Directors Cut

H-P Board Clash Over Leaks Triggers Angry Resignation

Perkins Slams Briefcase, Says, 'I Quit and I'm Leaving,' As Probe Fingers a Friend

A New Era of Governance

By Alan Murray

A year and a half after Carly Fiorina was pushed out as chairman and chief executive of Hewlett-Packard Co., the aftershocks of that firing continue to shake the computer company's board of directors.

The latest eruption came at a meeting on May 18, when the board reviewed the results of an extensive investigation into press leaks that was undertaken by new board Chairman Patricia Dunn shortly after Ms. Fiorina departed. The report, which relied in part on private telephone records, fingered George Keyworth, a longtime director and former science adviser to President Reagan, as the source of many of the leaks about board deliberations. A boardroom showdown ensued, during which the board voted to ask Mr. Keyworth to resign, and he refused, saying he was elected by the shareholders. Venture capitalist Tom Perkins, a friend of Mr. Keyworth, quit the board on the spot in anger.

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In the weeks since that meeting, Mr. Perkins has told business associates of the event, and also provided information to the Securities and Exchange Commission, prompting that agency to launch a probe into the matter. He is particularly concerned that the investigation involved the search of board members' private telephone records, and has questioned the legality of that practice.

In response, the Hewlett-Packard board plans a filing with the SEC today. Among other things, that report will say that Mr. Keyworth will not be nominated for reelection to the board at its annual meeting next March.

While full details of H-P's internal probe remain unclear, it appears to involve a controversial practice known as "pretexting." Under the practice, public investigators apparently call the phone company, and use personal information to falsely represent themselves as another person, in order to obtain that person's records.

Tom Perkins

H-P board members say the investigation was done by an outside contractor to the company, retained by another outside contractor. Those contractors continue to insist they used only legal methods to obtain the phone records. But some H-P board members acknowledge feeling uncomfortable with the methods used.

Viet Dinh, an attorney for Mr. Perkins, said in a statement that Mr. Perkins "resigned because of a disagreement about H-P's governance practices. The company for the past months has refused to disclose the substance of the disagreement, and Mr. Perkins is pursuing all appropriate remedies."

"The situation is regrettable," Ms. Dunn said in a statement. "But the bottom line is that the board has asserted its commitment to upholding the standards of confidentiality that are critical to its functioning. A board can't serve effectively if there isn't complete trust that what gets discussed stays in the

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room."

The story reflects a new era in the way American corporations are run. A few years ago, most boards of directors were clubby affairs, run by the chief executive, filled with members chosen by the chief executive, and likely to intervene only in times of crisis. Today, as a result of a host of changes that cascaded out of the corporate scandals earlier this decade, boards have become more powerful and more independent than ever. The Hewlett-Packard story shows many of them are still struggling to operate smoothly in this new environment.

Mr. Keyworth couldn't be reached for comment. Ms. Fiorina plans to tell her version of events in a book being published next month. This account is based on interviews with several of the people directly involved.

The confrontation at H-P has its roots in November 2004, when independent members of the board met in executive session, without Ms. Fiorina present, and discussed their concerns over her leadership. At the time, H-P's stock was performing poorly compared with shares of rivals such as Dell Inc. and International Business Machines Corp. Mr. Keyworth, a director since 1986, suggested the board bring back Mr. Perkins, who had left a year earlier because he had reached the board's mandatory retirement age of 72.

Mr. Perkins is a storied figure in Silicon Valley, having helped start one of the first venture-capital firms there, Kleiner Perkins Caufield & Byers. He worked for H-P in the 1960s, and joined the company's board in 2002 after it merged with Compaq Computer, where he had been a director. Once married to romance novelist Danielle Steel, Mr. Perkins recently wrote a racy novel of his own titled "Sex and the Single Zillionaire."

When told of the board's plans to bring back Mr. Perkins, Ms. Fiorina resisted, according to board members. Frequently lauded as the nation's leading female business executive, Ms. Fiorina was known for her marketing skill, but inside H-P she had a reputation for flashes of arrogance. She didn't like the idea of waiving the retirement age, and felt that if Mr. Perkins were to return, the board should wait until its annual meeting the following March. But Mr. Keyworth was particularly insistent, and Mr. Perkins was invited to attend the board's annual strategy session in January 2005, although he wasn't yet a director.

Unknown to Ms. Fiorina, Mr. Perkins also participated in a series of phone calls and email exchanges in December 2004 and January 2005. During the calls, some board members began to articulate their concerns over her management, according to people who participated.

In an interview late last year, Mr. Perkins said he didn't know of the board's concerns about Ms. Fiorina when he was first approached about becoming a director again. In the December 2004 phone calls, however, he quickly learned of the board's unhappiness. "The organization was becoming ever more horizontal, reporting more and more to Carly," he said in the interview. "The board respected Carly. She was Wonder Woman. But still, there are only 24 hours in a day."

Carly Fiorina

On Jan. 10, 2005, three board members—Ms. Dunn, Mr. Keyworth, and longtime H-P executive Richard Hackborn—met with Ms. Fiorina at H-P headquarters and laid out their concerns. They told her directors felt she didn't consult with them fully and were unhappy with the state of the company's business with corporate customers, according to people in the room.

In the discussion that followed, Mr. Keyworth, who headed the board's technology committee, argued Ms. Fiorina should elevate Shane Robison, the company's chief technology officer, to a top management job. She grew particularly irritated at that suggestion. Mr. Robison wasn't ready for such a position, she argued. Moreover, it was her job, not the board's, to choose management.

Nevertheless, Ms. Fiorina, who was chairman of the board as well as chief executive, agreed to tear up her agenda for the board's strategy retreat later that week, and focus instead on the directors' concerns. The retreat took place at the Park Hyatt in San Francisco. The board and Ms. Fiorina had a candid discussion of their disagreements, according to people present.

Holding Her Ground

For the most part, Ms. Fiorina held her ground, continuing to resist specific changes recommended by some members of the board, and refusing, in particular, to bow to Mr. Keyworth's desire to elevate Mr. Robison. But she indicated some willingness to bring in new management talent in the future. Afterward, some board members felt "cautiously optimistic," as one put it, that their differences could be resolved. "It was like the Berlin Wall had come down," a director said afterward.

A week later, however, Hewlett-Packard learned that a Wall Street Journal reporter had extensive details of the Park Hyatt discussions and was preparing an article. Ms. Fiorina was furious. She called the board members together on the phone and dressed them down for giving details of the meeting. No one confessed to the leak. A spokesman for The Wall Street Journal said the newspaper doesn't comment on its sources. A page-one story about the board's discussions appeared in the Journal on Jan. 24, 2005.

The leak, and Ms. Fiorina's reaction to it, widened the gulf between her and her board. Board members also were outraged by the leak, but felt it was a smaller issue than their concerns about the performance of the company, according to two directors. The board held another telephone conference on Jan. 28, with Ms. Fiorina participating from the World Economic Forum in Davos, Switzerland. She continued to express her anger. "Carly sought to make the leaks the No. 1 issue," said one board member, "and the board was seeking to make performance the No. 1 issue."

Board members say the leak, and Ms. Fiorina's reaction to it, didn't cause her demise, but probably accelerated it. Up to that point, many of them were hoping they could work out their differences with her. Afterward, many concluded it had become impossible to work together.

Less than two weeks later, on Feb. 7, the board met in Chicago. After hearing again from Ms. Fiorina, who laid out her views of her job and the board's job, the independent board members met in private and voted to dismiss her. At the same meeting, they also made Mr. Perkins a director.

In the aftermath of Ms. Fiorina's firing, Ms. Dunn was chosen to be nonexecutive chairman of the board—a position she still holds today. Ms. Fiorina's successor, Mark Hurd, previously chief executive of NCR Corp., was given the title of chief executive only.

Ms. Dunn, 53, is vice chairman of Barclays Global Investors in San Francisco, an asset-management unit of Barclays PLC. She had once been chief executive of the unit, but stepped down to fight cancer. She grew up in Las Vegas, where her father was entertainment director at various casinos and her mother had been a showgirl.

Patricia Dunn

In conversations with H-P board members after taking the new job, Ms. Dunn found many of them were still concerned about the leak. Ms. Fiorina had asked prominent Silicon Valley lawyer Larry Sonsini to interview directors, seeking both a confession and a reaffirmation of the board's confidentiality policy. Again, no one confessed. Mr. Perkins acknowledged talking to the reporter but said she already had all the details at the time. Ms. Fiorina herself suspected Mr. Keyworth was the source. But Mr. Sonsini's evidence didn't confirm that.

Internal Investigation

After Ms. Fiorina left, Ms. Dunn asked the company to carry out a deeper investigation, which began in the spring of 2005 and was overseen internally by the company. The investigation lasted for months and involved the use of outside investigative firms. The investigators began to narrow the list of suspects, but were unable to develop conclusive evidence that any one member of the board was responsible for the leaks. Ms. Dunn said she regularly informed the board of the investigation, but provided few details, at the investigators' request.

In January of this year, the board again held its annual off-site meeting with H-P management, this time at the Esmeralda Resort and Spa, near Palm Springs, Calif. A few days later, CNET News, a technology-news Web site, ran a story with details from the private meeting, quoting a "source with the company." Some of the information provided by the source was mundane: "By the time the lectures were done at 10 p.m., we were pooped and went to bed," the story quotes the source saying. But some got to the core of the company's plans. The source said H-P might buy more software companies and might work more closely with chip maker Advanced Micro Devices Inc. as "a cattle prod of sorts" to H-P's longstanding chip supplier, Intel Corp.

Outside board members have long leaked information to the media, often because they're at odds with the CEO and want to promote their own views. "The only people who leak more to the press are prosecutors," quips John C. Coffee Jr., a Columbia University law professor. Directors have a fiduciary duty to keep confidential any inside information that would affect the share price, but other leaks wouldn't necessarily violate the rules, says Mr. Coffee.

After the CNET leak, the H-P investigation was revved up again, directors say. Because the information in the CNET story was so specific, investigators were able to narrow the likely sources. Subsequently, the private investigators obtained phone records that showed Mr. Keyworth had spoken with a CNET reporter.

What happened next has become a key part of the current board furor. Before the regularly scheduled board meeting on May 18, Ms. Dunn and Ann Baskins, the company's general counsel, decided to give the report on the investigation to Robert Ryan, head of the board's audit committee and former chief financial officer of Medtronic Inc., directors say. Ms. Dunn and Ms. Baskins concluded the leak was a violation of the company's Standards of Business Conduct, which are overseen by that committee. In doing so they bypassed the Nominating and Governance Committee, then headed by Mr. Perkins, which normally handled matters concerning board operations.

On the day of the board meeting, Mr. Ryan met with Mr. Keyworth for breakfast at H-P's headquarters and reviewed the findings of the investigation. According to a person involved, Mr. Keyworth was shocked at the information in the report, and admitted to having had lunch with the CNET reporter. The report did not point to him as the source for the earlier Wall Street Journal article involving Ms. Fiorina. But it did suggest Mr. Keyworth had been involved in other news stories concerning confidential board affairs.

Knowing Mr. Perkins and Mr. Keyworth were close, Mr. Ryan also pulled Mr. Perkins into a private room before the board meeting and briefed him on the report.

When the board met, Mr. Ryan went over the investigative report in detail. Mr. Keyworth was given a chance to explain himself. He apologized, but didn't say that his conversations with reporters had been improper. He was then asked to leave the room, and the board had a long discussion. A turning point came when Mr. Hurd, the chief executive, was asked by a director how he would handle the matter if it had been an employee who had talked to the reporter. Mr. Hurd replied, "I would have no choice but to fire him," according to a board member.

As it became clear the board was going to ask Mr. Keyworth to leave, Mr. Perkins got angry. Directors say he defended Mr. Keyworth as a valuable and longstanding director, and said a "good man" was being trashed by the process. He also attacked Ms. Dunn, saying, "Pattie, you betrayed me. You and I had an agreement we would handle this offline without disclosing the name of the leaker." (Ms. Dunn says she never had such an agreement. "I always knew it would require advice of counsel. Counsel was explicit the matter needed to go before the full board," she says.)

Finally, Mr. Perkins rose from his seat, slammed his briefcase shut, and said, "I quit and I'm leaving."

After a moment of silence, Mr. Ryan turned to Ann Baskins, the company's general counsel. "Ann, is that a bona fide resignation?" Ms. Baskins said if the board voted to accept the resignation, it would be valid. Mr. Ryan responded: "I so move." His motion was quickly seconded and adopted.

The board then began a discussion of its responsibility to disclose the event. The law requires that when a director resigns, the company has to disclose whether it was the result of a fundamental disagreement.

Mr. Perkins was on his way to Turkey, to oversee the maiden voyage of The Maltese Falcon—his 290-foot clipper, one of the largest sailing yachts in the world. Contacted by Mr. Sonsini about his reasons for leaving the board, Mr. Perkins reportedly said: "Just don't make it for personal reasons. I don't want people to speculate about my health."

Board members say they concluded Mr. Perkins had no disagreement with the company, only with Ms. Dunn. Therefore they decided they had no obligation to file details with the SEC. Instead, the board issued a statement on May 19 that simply said Mr. Perkins had resigned, effective immediately. In the statement, Mr. Hurd thanked Mr. Perkins for his service, and said "he has been instrumental in championing improvements that are leading to a stronger H-P."

Mr. Perkins was concerned with the way his resignation was portrayed by the company, however, and subsequently contacted the SEC with his concerns, according to people familiar with the situation. Mr. Perkins has also been critical of the investigation, which he suggested involved illegal surveillance. Board members acknowledge some discomfort with the methods used by the private investigator who obtained the phone records, but H-P says it was assured by the investigators that the methods were legal.

Mr. Perkins previously had invited members of the board to come to Turkey for the launching of the Maltese Falcon. After the May 18 board meeting, however, he called Ms. Dunn's office and rescinded her invitation, according to one director.

Ms. Dunn's statement called the boardroom conflict "part of the board's progression from one that was more personality driven to one that is process driven and capable of upholding today's highest governance standards. Progression can be painful, we've seen that in changes within HP. But it's necessary and healthy."

—Joann S. Lublin contributed to this article.

Computing Problem

Events in the recent shake-up of Hewlett-Packard's board of directors:

November 2004: Director George Keyworth recommends Tom Perkins be invited to return to H-P board.

February 2005: H-P board votes to add Mr. Perkins and to dismiss Carly Fiorina as chairman and chief executive. Patricia Dunn becomes nonexecutive chairman.

March: H-P announces Mark Hurd as new chief executive.

January 2006: CNET News quotes an unnamed source on details of an H-P board strategy meeting.

May: H-P board reviews internal investigation of January leak to CNET. Board asks Mr. Keyworth to resign, but he refuses. Mr. Perkins quits.

Sept. 6: H-P board plans to file report with SEC on circumstances surrounding Mr. Perkins's resignation.

Leash Gets Shorter for Beleaguered CEOs

THE BUZZARDS are circling **Bristol-Myers Squibb** Chief Executive Peter Dolan. Business blogs are filled with obscenity-laced posts denouncing his tenure. Some large shareholders are demanding his head. And CNBC's sputtering money maven—and my former colleague—Jim Cramer, last Friday named the executive the "single worst CEO" in his Hall of Shame.

Does Mr. Dolan deserve this lynching? Well, maybe. More on that later.

But whether he deserves it or not, Mr. Dolan's likely fate is now clear: It is probably only a matter of time before the drug company's board bows to the inevitable and sends him packing. In today's unforgiving business environment, he can't effectively lead the company when faced with such a buzz saw of opposition.

By Alan Murray

Asked for comment, Robert Zito, chief spokesman for the company, responds: "The board has been extremely supportive of Peter and management."

During the past two years, this has become a familiar story. The firing of a CEO used to be a rare event—even the worst of them often managed to cling to power with remarkable tenacity. In the past two years, however, CEO firings have become commonplace. The list of companies whose boards have bounced the boss now reads like a big-business phone book: AIG, Boeing, Disney, Fannie Mae, Hewlett-Packard, Kraft, Merck, Morgan Stanley, Pfizer. And there are more to come. If I were a buzzard, I would set my flight plan over **H.J. Heinz** Co., where presiding director Thomas Usher repeatedly has signaled that CEO Bill Johnson is on a short leash. **Dell** CEO Kevin Rollins also might be one for the birds to watch.

What has happened here is a sea change in the way American businesses are run. And it has happened in a stunningly short period of time. Just a few years ago, CEOs still handpicked most members of their boards, and most boards gave their CEOs a long leash—or no leash at all.

Today's boards look very different. Directors are picked by a nominating committee, not by the CEO. And increasingly, shareholders and their advocates have some say in that selection. Patrick McGurn of Institutional Shareholder Services says this year there have been serious challenges against directors' re-election at roughly 50 companies. In 31 cases, the company avoided a proxy fight by settling—and in 25 of those 31 cases agreed to give the dissidents one or more board seats. Of the 19 challenges that made it to a shareholder ballot, the dissidents won seats in at least nine, and probably more. (Results in two cases are still pending.)

The end result: Boards are much less beholden to their CEOs, and much more susceptible to outside pressure, than ever before.

Increasingly, they have independent leadership as well. Nonexecutive chairmen of the board remain a rarity—only 9% of Standard & Poor's 500 companies have independent chairmen, according to the search firm Spencer Stuart. (Bristol-Myers is one of the few—James D. Robinson III became nonexecutive chairman last year as the result of a settlement with the U.S. attorney in New Jersey over charges that the company artificially inflated its revenue.) But a full 94% of S&P 500 companies now have a lead or presiding director—up from just 36% in 2003. And most importantly, the vast majority of boards now meet regularly in executive session—without the CEO present.

ADD TO THAT MIX the anger of shareholders who are upset about low returns and inflated CEO compensation, and you have the makings of a revolution. "It's a huge leap forward," says Ira Millstein, a lawyer and scholar who has long advocated such changes in corporate governance. "Boards are much more proactive than they were before."

Bad CEOs are being held to account. In the case of Mr. Dolan, shareholders might feel they have little reason to miss him—the company's stock lost more than half its value during his time as CEO. Insiders argue he has helped build the company's drug pipeline, and has gotten eight new drugs approved in the past four years, at a time when other pharmaceutical companies are struggling. But the company's recent effort to negotiate a settlement over a patent challenge to the company's best-selling drug, Plavix, turned into a disaster. The company was outmaneuvered in the settlement talks, and ended up with a Justice Department investigation to boot. How much blame Mr. Dolan deserves for all that might be debatable. But the CEO is the person who catches the spear.

There are some bigger questions here that remain unanswered. The CEO-centric corporation did a pretty good job creating jobs and wealth during the 20th century. Will newly empowered boards—and less-powerful CEOs—be able to do as well in the 21st? Even the strongest advocates of changes in corporate governance say that is an open question.

We know from past experience that CEOs on long leashes can get in trouble. The experiment with CEOs on short leashes is just beginning.

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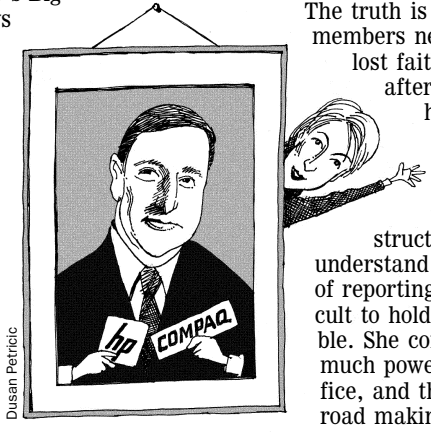
H-P Lost Faith in Fiorina, but Not in Merger

SO, WAS Carly right after all? I mean Carleton S. Fiorina, of course—the first businesswoman to achieve one-name fame, like Madonna, Oprah and Hillary. Ms. Fiorina was unceremoniously dumped as chief executive officer of **Hewlett-Packard** last year. At the time, the popular critique was that she forced the legendary technology company into an ill-advised merger with Compaq Computer.

Business-school professors clucked that Ms. Fiorina had steered H-P into a strategic backwater, lost between the low-cost producer—**Dell**—and the high-quality-and-service producer—**International Business Machines**. Her predecessor, the late Lewis Platt, used a blackjack metaphor, saying that by expanding in the troubled personal-computer business she had "doubled down on 16." Just days before Ms. Fiorina's firing, Fortune ran a cover story titled, "Why Carly's Big Bet is Failing." For days after Ms. Fiorina's departure, the company's stock rose, largely on expectations the new CEO would break it up.

Mark Hurd, the man chosen to succeed Ms. Fiorina, didn't undo the merger. He didn't defend it either. When asked whether it was a good idea, he refused to give an opinion. "It's over," he said. "My job is to make Hewlett-Packard the best company we can make it in the future."



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LATELY, SENTIMENT has begun to turn. H-P's fortunes are rising, while Dell's are falling. The direct-sales model that helped Dell drive costs into the basement—the company sells its computers mainly through catalogues and online—seems to be running out of gas, while the H-P "channel" strategy—selling through retail stores—is proving better at penetrating the fast-growing laptop and overseas markets.

At a meeting of H-P's board not long ago, Chief Financial Officer Robert Wayman did a retrospective look at the merger. The results were so compelling that even some board members were stunned, some attendees say.

At the time of the merger in 2001, the company set three broad goals: to strengthen its market position, to improve its competitiveness and to increase shareholder value.

H-P was in third place in the personal-computer market in 2001 and posting losses. Today, it is a strong second, breathing down Dell's neck for the lead and posting profits—though still not as much as it would like. In the industry standard computer-server business, H-P was then in fourth place and bleeding red. Today it is No. 1 and nicely profitable.

On competitiveness, the company's total operating expenses came to 21.5% of revenue back in 2001. Today, that is down to about 16%—and all but one percentage point of the decline happened before Mark Hurd's cost-cutting campaign took hold.

As for shareholder value—well, at the time Ms. Fiorina left office, there was little to boast about. But recently, H-P has surpassed all of its rivals. Total return to shareholders since the merger has been almost 50%. Dell has been almost flat in the same period, while IBM shareholders have lost substantial sums of money.

WHO DESERVES credit? Mr. Hurd gets kudos all around. Still, even he is quick to say that in H-P's PC business, "there has been a prolonged sustained march in performance that, frankly, predates me."

The truth is that H-P's board members never completely lost faith in the merger—after all, many of them had been a party to it. They just lost faith in Carly. She created a matrix-management structure they couldn't understand and muddled lines of reporting that made it difficult to hold anyone responsible. She concentrated too much power in her own office, and then took to the road making speeches and wasn't there when decisions needed to be made. Perhaps most importantly, she was disdainful of the board's efforts to change her ways.

It is difficult to find anyone involved with H-P today—board member, shareholder, employee, customer, analyst—who isn't happy that Ms. Fiorina is gone and that Mr. Hurd has taken her place. He is everything she wasn't. He dives deep into operations, is in love with the metrics and out of love with the media. He disdains vision; he is all about execution.

Carly's version of her ouster has yet to be told. She has a book coming out in October that her publisher promises will be "brutally honest about her triumphs and failures." Somewhere in there, she undoubtedly will give voice to her feeling that the H-P board overstepped its bounds in pushing her out and that H-P's current success is a vindication of her strategy.

On the second point, at least, she may be right. H-P's directors went through hell together. In the end, they got the best of both worlds—a charismatic CEO who brought about a hotly contested but transformational merger, and a no-nonsense, operations-oriented CEO determined to make the combined company work.

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By Alan Murray

A Tale of Two CEOs: How Public Perception Shapes Reputations

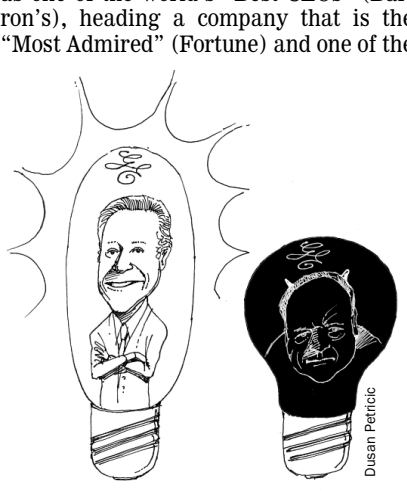
HOME DEPOT Chief Executive Bob Nardelli still doesn't get it.

In an interview with CNBC's Maria Bartiromo last week, he seemed genuinely bewildered as to how he had become the corporate world's equivalent of America's Most Wanted—under attack for greed and arrogance by shareholder activists and media hounds.

He must have had a similar look on his face that cold day six years ago when he met Jack Welch in an airport lounge in Albany, N.Y., and was told that Jeffrey Immelt, not he, would be the next CEO of **General Electric**. The decision, Mr. Welch later wrote, was hard for Mr. Nardelli to accept.

Messrs. Nardelli and Immelt are the Cain and Abel of the corporate world—both groomed for greatness by Mr. Welch but divided when their mentor had to choose. Mr. Immelt is tall and smooth, a graduate of Dartmouth and Harvard. Mr. Nardelli is short and gruff, with degrees from Western Illinois and Louisville universities.

Today, Mr. Immelt is regularly ranked as one of the world's "Best CEOs" (Barron's), heading a company that is the "Most Admired" (Fortune) and one of the



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two "Most Respected" (Financial Times). Mr. Nardelli is ... well, let's just say he is having a tough time. In the public's mind, the pair have come to symbolize the best and worst of their breed.

Yet here is what they have in common: Neither has earned a penny for shareholders. GE's share price has dropped more than $7 since Mr. Immelt took over—more than offsetting the $4 paid out in dividends during that time. And Home Depot's share price has dropped more than $6 since Mr. Nardelli joined up, while dividends have totaled only $1.67.

How Mr. Immelt turned poor performance into a badge of honor while Mr. Nardelli turned it into a badge of shame speaks volumes about the post-Enron world of business. Success and failure are no longer a simple matter of shareholder returns. For better or worse, it is a much more public game, involving a wide range of constituencies and requiring the skills of a politician.

Perhaps Mr. Welch understood that when he chose Mr. Immelt for the job. Mr. Nardelli was the better operating executive—he had repeatedly proven that during his tenure at GE. But Mr. Immelt was the more polished public persona, and more adaptable to change. Change came quickly. Days after Mr. Immelt took the job, terrorists attacked the U.S. A few weeks later, Enron unraveled. With share prices tumbling and corporate scandals exploding, CEOs came under heavy attack.

Mr. Immelt has worked to appease corporate critics. He made his company's operations more transparent, reached out to a wide range of "stakeholders," emphasized good corporate "citizenship" and even took the extraordinary step of adopting self-imposed limits on GE's greenhouse-gas emissions, earning kudos from environmentalists. Perhaps most importantly, he asked his board to forgo his cash bonus and give him "performance shares," which only pay if he meets his targets—though skeptics say those targets aren't that hard to meet.

Mr. Nardelli took a very different approach. On at least three occasions, when the game was going against him, he and his board tried to alter the rules. With shareholder returns in the dumps, they changed his incentive pay from a formula based on shareholder returns to one based on earnings per share. With store sales down, they decided to stop disclosing Home Depot's same-store sales. And when union shareholders went on the attack, they held a sham annual meeting, with no directors present and strict time limits on statements from the floor.

Mr. Nardelli's defenders argue he has had a much tougher job in the past five years than Mr. Immelt. GE was a finely tuned corporate machine; Home Depot was a mess. They give Mr. Nardelli high marks for cleaning it up. But many now acknowledge that the man once known as "Little Jack" made some big mistakes in dealing with his critics. On CNBC last week, Mr. Nardelli apologized for what he euphemistically called the "change in format" at the annual meeting, and said the company was reconsidering its decision to discontinue the same store-sales measure.

Still unresolved is the biggest problem—a pay package valued at some $245 million over five years. Much of that is in options that are still under water. Even if the package is worth only half that amount, shareholders may understandably recoil. If Mr. Nardelli wants out of the hole he has dug, he should forgo further cash salary until shareholders start making money. Stay tuned.

As for investors who fear this whole debate over public perceptions leaves them out in the cold, they may want to look at the third member of Mr. Welch's trio of wannabes—**Boeing** Chairman James McNerney. After doing a fine job for shareholders at 3M, he's seen Boeing's stock go up 20% since he arrived a year ago.

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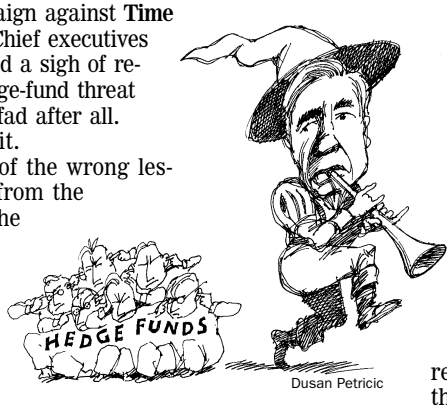
Hedge-Fund Lessons From the Icahn Affair

THIS IS SUPPOSED to be the Year of Hedge Fund Activism. Hedge funds, we've been told, are the new barbarians, rattling the gates of entrenched corporate management. Lawyer Marty Lipton, centurion of the palace guard, sent his warning out last December, urging big-company clients to steel themselves against hedge-fund attacks. **Merrill Lynch** began marketing its skill at building ramparts.

And then Carl Icahn—who declared in the pages of this newspaper just three weeks ago that he had no intention of giving up his campaign against **Time Warner**—gave up. Chief executives everywhere breathed a sigh of relief. Maybe the hedge-fund threat was just a passing fad after all.

Don't count on it.

Here are some of the wrong lessons being drawn from the Icahn affair, and the right ones:



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Time Warner Chief Executive Richard Parsons won this battle because he had loyal shareholders. In a meeting with the The Wall Street Journal last week, Mr. Parsons boasted that his company had "a pretty sophisticated shareholder base." True enough. But Mr. Icahn's goal at the outset wasn't to win over the old shareholders; it was to persuade a raft of hedge funds to become new shareholders. He wanted to be the Pied Piper of hedge-fund investors. And that didn't happen. When he played his music—with accompaniment from Bruce Wasserstein of **Lazard**—the hedge funds didn't follow.

Big companies are immune to hedge-fund attacks. The jury is out on this one. Mr. Icahn told me yesterday that "when you have an $80 billion company, hedge funds alone can't do it." But hedge funds control more than a trillion dollars, and they are desperately searching for good ideas to make big returns. Hedge-fund managers tell me that if the idea is right, the money will be there. Even if hedge funds can't win control of an $80 billion company, they can certainly create the momentum for change.

Mr. Parsons is doing a fine job running Time Warner. Don't get carried away. Many of the criticisms that Mr. Icahn and Mr. Wasserstein leveled at Time Warner had the sting of truth. The company has done a lousy job managing AOL, which missed out on the big surge in the search business and stuck with its "walled garden" approach to the Internet for far too long—though much of that precedes Mr. Parsons.

Moreover, there is something unnerving about Mr. Parsons's talk of his company as a giant hedge. The essence of leadership is vision, and the essence of strategy is choice. Mr. Parsons seems a little too willing to acknowledge his lack of a clear vision of the future, which makes it more difficult for him to make choices about where to devote his resources.

The problem is, no one else seems to have a very clear vision of the future of media, either. Mr. Icahn's idea of spinning off Time Warner's cable-distribution assets lost its luster last fall, as the stock price of cable rival **Comcast** took a tumble. Enlisting former **Viacom** chief Frank Biondi as his choice to replace Mr. Parsons didn't help much. Mr. Biondi was seen more as a retread of the past than a leader for the future.

So what are the real lessons in all of this? Here are some:

Companies can't sit on cash without risking a hedge-fund attack. Private-equity firms make much of their money these days by adding debt to the company balance sheet, enabling investors to get "leveraged" returns. Why shouldn't public-company investors be entitled to the same? Mr. Icahn didn't succeed in breaking up Time Warner, but he did succeed in forcing the company to buy back more stock, paying out cash and increasing its debt.

Mr. Icahn isn't going away. The investor turned 70 on the day he cut the Time Warner deal, but shows no sign of retiring. Next stop: South Korea, where he has targeted the country's largest tobacco manufacturer, **KT&G**, and is demanding three board seats. "I intend to keep doing this," he says.

The managers of the largest activist hedge funds are, by and large, pretty smart people. And they are doing a service for public-company investors. The backlash against these hot money movers—fueled by nationalism in parts of Europe and Asia—is overwrought. The Time Warner episode shows that the funds won't attack en masse unless they have very good reason. And if they have good reason, we should all cheer them on.

"Shareholder democracy" has never proven itself to be very potent at holding corporate leaders accountable. Maybe hedge-fund democracy has more promise.

Email me at business@wsj.com and read reader comments Saturday at WSJ.com/TalkingBusiness.

Pivotal Fight Looms for Shareholder Democracy

IN THE ANNALS of democracy, the current battle at the Securities and Exchange Commission doesn't rank with Bunker Hill, the storming of the Bastille or the collapse of the Berlin Wall. But it may deserve a page in the history books, nonetheless.

Against its will, the SEC is revisiting the fundamental question of how directors of publicly traded corporations are elected. Until recently, those elections were Stalinesque: Only one slate of candidates was on the ballot, and while shareholders could withhold their support, withheld votes didn't count. As long as one shareholder supported each director, those directors prevailed.

By Alan Murray

In the past couple of years, that has started to change. Under pressure from shareholder activists, many big companies have adopted requirements that directors win a majority of votes cast. That makes it possible, at least in theory, for holders to oust an unwanted director.

Now, activists want to take the next logical step, and allow blocs of shareholders to nominate directors for election on the corporate proxy ballot. Big business is fighting back with every weapon in its arsenal. And the SEC, unwittingly, has gotten caught in the crossfire. This behind-the-scenes battle may seem arcane, but those involved on both sides believe it could determine the future of the American corporation.

Some history: Three years ago, then-SEC Chairman William Donaldson picked up the banner of shareholder democracy and proposed giving shareholders limited ability to nominate directors. Big business and the White House forced him to retreat and, ultimately, to resign. Score one for big business.

Then last year, the American Federation of State, County and Municipal Employees took a different tack. The big public-employee union submitted a proxy measure to **American International Group** that would change the company's bylaws to allow shareholders to nominate directors. The SEC ruled AIG didn't have to put the measure on its ballot. In September, a federal appeals court disagreed, and tossed the issue back to the commission. Round two to the activists.

That leaves SEC Chairman Christopher Cox in the hot seat. He has two Republican members who toe the line of big business on this issue, and two Democrats who are sympathetic to the activists. He holds the balance.

For a conscientious conservative like Mr. Cox, the issue isn't simple. On big business's side is the principle of federalism. Corporate governance is ruled by state law—primarily in Delaware, since that is where most U.S. companies have incorporated (primarily because of corporate-friendly laws). The SEC has authority to oversee the proxy process, but not broad authority to rewrite corporate law.

Then there are the political realities of the current campaign. Most shareholder activists lean left. Labor unions and public pension funds are in the vanguard of the push for corporate democracy. Environmental groups and other social activists aren't far behind.

Weighing against that is the conservative notion that shareholders deserve some rights of ownership. If they can't elect the directors who represent their interests, what can they do? Moreover, strong oversight by shareholders should reduce the need for regulatory oversight.

Then there's the new Democratic leadership of Congress to consider. Massachusetts Rep. Barney Frank, who will chair the House of Representatives Financial Services Committee come January, says he thinks "corporate America would save itself a lot of trouble if it would embrace more shareholder democracy."

One of the ironies of this battle is that each side cites the dysfunctional board of **Hewlett-Packard**, which recently brawled over an investigation of boardroom leaks, as evidence for its position.

AFSCME says the H-P spectacle shows the need for fresh blood on corporate boards. The group already has submitted an AIG-like binding shareholder resolution to the technology company.

The Business Roundtable, an association of chief executives from big U.S. companies, counters that H-P is a frightening example of what happens when directors have separate agendas. Allowing shareholders to pick directors committed to, say, the ethical treatment of animals or fighting global warming would only make that problem worse. The danger, says John Castellani, president of the Roundtable, is you create "the corporate equivalent of the U.S. Congress."

Mr. Cox's view may be tempered by a meeting he had last week in London with officials of the Financial Services Authority, Britain's financial regulator. Shareholders of British companies have limited ability to nominate directors, and FSA officials insist that makes companies more responsive to holders. As for the Roundtable's concern about special-interest directors, FSA officials said the need to win 50% of holder votes cast takes care of that. In other words, democracy works.

Mr. Cox originally said he would decide this issue last month. Then he pushed it to December. Odds are it will get delayed once again until January.

But that's OK. This one is big. And the delays suggest he's heading in the direction of more shareholder democracy.

Alan Murray welcomes reader questions and will respond at **WSJ.com/TalkingBusiness**.

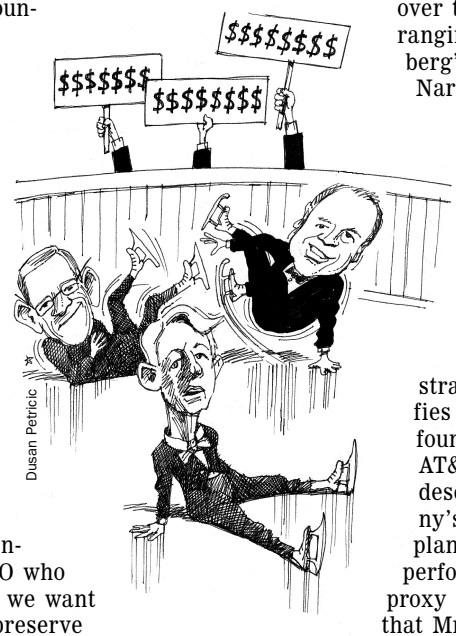
CEOs of the World, Unite? When Executive Pay Can Be Truly Excessive

THERE'S SOMETHING PERVERSE about chief executives who defend their paychecks with surveys of their peers. By doing this, the world's pre-eminent capitalists revert to a form of CEO socialism: From each according to his ability; to each according to Towers Perrin.

If there is a defense for paying a CEO five hundred times as much as the average worker, it can't be found in surveys by pay consultants. It has to be rooted in clear demonstrations of market value. That's why, in last week's column, I defended the nine-figure take-home of former **Exxon Mobil** CEO Lee Raymond. Critics may be offended by the sheer size of that payout. But shareholders can't be too upset with the results. And it's shareholders who foot the bill.

Trouble is, for every Lee Raymond, there is a Hank McKinnell. Mr. McKinnell is chief executive of the drug giant **Pfizer** Inc. Over the past five years, the company's shareholders have seen the value of their shares fall by 40%—a steeper drop than seen, on average, by shareholders of other companies in the industry. Yet the Pfizer chief still made $79 million in pay over that period, and has a guaranteed pension of $6 million a year for life. (Stanley Ikenberry, the lead director on Pfizer's board, says Mr. McKinnell deserves the pay for "guiding Pfizer through an incredibly challenging time" and "sustaining the investment in R&D necessary to provide long-term shareholder benefit.")

MR. MCKINNELL OWES his current prominence in the pay debate to Frederick "Shad" Rowe, a Dallas investor who has teamed up with oil man Boone Pickens and mutual-fund pioneer John Bogle, among others, to form a new group called the Investors for Director Accountability Foundation.



Unlike the usual CEO pay posse—populated by unionists, nuns, environmentalists and assorted others—Mr. Rowe's group is strictly business. "We don't sell our stocks because a company damages a tree in Bolivia," he says. "We prize the driven, egocentric maniacal CEO who builds value. But we want our directors to preserve that value for shareholders."

The group picked Mr. McKinnell as its first target, but he hardly stands alone in the pay-for-nonperformance Hall of Shame. Mr. Rowe started with a list of about 14 candidates that included **Verizon Communications** Inc.'s Ivan Seidenberg, **AT&T** Inc.'s Edward Whitacre and **Home Depot** Inc.'s Robert Nardelli.

Each of those men presides over a company that has seen total returns to shareholders fall sharply in the past five years. And according to the Corporate Library, each has underperformed relative to others in its industry. Yet the CEOs have received total compensation over the past two years ranging from Mr. Seidenberg's $27 million to Mr. Nardelli's $50 million. (Verizon officials insist that by their measures, the company has performed slightly better than its peers over the past five years.)

The kind of strange logic that justifies this largess can be found in a paragraph in AT&T's proxy materials describing the company's long-term incentive plan. For the 2002-2004 performance period, the proxy materials report that Mr. Whitacre and company had "substantially met all the performance goals set" by the compensation committee. In a nod to the fact that the company's stock had fallen to 67% of its previous value in the interim, the incentive payout "was reduced to 67% of the target amount."

IN SHORT, shareholders lost 33% of their investment, while Mr. Whitacre got 67% of his performance-based pay. Sound right to you? And that's on top of a salary that totaled $2.1 million last year, plus a bonus of $7.1 million. (Selim Bingol, an AT&T spokesman, points out that shareholders also got regular dividends, and he credits Mr. Whitacre with leading the company "through an extremely difficult time." He cites yesterday's favorable earnings report as an indication that AT&T "is now in the best position of any of our peers.")

Mr. Whitacre and his colleagues certainly deserve to be compensated for their time and effort. But it is very hard to justify an eight-figure salary with a time clock. It can only be justified by market success.

Defenders of the current system say CEO pay is set by market forces. But I am skeptical. Who else out there is eager to pay Messrs. McKinnell, Seidenberg, Whitacre and Nardelli upward of $10 million a year for lackluster performance? I'm reminded of the New York Stock Exchange directors who justified increasing Dick Grasso's pay package—which enabled him to amass $200 million, a good portion of it during his eight-year reign as CEO—by citing fears he might leave to become secretary of the Treasury, a job that pays $175,700 a year.

That kind of logic is only used by those spending other people's money. And that's why shareholders deserve a greater say.

Email me at business@wsj.com and read reader comments Saturday at WSJ.com/TalkingBusiness.