

# Dear Chairman

*Boardroom Battles and the Rise  
of Shareholder Activism*

JEFF  
GRAMM

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HARPER  
BUSINESS

## Contents

Introduction . . . . .	ix
1. Benjamin Graham versus Northern Pipeline: The Birth of Modern Shareholder Activism . . . . .	i
2. Robert Young versus New York Central: The Proxyteers Storm the Vanderbilt Line . . . . .	20
3. Warren Buffett and American Express: The Great Salad Oil Swindle . . . . .	45
4. Carl Icahn versus Phillips Petroleum: The Rise and Fall of the Corporate Raiders . . . . .	69
5. Ross Perot versus General Motors: The Unmaking of the Modern Corporation . . . . .	95
6. Karla Scherer versus R. P. Scherer: A Kingdom in a Capsule . . . . .	122
7. Daniel Loeb and Hedge Fund Activism: The Shame Game . . . . .	147
8. BKF Capital: The Corrosion of Conformity . . . . .	170
Conclusion . . . . .	192
<i>Appendix: Original Letters</i> . . . . .	203
<i>Acknowledgments</i> . . . . .	251
<i>Notes</i> . . . . .	255
<i>Index</i> . . . . .	277

## Warren Buffett and American Express: The Great Salad Oil Swindle

*“Let me assure you that the great majority of stockholders (although perhaps not the most vocal ones) think you have done an outstanding job of keeping the ship on an even keel and moving full steam ahead while being buffeted by a typhoon which largely falls in the ‘Act of God’ category.”*

—WARREN BUFFETT, 1964

**W**ARREN BUFFETT MAKES INVESTING sound easy. Part of his investment philosophy comes directly from Benjamin Graham: He views shares of stock as fractional ownerships of a business, and he buys them with a margin of safety. But unlike Graham, when Buffett finds a security trading at a large discount to its intrinsic value, he eschews diversification and buys a large position. To Warren Buffett, with his superhuman gift for rational thinking, this value investing strategy is easy. For the rest of us mere mortals, it is a minefield littered with the corpses of its practitioners. It is very hard to avoid career-imploding mistakes with a hyperconcentrated value investing strategy. Warren Buffett is the exception that proves the rule.

Every year, I make a pilgrimage to Omaha to hear Buffett and his partner, Charlie Munger, take questions for six hours at the Berkshire Hathaway shareholders’ meeting. I never tire of hearing them talk about business and industry. I don’t even mind listening to them discuss politics and macroeconomics. When they philosophize about value investing, however, it makes me a little uneasy.

To be clear, Buffett and Munger don’t say anything about value investing that isn’t true. They are right that you don’t need a superhigh

IQ to be a successful investor. They are right that it is relatively easy to evaluate the competitive dynamics of an industry and value companies. They are right that, if you are patient enough, the market will give you some fat pitches to swing at. And they are right that concentrating your portfolio into your very best ideas will give you the best outcome if you do good work.

Every tenet of Warren Buffett's value investing strategy holds true, but there's a cruel irony to contend with: Buffett-style investing is tailor-made to magnify irrational thinking. Nothing is going to coax out the inherent irrationality of a portfolio manager—his or her weakness to the forces of greed and fear—like supersize positions. Munger once said he would be comfortable putting more than 100% of his net worth into one investment. Most of the earnest business school students attending the Berkshire Hathaway meeting wouldn't stand a chance if they started investing like that. Investors need ice water in their veins to make concentrated value investing work.

Warren Buffett's biography, *The Snowball*, is not the story of an everyman from America's heartland succeeding on just hard work and determination. Buffett is a singularity, and even his worst mistakes tell an interesting story. Berkshire Hathaway, for instance, was a bad investment. The company featured a lethal combination of high capital intensity and low returns on invested capital. In other words, you had to put a lot of money back into the business for little, if any, return. Yet Buffett somehow parlayed Berkshire into one of the most valuable companies in the world, with more than 340,000 employees.

Berkshire Hathaway is itself an anomaly, just like the man who built it. It is a huge, decentralized, global conglomerate that somehow retains a corporate culture of excellence. Berkshire's business model is simple—find good businesses run by capable managers, let them do their jobs, and then harvest the cash flows. Like Buffett's value investing strategy, it is intuitive, it generates incredible results, and nobody else does it nearly as well.

It's hard to believe there was ever a time when Warren Buffett's aptitude for business was anything but superhuman. We think of him as a fully formed portfolio manager from the moment he launched

his first investment partnership in 1956, when he was only twenty-five years old. He compounded wealth for himself and his investors at an astounding rate over the next twelve years and never suffered a losing year. Despite this stellar track record, the Buffett Partnerships were very much a work in progress. Buffett was constantly refining his investment style, even toying with short selling and pair trades at one point. As he told the *New York Times* in 1990, “I evolved. I didn’t go from ape to human or human to ape in a nice, even manner.”<sup>1</sup> Buffett learned lessons from his mistakes as well as his victories. His biggest triumph was American Express. It proved to be a major turning point in his career.

The Great Salad Oil Swindle was an audacious fraud that nearly toppled American Express in the 1960s. It is a complicated story filled with valuable lessons about the fallibility of businessmen, and their capacity to ignore reality at critical junctures. While the saga exposes terrible behavior and a true villain, it features many more honest and capable people who unwittingly developed deadly blind spots. The fallout from the fraud also pitted Warren Buffett against a handful of shareholders who wanted American Express to maximize its short-term profits by ignoring salad oil claimants.

When Warren Buffett intervened at American Express as a large shareholder, he didn’t demand board representation or ask probing questions about the company’s operating performance. He didn’t call for a higher dividend or question the company’s capital spending. Instead, he wanted American Express to use its capital liberally to recompense parties who were defrauded in the swindle. Buffett had done enough research on American Express to understand that it was a phenomenal business. He would later refer to companies like this as “compounding machines,” because they generate huge returns on capital that can be reinvested at the same rate of return. Buffett knew that walking away from the salad oil claims would damage American Express’s reputation and its substantial long-term value. He wanted to prevent short-term-oriented shareholders from jamming the compounding machine’s gears just to save a few dollars. This was a new position for Buffett to be in. Before he bought American Express stock,

Buffett was the kind of penny-pinching investor who sought to extract value from his stock holdings as quickly as possible.

### WILTING WINDMILLS

At around the same time that Robert Young's New York Central began to collapse in 1957, a young Warren Buffett fired off a letter to a board member of a company he'd invested in. "I am writing this to you as you are apparently an 'outside' director of Merchants National Property," he wrote. Maybe my sensibilities, almost sixty years removed, are different than Buffett's, but I read that line as dripping with sarcasm. His next four words won't surprise you: "I am disturbed by . . ."<sup>2</sup>

Though he wasn't rattling a saber or testifying before Congress like the Proxyteers, Buffett was quietly employing a similar investment strategy for his partnerships in Omaha. He bought undervalued, often underperforming companies, and pushed for board representation or even control. One classic Buffett Partnerships investment was in Dempster Mill Manufacturing Company, a Nebraska windmill and farm equipment maker founded in the nineteenth century. Buffett framed it this way: "The qualitative situation was on the negative side . . . but the figures were extremely attractive."<sup>3</sup>

Dempster was a manufacturing business operating in a tough industry. It produced only nominal profits but traded at a very steep discount to its book value. Buffett was buying the company for less than half the value of its cash, inventory, and accounts receivable minus all liabilities. He first bought Dempster stock in 1956, joined the board in 1958, and then crossed 50% ownership to get control in 1961.<sup>4</sup>

Buffett pushed management to improve profit margins, but nothing worked. After years with no progress, he found an able manager, Harry Bottle, and installed him at Dempster to clean house. Bottle cut expenses, sold unprofitable facilities, and liquidated inventories. He turned Dempster's stagnant assets into ready cash, which Buffett promptly invested in stocks. By 1963, those stocks were worth more than Buffett had paid for the entire company. As he wrote that year:

B.P.L. [Buffett Partnership Ltd.] owns 71.7% of Dempster acquired at a cost of \$1,262,577.27. On June 30, 1963, Dempster had a small safe deposit box at the Omaha National Bank containing securities worth \$2,028,415.25. Our 71.7% share of \$2,028,415.25 amounts to \$1,454,373.70. Thus, everything above ground (and part of it underground) is profit.<sup>5</sup>

Buffett's investment in Sanborn Map, which he describes in the partnerships' 1960 annual letter, is also worth examining. Sanborn was a better business than Dempster. It sold detailed city maps to fire insurance companies, and was highly profitable for decades until the 1950s, when a new method of underwriting cut into revenues. By the time Buffett started buying Sanborn stock, it traded at \$45 per share but had \$65 per share of securities on its balance sheet.<sup>6</sup> There was also some potential in the existing operations. Profits were shrinking, but Buffett felt Sanborn's board of directors, populated by insurance executives, was neglecting the business.

Buffett bought enough shares to land a board seat, and then proceeded to wage war with the other directors to distribute the securities and revive the map business. When they rejected his idea of returning excess capital to shareholders, Buffett threatened to call a special stockholders' meeting to replace the board.<sup>7</sup> He complained to *The Snowball* author, Alice Schroeder, about his experience with Sanborn, "I remember cigars getting passed around. I was paying for thirty percent of every one of those cigars. I was the only guy not smoking cigars."<sup>8</sup> Buffett eventually prevailed and the company used its excess securities to repurchase 72% of its stock.

In the early years of his investment partnerships, Warren Buffett bought a lot of asset-rich companies at large discounts. These situations were messy, time-consuming, and often demanded conflict. In tiny Beatrice, Nebraska, where Dempster Mill owned the only factory in town, Buffett was vilified in the local press for laying off one hundred workers. He never wanted to go through that experience again, and he wouldn't have to. An improbable series of events was about to

drop American Express, one of the best businesses in the country, into the lap of a bargain hunter.

### LENDER OF LAST RESORT

In June 1960, an anonymous tipster called American Express to expose a massive fraud at Allied Crude Vegetable Oil Refining Corporation. At the time, Allied was the largest customer of American Express's field warehousing subsidiary, which was in the unenviable position of having guaranteed millions of dollars' worth of Allied's soybean oil inventory. The tipster, whom American Express employees called "the Voice," said he worked the night shift at Allied's facility in Bayonne, New Jersey. He challenged American Express employees to inspect Tank No. 6006, one of the largest tanks on the property. He explained that there was a narrow metal chamber filled with oil positioned directly under the measuring hatch. Everything else in the tank was seawater.<sup>9</sup>

Now, I'm guessing that you don't run a field warehousing company. But if you did, no phone call would scare the hell out of you like one that goes, "Psst! That warehouse you think is full is actually empty!" A field warehousing company's only job is to oversee and verify its customers' inventory in storage. American Express had issued warehouse receipts certifying Allied's ownership of millions of pounds of soybean oil. Allied was using these receipts, stamped with the American Express guarantee, as collateral for millions of dollars of loans. Norman C. Miller, who won a Pulitzer Prize for his reporting on the Salad Oil Swindle for the *Wall Street Journal*, quoted one of Allied's lenders: "We figured with American Express issuing the receipts, we couldn't go wrong."<sup>10</sup> American Express was risking its capital and reputation on the contents of a bunch of rusty storage tanks in Bayonne. How hard could it be to figure out what was inside them?

After talking with the Voice, Donald Miller, president of American Express Field Warehousing, ordered a surprise inspection.<sup>11</sup> American Express's inspectors checked empty tanks for hidden chambers, finding none. They took samples from the operational tanks, including No. 6006. The inspectors reported to Miller that about 15% of the tanks had

more water in the sample than could be explained by condensation. They also could not rule out a hidden chamber in No. 6006, because all the openings except the measuring hatch were welded shut. Despite these warning signs, the inspectors concluded that the tanks contained enough oil to cover all outstanding warehouse receipts.<sup>12</sup>

When the Voice first talked to Donald Miller, he wanted \$5,000 before providing more details about the fraud.<sup>13</sup> By the end of the summer, he was so frustrated with American Express's milquetoast response that he wanted to prove he was right, reward or no reward. Exasperated with Miller, the Voice called higher up in the organization all the way to President and CEO Howard Clark's office. Rather than offer mysterious leads, the Voice suggested a detailed six-point plan to expose the fraud.<sup>14</sup> The most important step involved hiring independent engineers "who cannot be compromised" to examine the tanks in Bayonne.<sup>15</sup> Clark's executive assistant immediately found the Voice credible and ordered an American Express investigator to take a closer look at Allied.

WITHOUT HAVING TO do an awful lot of digging, the American Express investigator, R. T. Roche, learned some alarming facts about Allied's owner, Anthony "Tino" De Angelis. Roche's internal memo, dated November 18, 1960, noted that De Angelis had been indicted by the Justice Department seven years earlier, and that IRS officials seriously considered criminal prosecution for tax evasion. Tino had more than a million dollars of tax liens against him and was suspected of bribing a government inspector. Roche implied that Tino was tied to organized crime and recommended that American Express plant an undercover man at the company.<sup>16</sup>

De Angelis's previous business dealings were especially troubling. Tino was a butcher who launched his own meatpacking business in 1938. He made a fortune in the 1940s, allegedly through black-market meat sales during World War II, and shady export deals after it.<sup>17</sup> In 1949, Tino bought control of Adolf Gobel Company, a large meatpacker listed on the American Stock Exchange. In 1952, the company lost a lucrative government contract by delivering substandard meat to a federal school lunch program and then overbilling the U.S. Department

of Agriculture.<sup>18</sup> A year later, the Securities and Exchange Commission began investigating the company for overstating earnings and, you guessed it, *inflating inventory*. Within five years of buying control, Tino drove Gobel into bankruptcy.

The SEC contended that De Angelis booked phony orders on Gobel's income statement and borrowed money against inventory that did not exist. The Justice Department indicted him in 1953 for pressuring an employee to make false statements about the value of Gobel's inventory during the SEC investigation. This is worth repeating: When Allied became American Express's largest field warehousing customer in 1957, Tino was under indictment for forcing an employee at his previous (bankrupt) company to lie about inventory values. American Express was guaranteeing millions of dollars of inventory for someone the SEC was accusing of borrowing against phantom inventory.<sup>19</sup>

Allied's recent actions also dispelled any hope that De Angelis had changed his ways since Gobel. In 1958, the Agriculture Department investigated Tino for falsifying shipping papers to defraud the U.S. government out of \$1.2 million. The government filed a civil fraud suit against De Angelis and Allied in 1960, the same year the Voice called American Express to warn about Allied's inventory scam.<sup>20</sup>

None of Roche's information about Tino's shady past was very hard to find. The *Wall Street Journal* reported on the Gobel scandal and the civil fraud suit against Allied. Any credit report on Allied would detail Tino's tax troubles as well as Gobel's bankruptcy and legal scrapes. This is why Allied needed American Express in the first place. The banks would never lend money to Tino De Angelis without independently verified collateral. By guaranteeing Allied's inventory, American Express, one of the most respected financial companies in the country, was the lender of last resort to a con man who repeatedly defrauded the U.S. government and fed substandard meat to America's schoolchildren.

### THE SIEGE OF BAYONNE

American Express in 1960 was not all that different from American Express today. It was a venerated company with a valuable brand, operating

in a profitable line of business. Most people didn't know American Express even had a field warehousing business until the Salad Oil Swindle brought the company to its knees. American Express's dominant travelers checks business exceeded \$1 billion in volume per year, and its fledgling credit card unit was growing 25% a year. The field warehousing business, by contrast, had lost money in about half of the previous sixteen years and had never made a meaningful profit. Not counting the Allied business, which of course turned out to be fraudulent, the warehousing subsidiary was losing money.<sup>21</sup>

Even if the subsidiary had reached Howard Clark's goal of \$500,000 of annual net income, field warehousing was a lousy business that American Express should have avoided. Warehousing customers are so capital-intensive that they must borrow against their inventory, and they have such weak credit that lenders require verified collateral. Because field warehousing companies compete for customers by promising to limit disruption, they compromise their ability to safeguard the inventory. The so-called independent field warehouse is really the customer's own warehouse with a new sign on it. The "independent employees" are existing workers who have been temporarily moved to the field warehousing company's payroll. These situations are rife with conflicts of interest and competing agendas, and the years leading up to the Allied fraud saw several large field warehousing scams.<sup>22</sup>

The *Wall Street Journal's* reporting on the salad oil scandal revealed that Tino was still paying Allied employees even after they had been moved over to American Express's payroll. Almost all of these workers received more money from De Angelis than they got from American Express, so their loyalty to Allied was never in doubt. Only these men knew how the tanks really worked. Only they understood the labyrinth of drainage pipes that connected the tanks, and they were the ones responsible for taking inventory readings for American Express.

THE VOICE FIRST explained Allied's fraud to executives at American Express in the summer of 1960. At that point, American Express could have extracted itself from Tino's swindle with very minor damage—it had warehouse receipts outstanding for 65 million pounds of soybean

oil, worth \$6.5 million. Incredibly, the swindle was not exposed until *three years later*. By then the fraud had increased tenfold—to the point where American Express was guaranteeing more salad oil in Bayonne than existed in the entire United States.<sup>23</sup> The warning signs were everywhere. The weekly inventory increases were so large that it was physically impossible to receive that much oil in so short a time, yet American Express officials watched without blinking an eye.<sup>24</sup> Even some of the bankers making loans against Tino's warehouse receipts called with questions along the lines of, "Are you sure you guys are on top of this thing?"<sup>25</sup> But American Express never uncovered the fraud on its own. Was it really possible to overlook such obvious warning signs without some kind of devious intent?

American Express field warehousing executives were more delusional than they were dishonest. Tino never bribed any of them, nor did he even pressure them to bend rules. He didn't need to. The closest American Express came to discovering the swindle was the surprise inspection after the anonymous phone calls. Tino coolly responded by terminating the field warehousing contract with American Express.<sup>26</sup> The best defense was a good offense, and American Express quickly rushed to soothe Tino's anger at the disruption.

While they were appeasing Tino, American Express officials were feebly processing the warning signs. The inspection report concluded there was enough oil in the tanks to cover outstanding warehouse receipts, but it also stated, "There is still no explanation for the mysterious telephone calls. There is definite information that water was in the tanks. There is the probability that there may have been kiting of warehouse receipts which represented the greatest possible loss to American Express Field Warehousing Corporation."<sup>27</sup> So why would American Express Field Warehousing move forward with the Allied contract with only minor upgrades in staff and oversight? The conclusion to the inspection report is telling: "Since Allied is the largest revenue-producing account on our books and our company would be operating at a loss without the account, I believe that an attempt should be made to salvage the account."<sup>28</sup>

At American Express, the field warehousing subsidiary needed large customers to make the business viable. The pursuit of short-term profit

and professional success blinded the field warehousing executives to the risks of taking on a client such as Allied. By 1963, American Express's field warehousing executives had convinced themselves of Tino's honesty and integrity. Several of them, including division head Donald Miller, invested personal money in one of Tino's other ventures.

In a relatively short time period, a handful of complacent and delusional employees at American Express put the whole institution at risk. CEO Howard Clark toyed with the idea of closing the warehousing business for years, but he kept letting his underlings talk him out of it. Clark even personally visited Allied's facility on one occasion. The only storage tank he climbed turned out to be rusted through on top, but he did not voice concern.<sup>29</sup> When he finally decided to get rid of the Allied business, a few weeks before the scandal broke, it was way too late.

THE GREAT SALAD OIL SWINDLE blew up in spectacular fashion in 1963, when Allied's creditors descended on Bayonne after Tino quietly filed the company for bankruptcy. Confusion gave way to panic as lenders and exporters holding American Express warehouse receipts for 1.3 billion pounds of soybean oil—receipts for 395 million pounds turned out to be forgeries—learned that most of the tanks contained water or unidentified sludge.<sup>30</sup> When Allied's bankruptcy trustees drained Tank No. 6006, they found seawater and a narrow metal chamber with soybean oil. More than fifty companies were affected, including Bank of America, Bankers Trust, Brown Brothers Harriman, Chase Manhattan, Continental Grain, Morgan Guaranty, and Procter & Gamble.<sup>31</sup>

Tino had taken his swindle to Wall Street, wreaking havoc on markets and collapsing his empire in the process. He used warehouse receipts to open margin trading accounts in a reckless attempt to corner the market in soybean oil. When the trade inevitably turned against Tino, the Produce Exchange had to shut down for an entire day so it could unwind his position. A well-respected brokerage firm with 20,000 clients holding half a billion dollars' worth of stocks took huge losses by letting Tino trade on margin. It was suspended by the New York Stock Exchange—only the second occurrence in 171 years—and was liquidated.<sup>32</sup>

The situation at American Express was grim. The company had roughly \$80 million of insurance, but it wouldn't cover loss by fraud. Publicly, Howard Clark alluded to American Express's insurance policies and was optimistic about the company's future growth and prosperity. In private, he huddled with lawyers to figure out if the company would have enough capital to meet claims against its warehousing subsidiary. Shortly after the scandal broke, Clark released a formal statement: "If our subsidiary should be held legally liable for amounts in excess of its insurance coverage and other assets, American Express feels morally bound to do everything it can, consistent with its overall responsibilities, to see that such excess liabilities are satisfied."<sup>33</sup> As accusations and lawsuits piled, the company's stock collapsed, attracting the attention of thirty-three-year-old Warren Buffett in Omaha, Nebraska.

#### UNLIMITED VIABILITY

American Express stock fell by more than 50% in the months following Allied's collapse. Investors' concerns about the company's exposure to Tino's swindle were exacerbated because shareholders did not have limited liability. American Express was the last major public company to be organized as a joint-stock company, meaning anyone who owned shares could be liable for the company's debts and obligations. Warren Buffett explained this dynamic to *The Snowball* author, Alice Schroeder:

So every trust department in the United States panicked. I remember the Continental Bank held over five percent of the company, and all of a sudden not only do they see that the trust accounts were going to have stock worth zero, but they could get assessed. The stock just poured out, of course, and the market got slightly inefficient for a short period of time.<sup>34</sup>

Buffett bought an enormous position in American Express. At one point the stock accounted for almost one-third of his portfolio.<sup>35</sup> But he never wrote about the investment in any of his partnership letters. Buffett only mentioned control positions and obscurities by name. In early

1964, when he was buying American Express as quickly as he could, the only new stock to appear in the investor letter was Texas National Petroleum, a tiny buyout deal that netted just over \$100,000 in profits. But despite its low profile in Buffett's partnership letters, American Express's effect on his investing philosophy was profound.

Buffett divided his portfolio into three categories: "control positions," like Dempster Mill or Berkshire Hathaway; "work-outs," which were special situations like Texas National Petroleum; and "generals," where American Express would fit. His description of "generals" in early 1963 focused mostly on bargain prices and margin of safety. He wrote, "Many times generals represent a form of 'coattail riding' where we feel the dominating stockholder group has plans for the conversion of unprofitable or under-utilized assets to a better use."<sup>36</sup> In other words, many of these stocks were low-return businesses trading at a discount to book value just like Dempster Mill and Berkshire Hathaway.

A year later, after Buffett had begun purchasing American Express, he updated his description of generals: "[W]hile the quantitative comes first and is essential, the qualitative is important. We like good management—we like a decent industry—we like a certain amount of 'ferment' in a previously dormant management or stockholder group."<sup>37</sup> By 1967, after he had made a killing on American Express stock, Buffett wrote:

Interestingly enough, although I consider myself to be primarily in the quantitative school (and as I write this no one has come back from recess—I may be the only one left in the class), the really sensational ideas I have had over the years have been heavily weighted toward the qualitative side where I have had a "high-probability insight." . . . So the really big money tends to be made by investors who are right on qualitative decisions but, at least in my opinion, the more sure money tends to be made on the obvious quantitative decisions.<sup>38</sup>

Buffett was attracted to American Express stock's steep fall, and the company's joint-stock structure, with unlimited liability, neatly explained the market's overreaction. But he did not buy into American

Express just to take a quick profit when the market stabilized. After surveying the performance of the company's products, he knew he'd found a great business—the kind that rarely crossed his desk before 1963.

Buffett had focused much of his career on buying asset-rich businesses for cheap. But American Express had basically no plants or equipment. Its value rested in its name, and Buffett surveyed banks, hotels, restaurants, and customers to determine that the scandal had not affected the brand.<sup>39</sup> His research helped him recognize the immense power of an asset-light business model. Whereas asset-rich companies like Berkshire Hathaway required a lot of investment to operate efficiently, American Express's travelers checks business actually created excess capital, a large float, between the time customers bought checks and used them. Because of the enduring power of the American Express brand, he likened the settlement with salad oil claimants to losing one dividend check in the mail—an annoyance, but by no means a catastrophe.<sup>40</sup> What was Buffett's "high-probability insight" on American Express? As he told *Forbes* in 1969, "Look, the name American Express is one of the greatest franchises in the world."<sup>41</sup>

### THE TYPHOON WILL PASS

American Express lost \$125 million in market value after the swindle became public. It eventually reached an agreement with salad oil claimants that would cost only \$32 million net of taxes.<sup>42</sup> But a funny thing happened on the way to resolution: American Express's settlement was delayed by an unlikely group—the company's own shareholders. A small group of shareholders filed suit to block any settlement, on the grounds that American Express had no legal obligation to pay the warehousing subsidiary's liabilities. Howard Clark may have felt he had a moral obligation to creditors, but shareholders argued that American Express legally owed nothing. They believed paying a cash settlement was a "gift" and a negligent use of assets that would damage shareholder value. They were especially frustrated that holders of forged receipts would receive any cash at all.

When public company shareholders don't have opinions, or hold

them tighter than they hold their stocks, the few who choose to speak up are afforded a tall soapbox. But if an empowered few assume the voice of all shareholders, how can we be sure they are looking out for committed, long-term owners? The outsize influence of active shareholders probably weighed on Warren Buffett's mind when American Express holders began agitating for the company to ignore the salad oil claims. Buffett knew the odds of this happening were slim, but why risk letting a handful of shareholders dominate the debate?

In Buffett's early years, he occasionally clashed with management teams and boards of directors of underperforming, asset-rich companies. When he was forced to go active, it often meant seizing control and dismantling assets. At Dempster Mill, for example, he generated shareholder value by taking money out of the business as quickly as possible. American Express was a different situation altogether. Management was making the right moves to protect the franchise, yet other shareholders were agitating to block them. The swindle generated national news coverage and many of the claimants were large financial institutions that sold American Express travelers checks. Buffett worried that shareholders' shortsighted attempt to avoid a settlement could permanently impair American Express's valuable brand. With a quality business at stake, Buffett wanted to intervene to protect the company's competitive advantage.

In some ways, Buffett's June 16, 1964, letter to Howard Clark (page 218) reads like a pep talk. He praises management, and then encourages them to keep up the good work. Behind the outward positivity, Buffett seems to be saying, "Come on, we have a great business here and we almost have this mess behind us, let's not screw it up now." The most astounding part of the letter is Buffett's suggestion that the Allied scandal would ultimately *improve* American Express's reputation for integrity. He writes, "While I am certain that management must feel at times like it is in the midst of a bottomless pit regarding the field warehousing activities, it is our feeling that three or four years from now this problem may well have added to the stature of the company in establishing standards for financial integrity and responsibility which are far beyond those of the normal commercial enterprise."

The idea that American Express could emerge from this debacle with heightened stature seems like a fantasy, or perhaps an attempt by Buffett to ingratiate himself to Clark. But as Peter Grossman explained in his 1987 book about American Express, the worst crisis in the history of the company had the perverse effect of strengthening the business and management team. Grossman wrote, “In fact, so much was gained that someone asked Howard Clark if a Soybean [scandal] was not a good idea every few years. But he replied, ‘I don’t think I have enough years of my life to give away for another scandal.’”<sup>43</sup> As it turned out, Buffett was completely right. Thus was born the Oracle of Omaha.

As Warren Buffett tallied huge profits from his American Express investment, the market around him devolved into a feeding frenzy for conglomerates and flashy mutual funds. But Buffett quietly continued on his own evolutionary pathway. His American Express investment pushed him further away from Benjamin Graham’s investment style. He explained years later, “I became very interested in buying a wonderful business at a moderate price.”<sup>44</sup> In 1969 he announced his plan to close his investment partnership. He had made enough “sure money” on quantitative decisions and was ready to move on to larger prey. Over time, Buffett became interested in buying whole companies. In light of American Express, this made perfect sense. Owning a great business is easier, and much more fun, than buying fractional interests in wasting assets. Buffett would use the value investing style he’d refined like golden soybean oil to raise Berkshire Hathaway, a doomed New England textile company, to the commanding heights of industry.

### WALL STREET WIZARDRY

While Buffett added tremendous value to Berkshire Hathaway in the late 1960s by buying an insurance company and a bank, many of his contemporaries took sound businesses and desecrated them with senseless acquisitions. The “go-go” stock market of the 1960s launched what is known as America’s third major merger wave (after the 1890s and 1920s). It was in large part a pointless bastardization. Whereas the previous

merger booms focused on horizontal and then vertical integration, public companies in the '60s binged on acquisitions merely for the sake of growth, which was richly rewarded by Wall Street no matter how it was obtained. The go-go era collapsed quickly, but a new generation of corporate raiders emerged from the ruins. Jim Ling's 1978 battle with Harold Simmons highlights the hostile raider's ascendance.

"Jimmy Ling the Merger King," who ran Ling-Temco-Vought (LTV), is a prime example of a conglomerator who built a fortune on Wall Street's willingness to pay up for growing companies. In 1955, he took his small Dallas-based electrical contracting business public. It was a challenge to find buyers for his stock—he even got a booth at the Texas State Fair to distribute copies of his prospectus—but Ling managed to raise about a million dollars.<sup>45</sup> From this start, he made a slew of acquisitions that put his company in the Fortune 500. Ling perpetually raised money from Wall Street and pursued baffling restructurings that facilitated future fund-raising. He sold various hybrid securities, such as preferred stocks convertible into common stock, and frequently made confusing offers to swap new securities for old ones. By 1969, after successful hostile tender offers for Chance Vought, Wilson & Company, and Jones & Laughlin, LTV was number fourteen on the Fortune 500. Ling's \$425 million hostile tender for Jones & Laughlin was, at the time, the largest ever cash tender offer.<sup>46</sup>

As LTV grew, Ling was widely praised for his "financial wizardry." The description was unintentionally apt: LTV's rise was a ruse facilitated by Ling's powers of obfuscation and Wall Street's emphasis on earnings growth and price/earnings ratios. Because Ling's company received a high valuation on public markets, he could raise enough capital to buy more earnings growth through acquisition. But this would not go on forever. There was a dirty secret behind LTV: Ling's acquisition record was spotty. Wilson may have been a success, but Chance Vought and Jones & Laughlin were both disasters. Before long, investors wised up to the conglomerators' game, and LTV's stock collapsed. Because Ling had borrowed heavily against his LTV holdings, his personal wealth was decimated.

## FROM OMEGA TO OMEGA

In the mid-1960s, at the height of the Merger King's fame, Harold Simmons, a thirty-three-year-old pharmacy owner, wrote to Ling seeking a meeting. Simmons had followed Ling's career from afar and was impressed by his ability to snatch up companies. When he was not managing his drugstore, Simmons was reading annual reports and dabbling in the stock market. He thought he had found a particularly undervalued company, Bath Iron Works in Maine, and he wanted to hear what Ling thought of the idea. Simmons was thrilled when Ling agreed to meet with him. He was even more excited when Ling praised Simmons's investment analysis.

When the two men met again in 1976, Jim Ling was in dire straits. His newest venture, Omega-Alpha, should have been called Omega-Omega, because it quickly fell into bankruptcy. It was another in a succession of low moments for Ling, who had been the toast of Dallas less than a decade earlier. Simmons, for his part, was riding high. He had sold his drugstore empire for \$50 million and was on his way to building a billion-dollar fortune raiding public companies. Simmons mimicked Ling's creative use of tender offers to win control of companies, but where Ling's goal was to grow LTV at all costs, Simmons focused on buying undervalued businesses. One of Harold Simmons's best talents was finding companies with hidden assets that the rest of the market overlooked.

In 1975, the same year Ling's Omega-Alpha filed for bankruptcy, Simmons found an obscure company called Valhi that traded at only \$5 per share despite owning \$50 per share in properties. Simmons figured out Valhi owned this hidden treasure by following the actions of D. Doyle Mize, former CEO of Zapata Corporation. Mize resigned as CEO of Zapata to become CEO of its small landholding subsidiary, Southdown. When Zapata spun off Southdown to its shareholders, Mize concentrated his ownership and made a fortune. He then tried to repeat the feat with Valhi. Mize pooled Southdown's best assets into Valhi, resigned as Southdown's CEO to become Valhi's CEO, and then spun Valhi off to shareholders including himself. Simmons surprised Mize by tendering

for Valhi's shares at \$15 per share. Mize topped Simmons with a \$17.50 offer, but Simmons ultimately won control with a \$22.50 tender offer.<sup>47</sup>

Shortly after Simmons's Valhi triumph, Jim Ling stopped by for a visit. Simmons did not form a partnership with Ling, as the former Merger King suggested, but he did take pity on his former investment hero. Simmons offered Ling a two-year contract as an advisor to Contran, Simmons's main investment vehicle. Ling immediately pitched several investment ideas—and Contran would go on to make good money buying Omega-Alpha bonds on Ling's recommendation—but there were flaws in his analyses. While Ling was smart, Simmons realized that he was also a consummate bullshitter. He spoke quickly and used a lot of confusing jargon when he explained his ideas, yet he was often blind to critical and obvious details. Still, the humiliating collapse of LTV and his personal finances had not dampened Ling's self-confidence. A week after his two-year contract with Contran expired, Jim Ling informed Harold Simmons that he planned to make a hostile tender offer for Contran shares.

"This is typical Ling," Harold Simmons told his lawyer: "overlook the details that'll kill you."<sup>48</sup> After two years inside the company, Ling knew that Contran was deeply undervalued by the market. He saw how much value was hidden in Contran's constituent parts like Valhi. He also knew that if he could win control, he could liquidate the company for a massive profit. But he was neglecting one critical detail: Harold Simmons already controlled 42% of the stock. For Ling to prevail, he would have to purchase almost 90% of the remaining stock outstanding. That is a tall order.

With Contran stock trading at \$20 per share on the open market, Ling offered \$35 to buy out several large shareholders. He later publicly tendered for shares at \$50, getting control of 41% of the company. At that point, Simmons had boosted his stake to 44%. If Ling could just get over 50%, he'd be on his way back to the LTV glory days. If he failed, however, he would own a huge, illiquid, debt-funded block in a company controlled by his enemy.

Jim Ling wasn't able to secure 50% of Harold Simmons's Contran. To make matters worse for him, Contran stock, which hovered around

\$50 per share in the last days of the battle, was sure to plummet in value. Ling wanted Simmons to repurchase his block at \$50. Simmons replied, "You can just keep that stock forever, because I'm not interested."<sup>49</sup> Contran ultimately bought the stake for a combination of cash and securities worth under \$30 per share. Jimmy Ling the Merger King was back in the dumps, banished to a desert planet of irrelevance. The circle was now complete. When they first met, Harold Simmons was but the learner; now he was the master. When he was asked later about Ling's attempted coup, Simmons showed no anger. It was just business, he insisted.<sup>50</sup> The age of the cold-blooded hostile raider had arrived.

#### JIMMY'S (WOODLAWN TAP) AND HAROLD'S (CHICKEN SHACK)

Jimmy Ling and Harold Simmons both made careers out of exploiting the market's ability to grossly misvalue public companies. Ling thrived in an era that saw superstar fund managers crowd into speculative companies promising growth. He used his own overvalued stock to raise money to purchase other businesses. Simmons prospered in the '70s, when the economy stagnated, markets tanked, and "go-go" was a gritty form of underground funk music in Washington, D.C. He scoured the wreckage in the markets for valuable companies that he could buy for a bargain price. One man capitalized on irrational optimism, the other on irrational pessimism. It's hard to believe, but over the same period a revolution was brewing in academia based on the curious notion that financial markets are near perfect. It altered the debate on hostile takeovers and helped bring corporate raiders out of the shadows and into the boardrooms of America's largest companies.

The efficient market hypothesis came out of the University of Chicago in the 1960s. It states that stock market prices fully reflect all publicly available information about a firm and represent the best possible estimates of its value. Even if some investors are irrational and respond to news poorly, they are random, normally distributed, and balance each other out. With efficient market theory, we can use fancy math formulas like this to compute a stock's expected return:

$$E(\tilde{r}_{j,t+1}|\Phi_t) = r_{f,t+1} + \left[ \frac{E(\tilde{r}_{m,t+1}|\Phi_t) - r_{f,t+1}}{\sigma(\tilde{r}_{m,t+1}|\Phi_t)} \right] \frac{\text{cov}(\tilde{r}_{j,t+1}, \tilde{r}_{m,t+1}|\Phi_t)}{\sigma(\tilde{r}_{m,t+1}|\Phi_t)}$$

Now, I'll admit to having a soft spot for academic economics and finance. There is a beauty to a scientific proposition, and a good one helps us think clearly about a question at hand. Nobel laureate Merton Miller, who like many of his Chicago colleagues is a joy to read, described the utility of one of his finance theories in an interview: "[the] proposition is the beginning of wisdom; it's not the end of it."<sup>31</sup> He explained that when the theory fails in the real world, we become wiser by understanding which assumptions failed and why.

But when early proponents of the efficient market theory focused on empirical research, it was more like the end of wisdom than the beginning. Economists love to process data, and this led to critical biases. Their own love of information made them view investing in the stock market as a game of information gathering. They worried more about their assumption that market participants have equal access to information than they worried about collective lapses in judgment. Because it is easier to do research on discrete events like earnings announcements, dilutive stock offerings, stock splits, and mergers, many of them focused their empirical work on pockets of the market that were more likely to be efficient. But it's easy for investors to get out their calculators and price stock splits quickly and accurately. It is much harder to research investors' collective judgment of a company's long-term prospects. For several decades, academic economists took for granted the rational expectations of market participants.

In an efficient market, divergent opinions balance each other out and guide stock prices to an optimal level. In the real world, misjudgments are much more likely to be biased in one direction, and mass hysteria is not uncommon. Even in periods when the stock market is stable, investors are capable of dramatically misvaluing a company. Joel Greenblatt, who taught me securities analysis at Columbia, likes to open the *Wall Street Journal* on the first day of class and point out the large difference between the fifty-two-week high and fifty-two-week low stock

prices of stable companies like Coca-Cola and Wal-Mart. Fund manager Howard Marks cites Yahoo!, which saw its year-end market value between 1997 and 2001 go from \$3 billion to \$29 billion to \$115 billion to \$16 billion to \$9 billion.

Why does this matter to us? If markets are not efficient, participants have the opportunity to exploit dislocations for their own benefit. Companies can take advantage of shareholders, and shareholders can take advantage of companies. Here's a good example of this phenomenon: If you believe in rational markets, a company buyout at a premium to its market price is a profit-maximizing event for all shareholders. In the real world, buyouts are opportunistic, and people can, and do, get screwed.

We also shouldn't ignore the role markets play in influencing management teams. Every CEO interested in protecting his or her job must worry about stock price performance. As Carl Icahn once said, "You better get that price up or someone else will do it for you."<sup>52</sup> But what happens when the investor base misvalues the company? All of a sudden the incentives can get twisted, leading to poor management decisions.

I saw Eddie Lampert, a hedge fund manager who is chairman of Sears Holdings, make some interesting points at a New York Public Library event in 2006. When he was discussing the challenges of managing a public company, he raised a question few people in the room had considered. How do you run a company well when the stock is *overvalued*? What happens when management can't meet investors' unrealistic expectations without taking more risk? And what happens to employee morale if everyone does a good job but the stock declines? Lampert, of course, knew what he was talking about. Sears closed that day at \$175 per share versus today's price of around \$35. In an efficient market, it's easy to develop tidy theories about optimal corporate governance. Once you realize stock prices can be totally crazy, the dogma needs to go out the window.

#### SAUL STEINBERG

As the efficient market hypothesis became more widely accepted in the 1970s, it had an important effect on the country's tolerance of takeovers.

In the 1960s, men like Jim Ling used hostile raids to fold small and medium-size companies into their conglomerates. Wall Street and its regulators tolerated the strong going after the weak, as well as medium-size companies gobbling up each other. But when blue-chip companies found themselves behind crosshairs, everyone freaked out. Saul Steinberg's brief dance with the mighty Chemical Bank in 1969 was proof.

Chemical was a 150-year-old bank with \$9 billion in assets. Steinberg was a twenty-nine-year-old go-getter who launched his first business in 1961, Leasco, which leased IBM computers to customers at cheaper rates than IBM offered. He took Leasco public in 1965, received a nice valuation for his stock after a couple of years of strong growth, and then had the good sense to diversify into businesses that IBM couldn't squash without a moment's notice.

In 1968, Steinberg announced a tender offer for Reliance Insurance Company, an overcapitalized property and casualty insurer ten times larger than Leasco. The tender was successful and transformed Leasco from a niche equipment rental company to a Fortune 500 business with \$27 million in annual earnings. Over the five-year period ending in 1968, Leasco stock had increased 5,410%. John Brooks called it "the undisputed king of all go-go stocks."<sup>53</sup>

The following year, Steinberg turned his attention to the banking industry, which he thought was as sleepy and conservative as the insurers. He began to buy shares in Chemical Bank and make early preparations for a tender offer. When Chemical's management got wind of Leasco's stock purchases, it waged a preemptive war. To force Steinberg's hand, the bank tipped off reporters that it was a target. It then used its power with regulators to stymie Steinberg's chances of launching a successful offer. The Department of Justice sent Leasco a letter raising antitrust concerns about a merger. The state of New York introduced and then passed an anti-bank-takeover law. Even the chairman of the U.S. Senate Committee on Banking introduced an anti-takeover law that would have blocked the takeover.<sup>54</sup>

"We'd touched some kind of nerve center," Saul Steinberg later told John Brooks. "All through those two weeks, bankers and businessmen I'd never met kept calling up out of the blue and attacking us for merely

thinking about taking over a big bank,” he said. “I always knew there was an Establishment—I just used to think I was a part of it.”<sup>55</sup>

Steinberg’s willingness to target giants was years ahead of its time, but luckily for him he was not yet thirty years old. It wasn’t long until Steinberg and his fellow corporate raiders would have their day. With help from the efficient market hypothesis and the free market movement of the 1970s, raiders were viewed less as a scourge and threat to industry and more as a disciplinary force. In the ’80s, the hostile raiders rode strong economic growth and Michael Milken’s blank checkbook to fame and riches.