

# Tyco's betrayal of board governance.

By Pascal N. Levensohn

BOARD ACCOUNTABILITY 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.

**SUMMER 2002 35 BOARD ACCOUNTABILITY**

Accident avoidance ...t be held responsible for improper acts by a How can a company avoid this type of accident- member of the management team. But the fact is waiting-to-happen in the boardroom? Three years that the board should have been aware of signifi- ago I wrote an article for **DIRECTORS & BOARDS** cantpayments to one oftheir own, and they should ["The Problem of Fmotion in the Boardroom," not have been so complacent as to simply rubber- Spring 1999] that analyzed, in the context of the stamp the CEO's actions. takeover battle for AMP Inc., the disproportionate influence of former AMP CEOs on the AMP board. An action step I expressed the view that former CEOs of compa- What can be done? It would be healthy, for example, nies do not make very good independent-minded to establish a cap on the maximum realizable cash directors because "It is naturally very difficult to value of stock options to directors in any one year, move a CEO aside, have him remain a voting board with future paytnents of the value to be held in re-' member, and proceed to undo major projects that serve based on some kind of multiyear performance this person has previously done with the board's standard or high water mark, similar to that imposed blessing. When more than one former CEO remains on many investment fund managers. Specifically, on the board, this problem is many investment managers, hedge funds, and ven r\* 1^ U U J u magnified. Retired senior ex- ture capitalists in particular, who receive an alloca- It WOUia úe Healthy to ecutives have a natural ten- tion of the profits of their portfolio appreciation, ... , , deticy to glorify their exploits must measure that profitability over a multiyear pe- estamtsn a cap on the and to treasure past contribu- riod. For instance, suppose a portfolio gains 50Û/O .. , , , tions as well as to protect one in one year and they are entitled to an allocation of maximum realizable cash another and their reputations. 20% of those profits. In the following year, if the , r \* 7 • It is therefore extremely risky

portfolio loses 20%, the manager may not receive an- Value of stock options to to keep them at the table " other profit sharing allocation until the portfolio has t. ^ . Again, the pattern is re- recouped the 20% in depreciation and exceeds the directors in any Oneyean peatedatTyco.Thehell-mem- original 50% high water mark. , , ber Tyco board of 2000 con- Directors commonly receive annual options sisted of three insiders, one awards, and, at Tyco, they have a history of con- former Tyco CEO, one CEO of a manufacturing verting their cash cotiipensation into stock. Cur- I company, and six investment company profession- rently directors can sell during open market win- I als (one of whom passed away in 2001 ). Eive of these dows for insiders, and they can reload the next year SIX mvestment professionals were either chairman and start all over again. Companies should revisit or president of their respective firms and three had this policy and create a longer-term, multiyear pro- mvestment banking backgrounds. Tyco's board tlius gram that requires directors to become long-term included four CEOs, three of them with direct Tyco shareholders who cannot lower the bar when the or predecessor compatiy backgrounds, and a con- company fails to deliver value to shareholders over centration of finance professionals rather than man- a multiyear compounding period. agers/operators. Such a board composition raises questions about the ability of tliese independent di- Where does Tyco go from here? rectors to be proactive and to adequately oversee the The \$10 billion CIT acquisition and its public di- vast and complex operating companies that com- vestiture within a 12-month period culminate prise Tyco. Xyco's failure to create a GE done. While we believe I believe that board members must be account- that IPO proceeds of S4.6 billion, added to over \$4 able for the actions oftheir CEO. This means that billion in existing cash and forecasted operating the board must be proactive in discharging the re- cash fiow of \$3 billion for 2002, legitimately meet sponsibthtyof CEO oversight and fully understand the \$7.7 billion in refinancing obligations that Tyco what tools management utilizes to achieve business faces between now and February 2003, investors' plan objectives. At a minimum, it would appear concerns continue to linger and Tyco's stock has not that the loyalty of the board to Dennis Kozlo^vski materially appreciated since the closing of this crit- led to an absence of oversight. Perhaps, while every- ical transaction. Investors aren't the only ones who otie was maktnng plenty of money, the board wasn't remain wary. Despite stabilizing its balance sheet, asking Kozlowskt a lot of questions. Clearly, if we Tyco has not yet convinced the ratings agencies that are to accept the board s statements that they had all is well. Prior to the IPO, S&P, MoSdy's, and Fitch no knowledge of questionable payments until ail downgraded Tyco's short-term atui lono-term months after they had been made, the board can- debt due to concerns regarding retlnancin^^ risk. 36 DIRECTORS ft BOARDS BOARD ACCOUNTABflLITY 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, GIT debt has been upgraded by both Fitch and Moody's and all indications are that S8iP 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, inter-related 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 22— 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 cata-

strophic 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. —Tyco confines 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

SUMMER 2002 37 BOARD ACCOUNTABILITY 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 \$1 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 38 DIRECTORS & BOARDS