of this critical transaction. Investors aren't the only ones who remain wary. Despite stabilizing its balance sheet, Tyco has not yet convinced the ratings agencies that all is well. Prior to the IPO, S&P, Moody's, and Fitch all downgraded Tyco's short-term and long-term debt due to concerns regarding refinancing risk, asset securitization, and the specter of having $5.9 billion in zero coupon bonds "put" back to Tyco in the event of balance sheet deterioration. Although it would appear that many of these issues have been suppressed, the lack of upgrades of Tyco's debt status is surprising. In sharp contrast, subsequent to the IPO, CIT debt has been upgraded by both Fitch and Moody's and all indications are that S&P will do the same.

Like the ratings agencies, we remain concerned about the lack of visibility into the minutia of company operations, which contain complicated, interrelated financing structures (debt, bank lines, swaps, forward contracts). Most of these instruments require the maintenance of certain balance sheet and income statement ratios that are precarious under the current environment. Although we recognize that many of the above financial concerns assume the "worst case" scenario for Tyco financially, the fact that this scenario exists begs the question.

Timeline of iniquity

January 22, 2002 — Tyco announces a complete about-face in its historic core growth strategy with a plan to break the company into four pieces in order to "maximize shareholder value." Says Kozlowski: "We believe each will be valued substantially higher than the implied valuations it has received in recent years as part of Tyco." However, in conjunction with this new strategy, the company announces that it posted negative free cash flow in the prior quarter. Tyco then projects a gloomy outlook for 2002. The market reacts negatively to this announcement, taking the stock price down 59% over the following five weeks. Over the same period, the S&P 500 declines by 1%.

January 28 — With the public filing of the company's 2001 proxy statement, a bombshell explodes: Tyco discloses that, in July 2001, $20 million in cash payments had been made to board member Frank Walsh and his designated charity as a "finder's fee" related to the CIT acquisition. These payments were made, and accepted by Walsh, despite the fact that Walsh was the Tyco "lead director," a member of the board's corporate governance and nominating committee, and personally a substantial shareholder in CIT. Subsequently the company affirmed that these were "improper" payments.

According to the company, the board did not learn of the $20 million in improper payments made to their lead director Walsh until approximately two weeks prior to the filing of the 2001 proxy statement in January 2002. Apparently these payments were authorized by Dennis Kozlowski and made with no knowledge from any other director. Recognizing that this prospective disclosure would cause significant harm to shareholders, according to the company's press release, the board demanded a return of the cash on January 16, 2002, which Walsh allegedly refused to do. Walsh and Kozlowski were not fired at that time. Instead, the proxy was filed on January 28. As a result of this disclosure, which omitted the fact that the payments were made without board knowledge or approval, the stock value declined by approximately $17 billion in one day.

The board had 12 days to fire Walsh over this issue and immediately initiate a plan to remove Kozlowski, but it did not. Instead, the board continued to support Kozlowski and endorse what would become a series of catastrophic choices for the Tyco shareholders. This culture of blame shifting and feigned ignorance is emblematic of the disease that brings a crisis of confidence in U.S. equity investing to the front pages of virtually every publication in this country.

February — Tyco confirms that it had acquired 700 companies for $8 billion in aggregate without disclosing the acquisitions in SEC filings.

April — Tyco announces that it would abandon the value-maximizing breakup plan it had just announced in January, and posts a $1.9 billion loss.

May — Tyco announces the possible impairment of goodwill on its balance sheet from the CIT acquisition, subsequently confirmed when the company takes a $4.5 billion charge and restates previously issued financial statements for the quarter ending March 31, 2002. While these reversals of course are enough to make one's head spin, they adopt a more sinister tone when considered in the context of subsequent alarming disclosures by the company and the media regarding conflicts of interest in the boardroom.

June — Kozlowski, under criminal investigation for suspected tax evasion, resigns. *The Wall Street Journal* and *New York Times* variously report ongoing investigations into irregularities concerning the alleged use of Tyco funds relating to property transfers in Florida; unreported plane leases to a Tyco director; the exploitation of insider sales reporting loopholes that facilitated undisclosed liquidations of more than $500 million in stock by Kozlowski and CFO Mark Swartz since July 1999; and as much as $2 million annually in unreported legal fees to a board member's law firm that compensated him on a formula that was directly tied to how much Tyco business was referred to his firm. A lawsuit filed by the company against former general counsel Mark Belnick alleges that Belnick accepted $35 million in undisclosed compensation between 1998 and 2001 without approval or knowledge of the board and improperly used $14 million in Tyco funds to acquire personal residences in New York and Salt Lake and that he covered up records in order to keep this information unknown to the board.

Ignoring the personal tax evasion allegations facing former CEO Kozlowski, the remaining directors are clearly pointing the finger of blame away from themselves. The Kozlowski, Belnick, and Walsh troika may, indeed, be proven guilty in a court of law of the multiple accusations levied against them. But there should be no doubt that the entire board must both acknowledge and bear responsibility for allowing a culture of duplicity and deception to flourish in the office of the Tyco chief executive for years as a precondition for the transgressions of the others. —*Pascal Levensohn*

While the Tyco board has publicly stated that they are conducting a search for a new CEO as well as considering expanding the board, I believe that this approach avoids taking proper responsibility for their breach of public trust and fiduciary duty. It may be possible that a talented, charismatic CEO will assume the reins at Tyco and restore credibility, growth, and stability to the company. It is also possible that an infusion of new talent to the Tyco board will quiet matters down at the company and keep it off the front pages. Tyco's operating businesses appear to remain strong, and the talented managers who must exist within the company should have a chance to show their talents with the Kozlowski cloud removed. But this may take years, while Tyco shareholders have lost 77% of their equity investment value in just six months.

Ultimate redemption

By all outward appearances, the entire Tyco culture was based on legal subterfuge and duplicity, from its Bermuda offshore tax status to its oblique, though apparently generally accepted, application of accounting principles.

In my opinion, the only way the Tyco board can redeem itself is to conduct a full auction of all of its operating entities and dismantle Tyco. If there is any fundamental value in the underlying assets, it should be unlocked through this process and the net cash proceeds should be distributed to the company's shareholders. Anything less is an avoidance of responsibility for one of the greatest corporate disgraces in the history of America and strikes a blow at our public company governance system.

A revealing perspective on CEO character

During the period beginning with the hostile takeover of AMP Inc. initiated by AlliedSignal Inc. in August 1998 and culminating in AMP's "friendly" acquisition by Tyco for $11 billion in Tyco common stock in April 1999, I had the opportunity to develop some valuable insight into the very different personalities of two CEOs — Larry Bossidy of AlliedSignal and Dennis Kozlowski of Tyco — as I represented a large block of stock held by the extended family of one of the co-founders of AMP, the Hixons. It was reported in the press at the time that the shares under my representation had a market value of approximately $320 million, representing the second-largest AMP institutional shareholding.

AlliedSignal made its unsolicited all cash bid for AMP on August 4, 1998. On August 5, Alexander P. Hixon, a former director of AMP who served for seven years from the late 1980s to the early 1990s, sent a letter to the AMP board advocating that the company maximize shareholder value by negotiating with all credible and interested acquirers, including but not limited to AlliedSignal. The AMP board vigorously resisted our suggestion to negotiate, and we received emphatic, if not threatening, exhortations from Bob Ripp, at that time the AMP CEO, and certain longtime AMP directors, to abandon our position and support their attempt to fight the takeover.

Keeping the AMP board's views in mind, we chose to assert our shareholder rights independently and met with representatives of both AlliedSignal and AMP. Finally, as AMP pursued an ill-conceived Pennsylvania legislative initiative to disenfranchise its shareholders in the name of preserving its independence, we expressed our views to *The Wall Street Journal* in an article that appeared on October 5, 1998. On November 23, 1998, AMP announced that it had agreed to be acquired by Tyco.

Between August 1998 and April 1999 I had the occasion to meet privately with both Larry Bossidy and Dennis Kozlowski, and one anecdote from both meetings now bears retelling.

We met with Bossidy in New York in September 1998. Bossidy sought support from the Hixons, and we sought to facilitate a negotiation between Bob Ripp, who was outspokenly anti-AlliedSignal, and Bossidy. Among other topics, we raised the question as to whether a post-merger operating role for Mr. Ripp could exist at AlliedSignal. While Bossidy listened politely, he responded emphatically, "There is no job for Bob Ripp at AlliedSignal, and I can't manufacture one or make him believe there will be one just to get his support for a merger."

The Tyco press release of November announcing the agreed acquisition included the following statement: "Bob Ripp will serve on the Tyco Board of Directors and will continue as President of AMP. 'We are extremely pleased to have Bob and his team join Tyco's management team,' said Dennis Kozlowski."

Four months later, on April 1, 1999, we met with Dennis Kozlowski and Mark Swartz on the afternoon before the AMP acquisition was scheduled to go effective to introduce the Hixon family, AMP's longest-term shareholders, to Tyco management and get a sense of the team's vision for the future of Tyco and AMP. During the course of our 90 minutes together, Kozlowski outlined his overall business plan, described the business philosophy of the conglomerate — "we are friendly oligopolists" — and mentioned, almost as an aside, that Bob Ripp would be terminated the next morning, just prior to the moment when the acquisition went effective, as he had no operating role at the company going forward and didn't belong on the Tyco board.

It is possible that Ripp's performance during the pre-closing period caused Tyco management to reevaluate their commitment to him. It is also possible that Tyco never intended to honor this commitment. When considered in the context of the tangled web of related-party transactions, intra-board lawsuits, personal tax evasion indictments, and now criminal indictments for tampering with evidence, this example may seem largely irrelevant. But it is relevant because it implies that good faith in business dealings was in short supply at Tyco.

— *Pascal Levensohn*