Controlling the Dark Side of Relational Investing

Edward B. Rock

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ARTICLES

CONTROLLING THE DARK SIDE OF RELATIONAL INVESTING

Edward B. Rock*

TABLE OF CONTENTS

I. TALES FROM THE DARK SIDE? SOME EXAMPLES OF RELATIONAL INVESTING .......................... 990
   A. Paying Protection Money .............................................. 990
      1. Corporate Partners and Polaroid .................................. 990
      2. Some Other Examples? .............................................. 993
   B. Keeping the Relations Happy ........................................ 995
      1. Du Pont and General Motors ....................................... 995
      2. A More Recent Example? ........................................... 998

II. THE LOGIC OF RELATIONAL INVESTING .................................. 1000
   A. The Basic Incentives I: Establishing the Relationship ............. 1000
      1. Management's Perspective ........................................ 1000
      2. The Relational Investor's Perspective ......................... 1002
      3. The Shareholders' Perspective ................................... 1003
   B. The Basic Incentives II: Marriage and the Problem of Commitment .... 1004

III. CURRENT LEGAL BARRIERS TO BAD RELATIONAL INVESTING .......... 1006
   A. Delaware Law ......................................................... 1006
      1. Issuing Sweetheart Preferred ..................................... 1006
         a. When Demand is Excused ....................................... 1008
         b. Delaware's Review on the Merits .................................. 1009
      2. Continuing Payments ................................................ 1012
   B. Federal Securities Law .............................................. 1014
      1. The Up Front Payment ............................................... 1014
      2. Continuing Payments ................................................ 1015
   C. Federal Antitrust Law ................................................ 1017

IV. ALTERNATIVE/ADDITIONAL STRATEGIES ................................ 1021
   A. Preventing the Payoffs ............................................... 1022

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INTRODUCTION

This season's candidate for shareholders' champion is the "relational investor." If only more investors would take large positions and then carefully and patiently work with managers to maximize long-term value, corporations would thrive, takeovers would be unnecessary, and we would grow rich or at least richer. Others have focused on the possibilities and patterns. In this Article, I focus on some of the problems.

Relational investing can be divided into three broad types. In the first type, an investor acquires a large (for example, 9.5%) interest in the firm and then, through patient and wise counseling and "continuous and textured monitoring," improves the management of the firm, profiting along with the other shareholders. I am sure that this sometimes happens, and I will refer to this type of investing as "good" or "virtuous" relational investing. In this context, one can think of


2 See, e.g., Monks, supra note 1; Pound supra note 1.

3 John C. Coffee, Jr., James R. Gillen, Ronald J. Gilson, & Lewis Lowenstein, Prospectus 5 Columbia Conference, supra note 1.
Pierre du Pont, when the Du Pont Company owned 23% of an ineptly managed General Motors. Du Pont became president of GM, replaced its management, reorganized it, and saved the firm—to the ultimate profit of both the du Pont family and the other shareholders. More recently, one thinks of how Warren Buffett, who owns 11% of Salomon, Inc., moved to New York to reorganize and possibly save Salomon after the Treasury auction scandal.

But I am a lawyer: I think about what can go wrong, and what, if anything, can be done about it. I therefore worry about a second and third type of relational investing. In the second version, an investor acquires a large (for example, 9.5%) interest in the firm at a discount in exchange for protecting incumbent managers from displacement or, more generally, from threats to their autonomy. In this second type, the relational investor profits from providing protection, while the other shareholders lose.

In the third type, the relational investor uses its substantial investment not to protect managers or improve management, but to advance its own business, i.e., by securing favorable contracts with the firm. The effects of this third kind of relational investing on shareholders and society are more ambiguous.

I will refer to these last two types of relational investing as “bad” or “corrupt” relational investing. Just as one can identify cases that look like good relational investing, one can also find cases that look suspiciously like bad relational investing. The promises and pitfalls of relational investing derive from these different possibilities. If the good sort of relational investing can be encouraged, while the bad sort is limited, shareholders—the principal beneficiaries of traditional corporation law—will benefit. If not, relational investing may do nothing more than increase agency costs.

Part I describes a number of examples of relational investing that suggest some of its potential pathologies. Part II abstracts from these stories, examining the competing incentives for virtue and vice, as well as some of the specific commitment problems that the corrupt relational investor must solve in order to make vice possible. Part III analyzes the existing and rather toothless legal controls over corrupt relational investing, examining Delaware corporate law, federal securities law, and federal antitrust law. Part IV examines, in a preliminary fashion, alternative approaches to controlling corrupt relational investing. I focus both on strategies that one might adopt to prevent the payment of protection money, and, more interestingly, strategies

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for indirectly undermining corrupt relational investing by under­
mining the relational investor’s ability to make credible commitments.
My preliminary conclusion is that much can go wrong with relational
investing, and little can be done to lessen the risks.

I. TALES FROM THE DARK SIDE? SOME EXAMPLES OF
RELATIONAL INVESTING

A. Paying Protection Money

Consider this problematic scenario: In exchange for buying a
large block of specially tailored preferred stock at a low price (what I
will refer to as “sweetheart preferred”), a relational investor agrees to
protect incumbent management from a hostile takeover or other
outside interference with business as usual. In this regard, consider
the following examples.

1. Corporate Partners and Polaroid

In the spring of 1988, at a time when Polaroid stock was trading
for between $30 and $35 per share, Shamrock Holdings, Inc. (“Sham­
rock”) accumulated slightly less than 5% of Polaroid’s stock. In
June, Shamrock contacted Polaroid in an effort to arrange a meeting
to “establish the ground work for a good relation s hip with the
company.”

To “protect” Polaroid’s shareholders from an anticipated tender
offer from Shamrock, the Board of Directors erected a number of de­
fenses. First, in July 1988, Polaroid established an Employee Stock
Ownership Plan (“ESOP”) which purchased 14% of its shares. Second,
Polaroid began to plan a share repurchase. Finally, Polaroid
searched for a friendly “white squire” to buy a block of Polaroid
shares.

In September 1988, Shamrock commenced a tender offer, offer­
ing $42 per share in cash for all outstanding shares of Polaroid’s com­
mon stock, conditioned upon the tendering of 90% of the shares and
judicial invalidation of the ESOP. Shamrock subsequently increased
its tender offer to $45 per share, and promised to raise the offer to $47

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(CCH) ¶ 94,340, at 92,217 (Mar. 17, 1989) [hereinafter Polaroid II]. See also Shamrock Hold­
ings, Inc. v. Polaroid Corp., 559 A.2d 257 (Del. Ch. 1989) (the Chancery Court opinion ap­
proving the ESOP) [hereinafter Polaroid I].
7 Id. at 92,217-19.
8 Id.
9 Id. at 92,217.
per share if the ESOP shares were declared invalidly issued.\(^{10}\) Polaroid’s board determined that Shamrock’s offers were “inadequate,” in part because they did not adequately reflect the value of pending patent infringement litigation with Kodak.\(^{11}\)

After Polaroid established its ESOP and while it was planning its share repurchase, Corporate Partners, an investment fund managed by Lazard Frères & Co., entered the picture. According to its promotional literature, Corporate Partners was in the business of protecting management from hostile tender offers:

The fund has been organized to make friendly investments, usually by taking large minority equity positions of approximately 10% to 30% in publicly held companies which could benefit from the presence of a large, supportive shareholder.

\* \* \*

The fund will provide two things: (1) an infusion of capital . . . and (2) a block of voting securities in the hands of one sophisticated entity which will support management and the board of directors.

\* \* \*

Corporate Partners is also able to provide insulation from market operators and hostile acquirors . . . .\(^{12}\)

During the fall of 1988, Polaroid, through its investment banker Shearson Lehman Brothers Inc., entered into negotiations with Corporate Partners and a number of other potential investors. According to Shearson, discussions broke down with one investor because it wanted a 40% interest in Polaroid, and with another because it was skeptical about Polaroid’s business plans.\(^{13}\) On January 30, 1989, Polaroid sold $300 million of special preferred stock to Corporate Partners and its investment partners.\(^{14}\)

Polaroid issued two special series of preferred stock to Corporate Partners: $100 million of Series B Cumulative Convertible Preferred Stock with annual cumulative cash dividends of 11%; and $200 million of Series C Cumulative Convertible Preferred Stock with annual cumulative payment-in-kind dividends of 11.5%.\(^{15}\) In addition, Polaroid issued seven-year warrants for 635,000 shares of common stock, exercisable at $50 per share (Polaroid’s self-tender price).\(^{16}\)

Both series of preferred stock had the right to vote with the com-

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\(^{10}\) \textit{Id.} at 92,217-18.

\(^{11}\) \textit{Id.}

\(^{12}\) \textit{Id.} at 92,216-17 (quoting Corporate Partners’ promotional literature).

\(^{13}\) \textit{Id.}

\(^{14}\) \textit{POLAROID CORP., NOTICE OF 1989 ANNUAL MEETING OF STOCKHOLDERS AND PROXY STATEMENT (Apr. 28, 1989), available in WESTLAW, SEC-Online file, at *10.}

\(^{15}\) \textit{Id.}

\(^{16}\) \textit{Id.}
mon stock and, in aggregate, represented just under 10% of the votes. As part of the purchase, Corporate Partners agreed to a number of restrictions. Specifically, Corporate Partners agreed not to
(i) deposit any voting securities in a voting trust, (ii) solicit proxies
or become a participant in a proxy solicitation, (iii) form a group
for the purpose of acquiring, holding, voting or disposing of voting
securities or (iv) otherwise act, alone or in concert with others, to
seek to affect or influence control of the Company. Moreover, Corporate Partners agreed not to sell its shares to a third party (though it apparently retained the right to tender into a Shamrock offer).

The preferred stock contained both put and call provisions. Polaroid had the option of calling both classes in seven years in cash at par. Polaroid could call the preferred early in the event of a final judicial determination or settlement of the Kodak litigation. In the event that someone other than Shamrock acquired control of Polaroid, Corporate Partners had an option to sell the shares back to Polaroid at a price reflecting an annual rate of return of 28-30%. Finally, Corporate Partners had the right to name two directors.

In March 1989, after Polaroid had placed 14% of its shares in an ESOP, 10% of its shares with Corporate Partners, and had launched an $800 million self-tender (16 million shares at $50 per share), Shamrock abandoned its takeover bid and negotiated a peace treaty. Shamrock and Polaroid agreed that Shamrock would withdraw its tender offer and proposed proxy contest, agree to a ten-year standstill, and withdraw all pending litigation, in return for Polaroid’s promise to distribute to shareholders a portion of its proceeds from the Kodak litigation and a payment of $25 million ($20 million as reimbursement of expenses and $5 million as a nonrefundable advance payment for radio and television advertising time on Shamrock’s affiliated radio and/or television stations). After the agreement was announced,

\[17 \textit{Id. at} *3.\]
\[18 \textit{Id. at} *10.\]
\[19 \textit{Id}.\]
\[20 \textit{A “put” permits its holder to sell a certain stock or commodity at a fixed price for a stated quantity and within a stated period. A “call” is the reverse—permitting its holder to purchase. BLACK’S LAW DICTIONARY 1237 (6th ed. 1990).}\]
\[22 \textit{Id}.\]
\[23 \textit{Polaroid Corp., supra note 14, at} *10.\]
\[24 \textit{Id. at} *11.\]
\[25 \textit{Id}.\]
Polaroid stock dropped $4.50, to $36 per share.\textsuperscript{26}

On October 7, 1991, just over two and one-half years after Corporate Partners purchased preferred stock for $300 million, Polaroid bought it all back for $420 million ($280 million in cash and $140 million in convertible subordinated debentures).\textsuperscript{27} Adding to this the nearly $30 million in dividends that were due quarterly in cash on the Series B preferred stock, Corporate Partners' profit on its $300 million investment approached $150 million, an annual return of nearly 20%. The new issue of subordinated debentures is convertible into common stock at a price of $32 per share, giving Corporate Partners potential control over 8.1% of Polaroid's shares.\textsuperscript{28} Immediately prior to the September 1991 announcement that Polaroid would buy back the preferred stock, Polaroid traded at $24.875 per share.\textsuperscript{29}

2. Some Other Examples?

Corporate Partners' investment in Polaroid is not an isolated example of sweetheart preferred. In the 1980s, Warren Buffett was Corporate Partners' chief competitor as management's savior. In 1987, Salomon faced a bid for control from Ronald Perelman.\textsuperscript{30} Salomon was vulnerable because its stock had dropped and, more troubling, Minorco had publicly disclosed that it wanted to sell its 14% block of common stock.\textsuperscript{31} To "protect" itself, Salomon bought back the Minorco block at a premium above market value, and then turned around and sold Buffett a new issue of special preferred stock carrying 12% of the votes for $700 million.\textsuperscript{32} A rather skeptical commentator estimated that on the open market, the preferred, which receives a dividend of 9% per year plus the same opportunity for gains as the


\textsuperscript{27} POLAROID CORP., PROXY STATEMENT (Mar. 30, 1992), available in WESTLAW, SEC-Online file, at *4.

\textsuperscript{28} Id. at *4-5.

\textsuperscript{29} Barnaby J. Feder, Polaroid to Buy Back Fund's Large Holding, N.Y. TIMES, Sept. 13, 1991, at D3. Corporate Partners has continued in the business of relational investing. In June 1990, it bought (at a discount) a 13% stake of newly issued common stock of First Bank System, a Minneapolis bank, and entered into an agreement not to engage in a proxy fight or sell more than a 5% stake to another investor. See Stephen E. Clark, A Big Equity Stake, Well Done, INSTITUTIONAL INVESTOR, Sept. 1991, at 178. Corporate Partners' subsequent investments (in Transco, Albert Fisher, Continental Cablevision, and First Bank Systems) have departed from the Polaroid model. While often involving special issues of preferred stock with restrictions, they did not arise in the context of a contest for control.


\textsuperscript{31} James Sterngold, Salomon to Sell 12% to Buffett, N.Y. TIMES, Sept. 28, 1987, at D1.

\textsuperscript{32} SALOMON, INC., 1987 ANNUAL REPORT (1988), available in WESTLAW, SEC-Online file, at *34; Sterngold, supra note 31.
common shareholders, would have sold for between $850 million and $1.2 billion.\textsuperscript{33}

In 1989, Buffett made similar “off market” investments. In July, Gillette, faced with takeover attempts by Ronald Perelman and Coniston Partners, sold Warren Buffett $600 million worth of a special convertible preferred stock issue carrying 11% of the votes, a dividend of 8.75%, and most of the upside potential of common stock.\textsuperscript{34} In August, USAir, another firm in play, sold Buffett $358 million worth of newly issued convertible preferred stock that carried with it a 9.25% dividend and the right to vote 11%.\textsuperscript{35} In December, Champion International, in the wake of hostile tender offers in the paper industry, sold Buffett $300 million of a new special issue of preferred stock with a 9.25% dividend and 8% of the votes.\textsuperscript{36} Unlike standard convertible preferred stock, these issues were mostly nonsalable.\textsuperscript{37} They differed in another respect from standard convertible preferred as well: they all voted on a fully converted basis.\textsuperscript{38} These negotiated purchases of preferred stock stand in stark contrast to Buffett’s traditional practice of establishing relationships by assembling large blocks in open-market transactions.\textsuperscript{39}

\textsuperscript{33} Lewis, supra note 30, at 22. Louis Lowenstein countered that the price Buffett paid represented the full value of the Salomon shares absent the takeover premium that disappeared with Perelman (Comment by Lewis Lowenstein on a draft of this Article).

\textsuperscript{34} Gillette Co., 1989 ANNUAL REPORT (1990), available in WESTLAW, SEC-Online file, at *17-18; Alison L. Cowan, Gillette Sells 11% Stake to Buffett, N.Y. TIMES, July 21, 1989, at D1.

\textsuperscript{35} Berkshire Hathaway Inc., 1989 ANNUAL REPORT (1990), available in WESTLAW, SEC-Online file, at *33; Kurt Eichenwald, Buffett’s Stake in USAir Seen as Takeover Move, N.Y. TIMES, Aug. 8, 1989, at D2.

\textsuperscript{36} Berkshire Hathaway, supra note 35; Jonathan P. Hicks, Champion Sells Berkshire 300,000 Shares, N.Y. TIMES, Dec. 7, 1989, at D4.

\textsuperscript{37} Berkshire Hathaway, supra note 35, at *18; USAIR, 1989 ANNUAL REPORT, available in WESTLAW, SEC-Online file, at *108-09.

\textsuperscript{38} Berkshire Hathaway, supra note 35, at *18. As Buffett put it, the managers of these companies have demonstrated some confidence in us, insisting in each case that our preferreds have unrestricted voting rights on a fully-converted basis, an arrangement that is far from standard in corporate finance. In effect they are trusting us to be intelligent owners, thinking about tomorrow instead of today, just as we are trusting them to be intelligent managers, thinking about tomorrow as well as today.

\textsuperscript{39} See, e.g., General Food Shares Bought, N.Y. TIMES, Feb. 20, 1981, at D4 (Buffett discloses acquisition of 5.2% interest in General Foods); Robert J. Cole, Coke Says Buffett Has 6.3% Stake, N.Y. TIMES, Mar. 16, 1989, at D1 (Buffett acquired stake over eight or nine months); Buffett Acquires 5.8% Rorer Stake, N.Y. TIMES, Apr. 7, 1990, at D3 (Buffett disclosed that he has amassed a 5.8% stake); Buffett Acquires 9.8% of Wells Fargo Shares, N.Y. TIMES, Oct. 25, 1990, at D4 (Buffett disclosed that he purchased control of 9.8% of the company); Buffett Lifts Stake in Wells Fargo to 10.75%, N.Y. TIMES, Aug. 13, 1992, at D6 (Buffett increased stake by buying shares worth about $41.5 million); Buffett’s Firm Increases Stake in
A few other examples: In 1989, General Electric Capital Corporation bought $28 million of a special issue of 10% preferred shares from Dunkin' Donuts Inc. in the face of a tender offer.\(^4\) Diamond Shamrock defeated a hostile partial tender offer by T. Boone Pickens in early 1987 by selling a $300 million issue of special preferred shares to Prudential.\(^4\) Prudential played the same role for Phillips-Van Heusen.\(^4\) The intuition that relational investors who purchase special issue preferred stock profit at the expense of the common stockholders is consistent with recent empirical work.\(^4\)

B. Keeping the Relations Happy

Another problematic scenario: The relational investor acquires a large block of stock in the firm, perhaps on the open market, and designates a number of directors. Everyone now understands that the relational investor has the power to replace incumbent managers if it becomes unhappy with their performance. Shortly thereafter, the relational investor becomes one of the firm's largest suppliers, outpacing all competitors in securing the firm's business.

1. Du Pont and General Motors

The Du Pont Company's\(^4\) investment in General Motors ("GM") provides, for some, an attractive model for corporate governance—a potential alternative to the Berle & Means corporation.\(^4\)

\(^4\) Laura Jeresi, Enter the Core Investor—no Cheers and Boos, Bus. Wk., Sept. 18, 1989, at 104.


\(^4\) In keeping with Chandler and Salsbury's practice, I will use "Du Pont" to refer to the company and "du Pont" to refer to the family and its members.

\(^4\) See LOUIS N. LOWENSTEIN, SENSE & NONSENSE IN CORPORATE FINANCE 211-17
The story is well known, but worth summarizing. In 1917, Du Pont acquired about 23% of GM stock at a time when GM was a distant second in the automobile industry. At the same time, Pierre du Pont, then Chairman of the Board of Du Pont, also became Chairman of the Board of GM. By the end of 1920, after a badly managed postwar expansion and a significant recession, GM was on the brink of bankruptcy. At that time, Pierre du Pont, who had withdrawn from active management of Du Pont in 1919, became President of GM. During the next two and one-half years, he devoted himself full-time to reorganizing and restructuring GM, turning over the presidency to Alfred P. Sloan, Jr., in May 1923. By 1928, GM had replaced Ford as the leading American automobile company.

From one perspective, this seems to be the paradigm of good relational investing. A large shareholder, by virtue of its holdings in the firm, actively monitors managers and, when necessary, steps in to replace bad managers and to reorganize the firm. Pierre du Pont's scrutiny of GM was an example of “continuous and textured monitoring.”

But even in this paradigm case, there is more to the story. Du Pont's holdings of GM gave rise to a major antitrust case, leading to forced divestiture. The courts' opinions describe a different, and potentially more troubling, aspect of the relationship.

Pierre du Pont and his long time business associate and the treasurer of Du Pont, John Raskob, first invested in GM in 1914, becoming directors in 1915. In 1917, when Raskob recommended that Du Pont acquire a significant interest in GM, his memo identified two principal reasons. Not only would the investment be profitable, but also “our interest in the General Motors Company will undoubtedly secure for us the entire Fabrikoid [an artificial leather], Pyralin, paint and varnish business of those companies, which is a substantial factor.”

Beginning with the 1917 purchase of GM stock, Du Pont set about increasing its sales to GM. From the beginning, the Du Pont...
people at GM kept tabs on the amount of GM business going to Du Pont and the amounts placed with Du Pont's competitors. The most prominent example was J. A. Haskell, the former sales manager and vice president of Du Pont, who became GM's vice president in charge of the Operations Committee, a director, and a member of GM's Executive Committee. Haskell openly set about gaining the maximum share of GM's sales for Du Pont, setting up lines of communication within GM to keep him, and, through him, Du Pont, informed of GM's purchases. As part of this effort, Haskell wrote letters to GM divisions directly inquiring into the extent to which they were purchasing their requirements from Du Pont.

By 1920, Pierre du Pont, then President and Chairman of the Board of GM, was able to report to his brother, Lammot du Pont, Vice President of Du Pont, that Du Pont had secured the lion's share of GM's business from four of GM's divisions. Du Pont predicted "that with the change in management at Cadillac, Oakland, and Oldsmobile,' he thought Du Pont should be able to sell substantially all the paint, varnish and fabrikoid products needed, further, he thought a 'drive for the Fisher Body business' should be made." The contrast between GM's purchasing and Fisher Body's purchasing is striking. While GM owned 60% of the stock of Fisher Body, a voting trust gave the Fisher brothers broad powers of management; they insisted on running their own show. For years, they withstood pressure from high-ranking Du Pont and GM executives to switch to Du Pont. Even after GM acquired 100% of Fisher in 1926, they still had sufficient power to resist. By the late 1940s, however, even Fisher Body had fallen into line.

The government presented no evidence of any formal agreement between GM and Du Pont whereby GM would buy from Du Pont. Indeed, the trial court recounted instances when GM purchased from Du Pont's competitors. Yet, the evidence is clear that high-ranking executives of General Motors who were part of the Du Pont group, like Haskell, made constant inquiries and reviews of GM's purchases. This sort of open scrutiny by representatives of the dominant shareholder likely made a substantial impact on purchasing managers. As the Supreme Court noted, "[i]t would be understandably difficult for them not to interpret it as meaning that a preference was to be given to Du Pont products." For the Supreme Court,

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51 Id.
52 Id.
53 Id. at 270.
54 Du Pont (GM), 353 U.S. 586, 603 (1957).
The fact that sticks out in this voluminous record is that the bulk of Du Pont's production has always supplied the largest part of the requirements of the one customer in the automobile industry connected to Du Pont by a stock interest. The inference is overwhelming that Du Pont's commanding position was promoted by its stock interest and was not gained solely on competitive merit.\(^{55}\)

The *Du Pont (GM)* case provides an illustration of how relational investing *could* be used to enrich the relational investor through preferential contracts, rather than to enrich the shareholders as a whole through improved management. But the evidence from that case suggests that whatever drove the relationship in its early years, it is unlikely that fabric and finish contracts drove it by the time of the antitrust action. When the government's case was filed in 1947, Du Pont's interest as the owner of 62 million shares was worth approximately $2 billion, while it supplied only about $22 million per year in fabrics and finishes.\(^{56}\)

Moreover, a private suit was filed by minority shareholders of GM in the wake of the Supreme Court's decision, alleging that Du Pont violated sections 1 and 2 of the Sherman Act, section 7 of the Clayton Act, and its fiduciary duties to GM, by using its stock interest to displace competition in fabrics and finishes between 1950 and 1959.\(^{57}\) After a bench trial, the trial court rejected plaintiffs' claims, holding that Du Pont "did not, by reason of its stock ownership, control the purchases by General Motors of finishes [and fabrics] from du Pont, and it did not insulate General Motors from competition in this line of commerce during the years 1950-1959."\(^{58}\) Indeed, applying Delaware law, the trial court held that Du Pont's sales to GM met the entire fairness standard: the sales and purchases resulted from competitive conditions, they were at competitive prices, and of competitive quality.\(^{59}\)

### 2. A More Recent Example?

In early 1989, Transco Energy Company, an oil and gas concern, sold Corporate Partners $125 million of a special issue of 9.25% convertible preferred stock entitled to vote with common stock, repre-
senting 9% of the votes,60 in connection with Transco's acquisition of Texas Gas Transmission Corp. (a natural gas pipeline system being auctioned by CSX Corp.).61

Over the subsequent months, Transco and related entities paid Lazard Frères the following fees: in May 1989, $937,500 plus expenses for financial advisory services in connection with the private placement of the 9.25% preferred as well as $3,500,000 for investment banking services in connection with the acquisition of Texas Gas; in August 1989, $707,441 plus expenses for financial services in connection with the sale of certain onshore oil and gas properties; and in September 1989, $8,048,455 plus expenses in connection with the sale of certain other assets, and another $500,000 in connection with other asset sales.62

Subsequently, in 1990, Transco engaged Lazard as its agent in the sale of a natural gas field in Louisiana for a fee of .66% of the ultimate sales price.63 In June 1992, that property was sold for $82 million,64 resulting in an additional fee of $541,200 for Lazard. Thus, from 1989 through 1992, Lazard received $14,234,596 in investment banking fees (plus expenses) from its involvement with Transco.

One does not know whether Corporate Partners’ investment in Transco led to the Lazard assignment, whether Lazard’s long-time representation of Transco led to the Corporate Partners investment, or whether the events were entirely unrelated. Corporate Partners maintains that they were unrelated.65 But the Transco/Lazard/Corporate Partners relationship effectively illustrates the potential for using investment banking fees to keep a relational investor happy. Perhaps it is a recognition of this difficulty that has led Ali Wambold (co-Managing Director of Corporate Partners and a partner in Lazard) to maintain that “the Corporate Partners fund is completely separate from Lazard’s investment banking business . . . to prevent potential conflicts of interest.”66

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61 W. David Gibson, Selling a Friendly Stake, INSTITUTIONAL INVESTOR, Mar. 1990, at 93.
63 Id. at *30.
65 Personal communication with Lester Pollack, Sr. Managing Director, and Jonathan Kagan, Managing Director of Corporate Partners, June 23, 1993.
66 Rosalyn Retkwa, White Squire Can Help You Make it Through the Knight, CORP. CASHFLOW, Mar. 1990, at 10.
II. THE LOGIC OF RELATIONAL INVESTING

These examples suggest the possibility that sometimes relational investing may be corrupt rather than virtuous. Before turning to existing and potential legal responses to bad relational investing, one needs to focus on the structure of the relationship between relational investors and managers. The following subsection focuses on the incentives in the formation of the relationship. The next subsection focuses on the incentives once the relationship has been established.

A. The Basic Incentives I: Establishing the Relationship

Consider the following stylized fact pattern. Let us assume that Relational Investor ("RI"), an investment fund specializing in relational investing, is considering acquiring a 9.5% interest in Managerial Inc. ("MI"), a heretofore management dominated corporation. Consider the prospect from the various perspectives: the perspective of MI's managers; RI's perspective; and the perspective of the other shareholders of MI.

1. Management's Perspective

How managers might greet the prospect of RI's arrival will depend on a number of factors. If their control over MI is secure, one might expect managers to be rather hostile to the idea of RI acquiring a block sufficiently large to jeopardize their independence. Indeed, if RI is likely to threaten managers, either by criticizing managers' decisions, blocking managers' plans, limiting managers' compensation or expenditures on perquisites, or seeking to displace managers, managers are likely to offer vigorous resistance to RI's arrival.67

67 Past experience teaches that unhappy relational investors can make life miserable for managers. Recall the difficult relationship between Chris-Craft Industries and Warner Communications in the years after Chris-Craft acquired a 19% interest in Warner in helping Steven Ross resist a 1983 takeover attempt by Rupert Murdoch. See e.g., Wolfgang Saxon, Deal Ends Murdoch's Fight to Take Over Warner, N.Y. TIMES, Mar. 18, 1984, at 33; Alex S. Jones, Chris-Craft Gets 19% of Warner, N.Y. TIMES, Jan. 19, 1984, at D1.


See also Robert J. Cole, Chris-Craft and Warner, N.Y. TIMES, May 10, 1985, at D6 (Steven Ross and Herbert Siegel are "working on 'a complete divorce'"); Robert J. Cole, Concession to Chris-Craft on Warner, N.Y. TIMES, May 6, 1989, at 35 (Time and Warner "willing to concede that Warner had violated a contract with Chris-Craft" and "asked the Delaware Chancery Court to order Chris-Craft to decide what it wants in return"); Geraldine Fabrikant, Chris-Craft Gains Seats, N.Y. TIMES, Feb. 8, 1986, at 34 (Chris-Craft ends up with 6 of 16 seats on Warner's board); Warner Blocked by Judge in $1.2 Billion Lorimar Bid, N.Y. TIMES,
But if sharks are circling, that is, if there is some reason to believe that the firm is in play or that a group of shareholders has organized sufficiently to threaten managers’ autonomy, the arrival of RI may be more welcome. If RI offers to protect managers from being displaced in a hostile tender offer or from other threats to their autonomy, managers may not only welcome RI, but may be willing to pay a significant amount of the corporation’s money to encourage RI to come aboard.

The extent to which a relational investor can offer protection depends on the nature of the threat. Managers of RI can face threats from at least three directions: hostile tender offers; proxy fights; and organized shareholders exerting their influence through internal corporate channels, including the board of directors, shareholder proposals, corporate elections, and other informal means. Because of the way that Delaware law has developed, relational investors have recently been able to offer the greatest protection from hostile tender offers, but much less protection from other threats.

In this connection, section 203 of the Delaware Corporate Law provides a crucial piece of the puzzle. Enacted in 1987 in the wake of the United States Supreme Court’s decision in *CTS Corp. v. Dynamics Corp. of America* (*CTS*), section 203 prohibits a hostile bidder from engaging in any “business combinations” with the target for three years unless it acquires 85% of the shares in the transaction that takes it over the 15% threshold. Such a delay seriously interferes with tender offer financing, as well as with paying down acquisition debt by selling assets of the target, and therefore provides a substantial impediment to hostile tender offers. The effect of section 203 is that, as a practical matter, a friendly nonmanagement shareholder holding 10% or so can go a long way towards blocking any hostile tender offer.

But if the threat to managers comes from elsewhere, a 10% shareholder cannot provide managers with as much protection. If, for example, a bidder combines a tender offer with a proxy fight, holding

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Recall, also, GM management’s experience with Ross Perot. See, e.g., *Grobow v. Perot*, 539 A.2d 180 (Del. 1988). After Perot became the largest shareholder of GM, he became increasingly critical of GM’s management; GM ultimately repurchased his shares. *Id.*


out the promise to shareholders of a substantial premium if they replace incumbent directors with a new slate committed to permitting a bid to go forward, a relational investor will no longer have a blocking position. In this situation, the 85% requirement of section 203 will be avoided if the shareholders elect a new set of directors who approve the “business combination” or the tender offer before the bidder becomes an “interested shareholder,” i.e., before the bidder crosses the 15% threshold.

Similarly, a relational investor cannot protect managers from the threat posed by organized and dissatisfied shareholders. To the extent that shareholders exert their influence internally, putting a 10% block of shares in the hands of a friendly relational investor will provide only limited protection.

This simplified analysis suggests that managers will be most likely to seek out friendly relational investors when (a) they are threatened, (b) that threat comes from a hostile tender offer, (c) a friendly relational investor can block a hostile tender offer, and (d) better alternatives are not readily available. Indeed, one is struck by the relatively large number of relationships established in the period between the enactment of Delaware section 203 in 1987 and the decline of the hostile tender offer at the end of the decade.

2. The Relational Investor’s Perspective

Now, consider the prospect of investing in MI from the relational investor’s perspective. Whether or not it is an attractive investment prospect will depend on the costs, benefits, and risks. In the good scenario, where RI determines to acquire its interest by buying 9.5% in the market, and thereafter uses its stock position to improve management of the firm, RI’s returns will depend solely on how much the returns on the stock will improve by virtue of the improved management, and how likely it is that RI will succeed in improving the management or bringing in new management. Central to RI’s calculation will be the fact that RI, as a shareholder, will get only its pro rata share (9.5%) of any improvement in the firm’s fortunes, while it will bear 100% of its costs of monitoring and disciplining.

But, if managers are willing to pay protection money, that is, to pay RI directly or indirectly to protect them from interference, the calculation fundamentally changes. In addition to whatever increase in value might arise from improved management, RI now can expect 100% of any direct or indirect payments. Similarly, if RI can expect to increase significantly its sales or profit margins to MI by virtue of
its stock interest, those additional profits must be added to the potential returns on the investment in calculating overall returns.

Here, we come to the crux of the problems posed by relational investing. From an economic perspective, RI will be indifferent between gains from improved management, gains from direct or indirect payoffs, and gains from increased sales or profit margins. Whichever has the highest net present value will be the most attractive. But there are three factors that make it substantially more likely that profiting from protection payments, when offered, or expanded sales or increased margins will dominate good relational investing. First, RI will only receive a pro rata share of the gains from improved management while it will receive all of the protection money and all of the profits from increased sales or increased profit margins. Second, improving management can be costly and RI will bear all of its costs. Third, the gains to RI from improved management are far more speculative than gains from either a protection payment, expanded sales, or increased margins. There is precious little evidence that relational investing significantly improves performance, much less that the magnitude of the gains makes relational investing economically attractive. However savvy a relational investor, it is hard to imagine relational investing earning the 20% annual return that Corporate Partners received on its “investment” in Polaroid.

3. The Shareholders’ Perspective

But, while relational investors will be indifferent to the sources of their gains, other shareholders will not be. In the first scenario, where RI’s efforts improve the quality of management, gains from improved management benefit shareholders pro rata, while RI bears the cost. As such, from the shareholders’ perspective, good relational investing is an undiluted pleasure, a free ride.

In the second scenario, when managers seeking insulation from threats to their control make direct or indirect payments to RI for protection, the other shareholders lose. Such payments add directly

71 For an optimistic recent survey of the empirical evidence that still finds only modest support for the view that monitoring by large shareholders improves corporate performance, see Bernard S. Black, The Value of Institutional Investor Monitoring: The Empirical Evidence, 39 UCLA L. REV. 895, 917-27 (1992). See also Gordon & Pound, supra note 43.

72 This fundamental conflict of interest between relational investors and other shareholders makes one wonder what drives the relational investing observed abroad, namely, Japanese keiretsu and German universal bank dominated governance structures. Specifically, one wonders how relational investors in those systems benefit: Does their profit come in the form of higher stock prices, or higher dividends from better management, or in a stream of fees for banking or other services? See, e.g., John C. Coffee, Jr., Liquidity Versus Control: The Institutional Investor as Corporate Monitor, 91 COLUM. L. REV. 1277, 1294-1306 (1991).