



**HARVARD Kennedy School**  
JOHN F. KENNEDY SCHOOL OF GOVERNMENT

# WIDOWS AND ORPHANS

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## Introduction

Most CEOs grow to hate the treadmill of quarterly reporting. I certainly did, and I was the CEO of a company that boasted 29 consecutive quarters of sales and profit growth in excess of 50% and four stock splits. We were the first software company to reach \$1 billion in valuation.

However, the more successful my company became, as quarter after quarter it met projections and the price/earnings ratio climbed, the greater the pressure to continue to perform. Even a slight slowing in growth rates could cause a dramatic fall in the price of the stock and threaten to trigger a class-action lawsuit against management. Consequently, management diverted an inordinate amount of time and energy to the quarterly reporting process, particularly as each quarter drew to a close.

Yet I knew, as does every CEO, that operating a company on a quarterly basis is no way to "run a railroad." This narrow, short-term view gives lawyers and accountants too much influence, but that is only part of the problem. What is more important is that the natural conflict between customer and investor interests intensifies in a public company. The dilemma is this: Do customers get the service they want, or do investors get the profits they want? Many economists say a CEO should be able to satisfy both requirements, but does it really happen?

Most CEOs of dynamic American companies have lime time to ponder this issue or to compare their predicament with similar customer/investor conflicts in other countries, such as Germany and Japan. As the former CEO of a high-growth, high-tech company, I am sure of three things: my company became successful by focusing on customer needs; by so doing, it created great investor rewards; and the company changed in fundamental ways once it went public.

While thinking about these changes and what brought them about, my initial sense was that the American financial system was fundamentally flawed and that quarterly reporting might be at the heart of it. However, quarterly reporting turned out to be just a highly visible symptom of the problem. The real root cause lies in the legislation of the 1930s, which was designed to protect investors, including "widows" and "orphans," from the abuses associated with the 1929 stock market crash and subsequent bank failures. The term "widows" refers to unsophisticated investors, those outside the mainstream of the American financial system. Widows are the last to know, and as a result they usually buy high and sell low. "Orphans" refers to the often-neglected customers of American publicly held corporations.

What follows is a personal view of the American financial system.(1) My experiences and views may not align with accepted economic theory. Therein, perhaps, is their value.

## The Legislative Foundation

"The period from 1924 to 1928 was an era of greed that has never been witnessed in the United States," according to Joseph Auerbach, Professor Emeritus of the Harvard Business School and eyewitness to events leading up to the crash. Considering current abuses, this is quite a statement. Professor Auerbach also said that American investors were particularly furious with the banks after the 1929 stock market crash because the banks had sold them the securities.(2)

This resentment led to legislation designed to protect the investor via an efficient market. So many people lost so much in the stock market crash and the subsequent bank failures in the early 1930s that something

had to be done. Ten million investors in the 1920s (versus 500,000 in 1900) had a significant political clout, and they had become very unhappy. They helped elect Franklin Roosevelt to the White House in 1932, based largely on his promise to propose corrective legislation that would protect the small investor.

The first legislation, enacted just a few months after Roosevelt took office, required full disclosure of material corporate information in a public offering by an issuer (Securities Act of 1933). This was followed by regulation of stock markets and trading in securities of publicly registered companies via the creation of the Securities and Exchange Commission (Securities Exchange Act of 1934), an agency that is still fundamentally unique to the United States. Additional acts were implemented, including the Glass-Steagall Act of 1933, which required banks to divest themselves of their investment banking divisions.<sup>(3)</sup> One purpose of the legislation was to make the seller of securities "beware," not the buyer. This reversed traditional concepts of responsibility in such transactions.

It is important to note that the legislation creating the Securities and Exchange Commission (SEC) included the necessary administrative tools to implement the legislation effectively. Therefore, the SEC — with vast and unique regulatory powers — became a highly respected, powerful, and often feared agency of the American government. No other country in the world has an agency with such regulatory powers.

This investor-protecting legislation was designed to avoid a repeat of the great stock market crash of 1929. The system worked well while the United States was the dominant economic force in the world.

Unfortunately, this is no longer the case. In fact, some of the seeds of America's current competitive problems in a global economy were sewn in the above-mentioned and related legislation.

Despite noble intentions, these legislative "fixes" have resulted in:

- Customers treated as second-class citizens (i.e. orphans).
- Institutionalization of the short-term focus.
- Encouragement of absentee ownership.
- Loss of control by investors.
- Domination by self-serving professional managers.
- Acquiescent boards of directors.

### **Life in the Investor Market**

The American financial system can be broken down into customer and investor markets. For example, my company spent the first year of its existence in the investor market raising money.

The following 10 years were spent in the customer market building a successful company based on new technology, marketing skills, and customer service. Consequently, we re-entered the investor market in 1978, via a public offering and continued to operate in both the investor market and customer markets until the company merged. This company's history illustrates some of the forces that led up to a public offering and dictated the decisions of a publicly held company.

In 1968, a new corporation was formed, hereafter called the Company, to specialize in computer software products. At this point, I had my first contact with the investor market via Burnham & Company, a firm that agreed to raise \$480,000 in exchange for 40% of the equity in the Company.

Sol Manber, a long-time business associate, opened the door for me at Burnham & Company. The "investment bankers" we were to meet at Burnham had backed Sol in a number of, previously, successful ventures, including Alphanumeric, Inc. Its stock had gone public at \$6 and shot up to \$600 per share while total company sales were \$609! Yes, \$609! IBM had signed a contract to sell Alphanumeric's text editing system under IBM'S name. Naturally, the stock took off but eventually experienced an equally spectacular collapse.

This is why, I, and many people like me, are inclined to think of Wall Street as a great gambling casino. While euphemisms like "investor" are dutifully used by representatives of the New York Stock Exchange, SEC, and other members of the securities establishment, "gambler" seems more accurate. Thanks to various regulations, there are far fewer "crooked tables" in casinos today than there used to be. Ironically, investor-gamblers can still lose just as much money as ever, and they often do, as exemplified by the investors in ill-fated Alphanumeric.

The partners at Burnham who did the Company's deal were Howard Golding and James Metkovich. Working with them was a most unusual experience. I got the feeling that Burnham & Company was a very loose association of investment bankers. They seemed more like bookies who "laid off" pieces of large investments (bets) to their dentists, doctors or other chance acquaintances. In fact, some of the Company's original 25 investors were dentists and doctors. During the negotiations, we often went to Oscar's, Wall Street's "high-roller" restaurant of the time.

During our first lunch, I was startled to hear James Metkovich uttering religious expressions reminiscent of my Irish Catholic mother, such as "Thanks be to God," and "Jesus, Mary and Joseph," and "God willing," all expressed with the fervor of a monk praying that this deal would be successful. I certainly hadn't expected to be hearing such expressions in these halls of greed. James, I soon teamed, was a former Christian Brother, and math teacher, before getting a job as an analyst on Wall Street. Now he was doing deals as an investment banker at Burnham & Company and becoming very successful, so successful that some people believed he had the "magic," or was, as Tom Wolfe would say, "a master of the universe."

Thus, many doors were opened to Metkovich and Golding, including those at some very conservative Boston investment houses. The last time I saw James and Howard together, they were forming the investment banking arm of an "over-the-counter" house and looking at corporate jets to help them make bigger deals, faster. However, the market conditions turned very bad very fast, and, as so often happens on Wall Street. There wasn't going to be any jet, or any investment banking arm of the brokerage house, or eventually, any job for them. Regardless, I am afraid that James and Howard would have long since been replaced by 25-year-old graduates of our prestigious business schools with their \$185 Hermes ties.

But Howard and James did find 25 investors who agreed to put up \$480,000 in this new company that was to specialize in computer software products. This experience with Wall Street left me with the distinct impression that if any industry needed some regulation for the good of all parties concerned, including widows and orphans, it was the securities industry.

When the Company was about 2 years old, it faced its first major crisis. Quite simply, we were going bankrupt. The situation deteriorated to the point that we had only \$500 of the original \$480,000 investment left, and a payroll of \$8,500 due that day. Fortunately, a check for, literally, \$8,500 arrived in the mail that day. However, while this check solved the immediate problem, we were still on our way out of business.

We returned to Wall Street to seek additional funding but it wasn't going to be any for us, or any other company. This became crystal clear to us as we sat in the office of the president of a Wall Street investment banking firm while he took a telephone call and subsequently turned down the opportunity to become involved with a company that had 100 consecutive years of profitable operation. We felt somewhat sheepish bringing up our 2-year-old company with its miserable financial performance. We knew what the answer was going to be and why. Not only had conditions become pretty desperate on Wall Street but the facts clearly demonstrated that the Company wasn't doing very well in the customer market. As a result, the investor market wasn't responding either.

### **Life in the Customer Market**

Our problem was that we had only one product—a report generator package called Culprit—that wasn't selling very well. As if being a one-product company weren't enough, we were out of money, technical resources, and time.

We had sold fewer copies of Culprit than we should have because, at the time, our technical managers, although very talented, thought prospects should like the system the way they developed it— not the way the prospects wanted it to buy it. So while many Culprit prospects thought the package was a terrific product, and a major technical advancement, they eventually bought technically inferior products because the competition offered the desired features. This certainly was the product market at work.

We had to make an extremely difficult choice. Since our lead technicians wanted to do things their way, I suggested that it would be best if they formed their own company to do so. The technicians I kept were much more willing to be responsive to customer needs, as our prospects perceived them. As a result, things changed for the better. However, the EDP Auditor version of Culprit was key to turning the corner.

Someone in the Company compared developing the EDP Auditor system to the parable of the loaves and fishes because I had created two products out of the one Culprit system, and named one of them "EDP Auditor." While they were actually the same system, we provided a considerably different level of support and training for the EDP Auditor product, which was tailored to non-programmers. We even formed an EDP Auditors' "Users' Group." Each user had to speak about how he or she used the product, which was of great value to the other attendees. We also included a preprogrammed EDP Auditor library of commonly used routines, such as audit verification notices and statistical sampling. As a result, we were making the auditor's job easier. In other words, we were focusing on customer needs.

As the new EDP Auditor package gained in popularity among auditing departments of major banks, the fast turnaround of reports quickly caught the eye of senior banking management. Auditors were producing very valuable and impressive reports in days. Management began asking, "How could this be when our data processing department said the same report would take three months; why can't they produce reports like these?" Consequently, data processing departments, which long had been resistant to products like Culprit because their programmers might have to change their ways of doing things, bought the package as a defensive move.

While, previously, we couldn't sell very many Culprit packages at \$10,000, we were now selling many EDP Auditor/Culprit packages at \$20,000. We had identified a special product market niche and responded to it well.

We also learned something very important about organizations as we coped with this crisis. When our money was running out and we had to cut back from nine employees to five, there was concern that our service would suffer. Instead, to my great surprise, we achieved better customer service with five people than we had with nine. This was because these five employees clearly understood that we were in business to satisfy customers' needs. We pulled together with a common mission and made money for the first time. Focusing on customer needs was the key to the solution. It sounds so simple and obvious, yet in my experience it is rarely practiced in new or old ventures. That's why so many fail.

This anecdote exemplifies the problems that most new ventures have to cope with in order to survive and prosper in the product market. We competed in the marketplace based on the merits of our products, our responses to customer requirements, our reputation for service, and our marketing skills. As a privately held company, we were able to devote all of our energies to these ends, and we therefore survived at a time when most software companies failed.

### **Return to the Investor Market**

In December 1977, we allowed three venture capitalists to buy shares in the Company from members of management, myself, in particular, for reasons I will discuss later. Initial Public Offerings (IPOs) were so clique-ish that potential investors looked to see what members of the clique, if any, were involved in the new issue. If the "right" members were included, they bought in automatically. It was during this period of prospectus preparation that I first heard the quaint phrase reminiscent of another era: "widows and orphans."

When the Company had maintained five years of audited statements that demonstrated an unbroken chain of sales and profit growth in excess of 50% per year, we had thus passed our first hurdle to a public offering and entry into the securities market.

We committed to an underwriter that specialized in taking high-tech companies public. The Company was to be the first software products company any underwriter took public. The firm arranged "dog-and-pony shows" for the Company in Los Angeles, San Francisco, New York and Boston. The meeting in San Francisco took place with a standing-room-only crowd on the 52nd floor of the Bank of America building with a fantastic view of the fog rolling in over the Golden Gate Bridge. On the other hand, I could also see Alcatraz; one knew that going public was a serious undertaking fraught with potential trouble.

There was great interest in the stock, but pricing of a security takes place at the last possible moment. As part of my indoctrination, the president of our underwriting firm invited me to attend a dog-and-pony show for another company, two weeks before ours.. At this time, he explained that the company wanted to go public at \$14 per share and why he felt it should be \$10.

We agreed to price the Company's stock in the \$15 - \$20 range. On the day of the pricing, the president of the underwriting firm said that he wanted to price the stock at \$18 per share. When I objected, he proceeded to give me the identical speech, word for word, that he had given me two weeks earlier. When I pressed for \$20/share, he threatened to walk away from the deal. I insisted on \$20 and reminded him that I also could and would walk away from the deal, and would. The money in the bank from the venture capital deal had strengthened my resolve; otherwise, I would have caved in. He finally acquiesced and went along with the \$20-per-share price. The stock rose to \$28 the first day and then receded to \$13. Most of the

people who purchased the stock at \$28 seemed to be "widows," unsophisticated investors. I met many of them, including some who sold the stock at \$13 within two months because they needed the money.

The underwriter had emphasized continuously that it was important to place the Company stock with institutions that would invest for the long haul and stay with us. Because it was a "hot" deal, only the best customers of the underwriter were allocated shares out of the 300,000-share initial offering. No "widows," to my knowledge, were in this group of "insiders." I found out much later that many of these institutions "blew it out" within a matter of hours, making upwards of \$8 per share for their efforts. However, if these alleged long-term investors had kept the stock for seven years, it would have been worth \$800 per share. Obviously, the underwriter was most interested in these customers making short-term gains because he had many more deals coming along to sell them. Yet the underwriter would say that, because of the laws of the 1930s, the burden of "beware" was on his company and that he was only acting in the interests of the buyer by pricing the shares as low as possible.

### **The Pressures of Quarterly Reporting**

A company that goes public immediately feels the pressure to maintain good quarterly performance. Along with this comes apprehension over new industry developments that could impact the life or performance of the company. In the Company's case, this fear came true within six months after the public offering. IBM introduced a new computer (IBM 4300) and proceeded to call on what seemed like all of our customers and prospects, claiming that the Company's software wouldn't run on the new computer. IBM also said all future applications would be based on IBM'S database management system. Consequently, our customers and prospects would be outside the mainstream of all future IBM application development. Every customer, it seemed, went into a panic and every prospect went into a "hold" status. The disaster of a "down quarter" loomed on the horizon. Fortunately, we solved the problem by creating a new "main message" that resulted in a very effective counter-marketing program, literally overnight. We got through the fourth quarter unscathed and, most importantly, learned how to compete with IBM.

While all 29 quarters were not as dramatic as this quarter as a publicly held company, many of them were. Certainly each one was a high tension situation while we "met the numbers." The suspense is built in because each quarter begins with a "clean slate." In the software products business there is no backlog of orders. Sales are usually installed in the same quarter in which they are sold. We never knew until literally the last minute of the quarter what the revenues were going to be. Add to this the fact that the Company had the highest price/earnings ratio (57/1) on the New York Stock Exchange for five years in a row—with an eventual valuation of \$1 billion—and you have the ingredients of tension. One slight slip could mean a one-day \$500 million loss in valuation.

In addition, the employees of new public companies are often stockholders, and they, like others, begin to monitor the performance of the company's stock on a daily basis. Sudden moves up or down bring many questions from employees, vendors, large stockholders such as institutions, as well as members of the company's board of directors. Many of these price fluctuations may have little to do with the company's performance. These fluctuations are often related to selling by institutions such as pension funds in an attempt to make their own quarterly reports look good. Added to this are the tremendous pressures on management to perform in keeping with analysts' predictions. A great performance that doesn't quite meet analyst expectations is considered something of a failure.

Despite these "external" pressures, some CEOs tried to focus on the longer term, including Paul O'Neil when he was at Alcoa, who stated, "The emphasis on quarterly results is ridiculous."<sup>(4)</sup> Robert McCrane, co-manager of T. Rowe Price's New Horizon Fund, jokes that the first and last week of every quarter he goes on "torpedo watch" as he braces for computer companies to announce their earnings. Michael Murphy, editor of Computer Technology Stock Letter, calls these periods, "four- times-a-year lunacy."<sup>(5)</sup>

A variation on this theme, Genentech Inc.'s recent agreement to sell a controlling interest to Roche Holding Ltd., is designed to free Genentech from the tyranny of Wall Street. "We have so much we want to do," said Genentech's president at the time, G. Kirk Raab. "The quarterly pressures of the stock market, though real and understandable, inevitably inhibit the brain trust here on this 30 acres."<sup>(6)</sup>

In a publicly held company, the overwhelming need to produce good quarterly results shifts the focus from the customer to the bottom line. As much as 30% to 50% of executive management's time can be consumed in the reporting process, particularly as the quarter comes to a close. There isn't much time or energy left to focus on customer needs, and management decisions, despite claims to the contrary, are greatly influenced by the quarterly reporting cycle. Some examples:

- What impact will a new product or company acquisition have on earnings?
- Will certain expenses be absorbed this quarter or put off until the next quarter?
- Will the new product be released before its time in order to generate badly needed revenue?
- What reduction in customer service levels can be made to reduce costs?
- Will accounting reserves be increased or decreased?
- Should accounting methods be changed?
- Should revenue recognition policies be changed?
- How deep will price discounting have to be to win competitive situations at the end of the quarter?

The examples are endless, but in every case the focus shifts away from the customer in a publicly held company to the bottom line as management tries to keep Wall Street, analysts, large investors, and the trade press happy with a rich stock, which also happens to be the best defense against an unfriendly takeover. Despite economic theories to the contrary, it's virtually impossible to keep the customer as the number one concern in this environment.

### **The Role of Financial Analysts**

"Buy-side" and "sell-side" analysts have been the securities market's traditional scorekeepers, and they therefore create much of the quarterly pressure. They try to determine what corporate results are going to be, which isn't easy based on the information available to them. Buy-side analysts work for institutions or corporations that manage money. Like sell-side analysts, they attend company briefings, meet with management, ask questions, but generally keep their views to themselves. Their primary interest is to determine whether they should recommend the purchase of a new issue, or add to or sell their current holdings in a company's stock.

Sell-side analysts work for brokerage firms, and their goal is to generate commissions for their respective companies via the purchase or sale of securities as a result of their recommendations. Each aspires to be the top analyst in his, or her, field based on a survey of the readers of *Institutional Investor*. In contrast to buy-side analysts, sell-side analysts like visibility. As part of this publicity effort, they prepare written reports that are distributed to brokers, institutions, prospective clients, media, and other interested parties.



Sell-siders also hold seminars featuring the companies they follow in order to "showcase" them to prospective buyers.

The worst thing that can happen to a sell-side analyst is to be surprised. Consequently, sell-side analysts aggressively pursue the executives of any company that they follow to make sure that their estimates of projected quarterly and yearly revenue and profits turn out to be accurate. The issue of insider information is very much a grey area in this atmosphere.

For example, many chief financial officers feel obligated to "talk" analysts off some overly optimistic or pessimistic estimate. Otherwise, the analysts will feel that they have been misled and might develop a negative view of the company. Any such pejoratives will hurt the stock price of a company and might even be used by competitors in their sales efforts. Some sell-side analysts get too close to companies and their management. They may become so bullish or negative on a company that their reputations become intertwined with the performance of the company. They may even help contribute to a self-fulfilling prophecy via their reports which, in turn, may be used in competitive situations by companies that have been issued "buy" recommendations against companies for which they have issued "sell" recommendations.

What is ironic is that many American corporate CEOs have turned over the forecasting process to analysts, and then they feel great pressure to meet these analysts' forecasts. In my opinion, government regulation requiring quarterly reporting institutionalizes a short-term or quarterly focus on results in part by creating an "industry" comprising fund managers, analysts, lawyers, accountants and regulators whose very reason for being stems from quarterly reporting requirements. Yet all this regulation, in my opinion, does little good for the "widows," who always seem to be the outsiders in the American financial system. Nor does it help "orphans," who are neglected in the efforts to "make the numbers."

#### **The RICO Statute and 10b-5**

One of the reasons the SEC has been such a respected and feared agency is that James Landis, and other pioneers, provided powerful enforcement tools to the administrators of the Securities Exchange Act of 1933 and 1934. This tradition has been carried on with Rule 10b-5 lawsuits, which since the 1940s has allowed stockholders to test the issue of fraud or deceit in a securities transaction if they feel there has been a failure of material disclosure.

However, a new phenomenon has arisen in recent years in the form of law firms that take advantage of this regulation by specializing in companies whose stocks are selling at high price/earnings ratios. These firms bet on the possibility that these companies may eventually have a "down" quarter. A few shares are purchased by a group of individuals known to the law firm. If the price of the stock tumbles on some unexpected bad news, the law firm undertakes a class-action lawsuit on behalf of these few stockholders as plaintiffs. In addition, the firm represents all stockholders who may have purchased or sold shares during a specific period of time. The aggregate amount sought may represent millions of dollars, yet the firm's real clients may have lost only a few hundred. The law firm makes its money via the legal fees generated in representing the class action, assuming the suit is won or, more likely, settled out of court.

Ironically, the company will often settle the case out of its insurance company funds, even in insider-trading cases. Because the law firm will use any public statement from the company's management in an attempt to show that management misled the investing public, executives become hypersensitive about saying

anything about the future performance of the company. Worse, any article that has appeared in any newspaper or other publication, regardless of accuracy, will be used against management and the company if it helps the lawyers' case.

Compounding the problem is the current use—or abuse—of the Racketeer Influenced and Corrupt Organizations law (RICO), a law whose intent was to help prosecutors bring cases against mobsters. Now RICO is used 90% of my time (7) by people suing legitimate businesses.

The result is that executives and their legal advisors spend an inordinate amount of time making sure they don't say or write anything that could be held against them at some later date. Sun Microsystems was hit with a IOb-5 lawsuit despite making every effort to inform investors. For eighteen months they had identified any potential risk in their 10-Q [the quarterly report required under the 1934 Act], and then the down quarter happened and they were hit with a law suit."<sup>(8)</sup> Any CEO who is interested in survival is going to use his or her time making sure there is no conflict with government regulations. It is extremely unsettling for a member of management to receive a call from the SEC about some real, or imaginary, infraction or be named in a IOb-5 lawsuit including the use of the RICO statute which can produce treble damages if a conspiracy can be proved. Customer satisfaction seems far less important in this environment.

#### **So Why Did the Company Go Public?**

The Company didn't go public because it needed the money. It was a "cash cow" that funded extensive new product development out of operating income while still maintaining 20% - 22% before-tax profit levels.

Despite this outstanding financial performance, I believe the pressures surrounding the Company were counterproductive in an intellectual, product-development-oriented environment. Meeting quarterly and yearly financial goals is totally inconsistent with the nature of software development. Software products are rarely developed on time, within budget, or completely free of errors. Trying to match this unique environment with the requirements of a quarterly reporting cycle is virtually impossible, yet the Company did it without a hitch for 29 quarters in a row as a publicly held company. However, in my opinion, it was like playing Russian roulette because we began every quarter without a backlog of sales. Once we went public, the "fun" of the Company changed to pursuing the more shallow satisfaction of meeting quarterly goals and hoping the stock would increase in value.

However, I never would have founded the Company, nor would investors have been available, nor would key employees have joined the Company, if all didn't think that there was the possibility of a big payoff somewhere down the line, particularly, from a public offering. Therefore, despite its other problems, a publicly held vehicle is a great incentive to entrepreneurs, as it was to me, and its job-creating value is of enormous value to the country.

Any company with a track record to accommodate an IPO in a booming market is under tremendous pressure to do so. The window may be open for just a short period of time, and if a move is not made, years could pass before the next good opportunity arrives. In the Company's case, it had been almost 10 years since the last good "window." However, a sophisticated member of the board in such matters sensed that the window might open again the following year. He guessed right. When the Company went public

the stock market showed the steepest single-day rise in the history Of Wall Street to date. Therein was the most important reason why we went public: everybody had a chance to make a lot of money.

Investors and board members certainly wanted to. In 1968, 25 individuals had invested \$480,000 in return for 40% of the equity in the Company. It had been 10 years since their investment, and a payback was due.

Management and employees also wanted to make money. No one in the Company was wealthy. This was their golden opportunity to amass some wealth. This certainly applied to me as well.

As a publicly held company, the Company had four stock splits and 29 consecutive quarters of sales and earnings in excess of 50%. It was the first software products company to be listed on the New York Stock Exchange, and to reach \$1 billion in valuation. An original \$25,000 investment was to become worm \$25 million. In other words, the Company was a "darling" of Wall Street during this time. If you asked any stock-owning employees or investors, today, whether we should have gone public then the answer would be definitely "yes." This was the American dream incarnate.

### **Role of the Board of Directors**

The Company's board of directors was put together in the classic entrepreneurial way. Outstanding people from the business world—who were also friends, a brother-in-law and an investor—made up an always harmonious and friendly board. One long-term board member and Harvard Business School graduate, used to close every board meeting with the statement, "I don't know what you're doing, but whatever it is, keep it up!" Of course, the Company had experienced 13 years in a row of consistently high sales and earnings growth. When I stepped down as president, I added three highly regarded business people whom I hoped would be very aggressive in monitoring the "home-grown" management team.

However, when the Company's fortunes turned downward and the Company resorted to professional managers, the Company's board members, like most board members, did not have the time, energy or knowledge to adequately monitor or evaluate the professional management team's performance. Most board members are incredibly busy people with their own company problems to think about. They have to rely on management for better or worse. A company in trouble is a terrible burden to them.

In addition, most boards want to support management, and they consequently are inclined to vote for poison pills, golden parachutes and employment agreements. Why not? Most board members are not significant investors and have very little at stake. Compound this with the fact that individual investors have little corporate influence and that—because of regulation—institutional investors exercise very little, and you get an atmosphere of absentee ownership making it possible for even the best-intentioned professional managers to take advantage of a company. In addition, it is often very difficult to change management, even if their performance is less than satisfactory.

### **Merger**

The day we went public in 1978 I knew that my departure from the company was inevitable. Being on a quarterly treadmill is not a very satisfying long-term career path, particularly when you begin every quarter

without a sales backlog. Also, Wall Street is such an unnatural constituency when compared to customers and employees. This is because it thinks of most companies as just merchandise.

However, the company had become enormously successful in every way and I decided it was time to bring along a management team made up of key employees with the intent of turning the Company over to them. After the team had delivered on the numbers for two years, the Board approved the new President and a change in the name of the Company. I became Chairman of the Board and took offices in downtown Boston, with the intent of leaving the Company after a reasonable period of time. I was interested in a year made up of four seasons rather than four quarters.

Unfortunately, within two years the company had its first "down" quarter as a publicly held company. While I became much more involved in order to help make the year reasonably successful, I wanted no part of the quarterly treadmill again. As a result, I cast about for an individual who had demonstrated management experience with larger companies and knew the non-IBM market well. Such a person was hired and I retired from the Company completely. As time would prove, it would have been much easier if I had gotten back on the treadmill.

Nevertheless, as losses continued to mount under the new team and the Company's \$50 million war chest dissipated, I became increasingly concerned and decided to return to the board of directors. Eventually, I was appointed chairman and CEO in a classic boardroom drama. It was not a pleasant or easy task as a founder to reclaim control of a company in such circumstances. However, because of major cost cutting and new product introductions, within a year the Company was making its first substantial quarterly profit in three years.

As a result, the Company was able to negotiate a merger with Computer Associates International, Inc., for approximately \$330 million. This would eventually increase to \$3 billion for those who held the stock. An aside was that management received \$12 million in golden parachute payments. When management has golden parachutes whereby they will receive millions of dollars in bonuses, even if a company does not succeed is, in my opinion, a conflict of interest.

### **Then What's The Problem?**

Many people might conclude that the American financial system was working pretty well and that the Company simply suffered from a case of bad management. However, in my opinion, it is not quite that simple. Business problems invariably have their roots in decisions made years earlier.

In many cases, they have to do with anticipating and coping with changes in the marketplace. In the Company's case, going public impacted these and many other issues by:

- Gradually increasing focus on growth and "meeting the numbers."
- Gradually decreasing focus on customer and prospect needs.
- Increasing the importance of Wall Street and its analysts versus the computer industry, trade press and consultants.
- Encouraging the movement of the key people out of the Company.

From a personal standpoint, the most important point was that running a publicly held company focused on quarterly reporting was not an enjoyable, long term career path. In fact, there would have been no

overwhelming desire on my part to leave the company, if it hadn't been for quarterly reporting. On the contrary, the Company had a great reputation, was the most successful and admired software company in the industry, had outstanding people, and a very happy client base. There was no reason to want to leave, except to get off the quarterly treadmill.

### **New Competitive Decisions**

For example, years after the IPO, the Company began receiving many inquiries from customers and prospects regarding relational database technology, a new and important technology quite different than the Company's network technology. For the layman, network, at the time, was to relational as a jet aircraft was to a helicopter. The market was beginning to ask for relational for easier analysis and reporting purposes, as opposed to a networked system designed to support heavy-duty applications used to run a company. However, when I suggested that the Company might pursue a two-database strategy, key members of the Company's development staff were negative. As a network-based company, we had biased development people who despised and denigrated relational technology because of its major performance shortcomings. Meanwhile, relational zealots added fuel to the fire by denigrating network technology as old and complicated as object management (the latest technical evolution) enthusiasts were to knock relational.

My decision to take a different route was influenced by the Company's completion of a new and powerful applications development tool that would allow the Company to address the applications software business in a new and very significant way. The almost unlimited opportunity for new applications would allow the Company to continue to grow at the 50% rate necessary to support the very high P/E ratio well into the future. Following the relational track would have meant uncertain revenue growth in the coming few years, which undoubtedly would have resulted in a crash in the Company's stock valuation. The demand for relational technology was still a debatable issue, and Digital's great hardware success, which helped fuel the growth of relational database management systems, was still years off.

However, while we were experts in database technology, we were neophytes in application software. To cope with this lack of knowledge, we purchased the leading MRP II and financial packages from existing vendors and undertook to rewrite them using the Company's database management system. This formidable undertaking was fraught with all kinds of management and quality-assurance problems but we were able to build the most advanced applications in the world.

To give you some indication of the task, the Company's total product value (the sum of the selling prices of all the products the Company had to sell) increased from \$300,000 to \$3,500,000. Nevertheless, without these products, and related strategy, I doubt that the Company would have been able to continue to grow at a rate of 50% in both sales and profits over the next five years. But that performance came with a price.

While we were building the best application technology in the world for IBM mainframes, there was the slowdown in IBM mainframe sales caused by a market shift to non-IBM-compatible departmental machines—such as those made by Digital and Sun Microsystems work stations—and personal computers. The Company was locked into the highly saturated IBM mainframe market with a proprietary software technology at a time when prospects wanted independence from hardware and software vendors. IBM'S introduction of a competing system called DB2 only compounded the problem. We were, for the first time, being out-positioned by the competition because we were building technology the way we felt our

customers ought to like it VS what they wanted to buy. This was second time in the Company's history when we had fallen into this deadly trap.

However, the competitive world of software technology was always complex. What the Company needed was another good main message that positioned the competition on the defensive, something it had done every two years, for fourteen years, with great success. We, eventually, created one that worked, and led us to profitability, and, ultimately, a merger.

A related tactic would have been to announce to the financial community that the Company was not going to continue to attempt to grow at its traditional 50% rate. It was impossible. However, a *Wall Street Journal* article about a high tech firm called Exabyte, a very profitable firm that had grown from zero to \$160 million in sales in just four years, demonstrates one result of this approach:

The closeness to its customers and its own internal control system—now a network of 600 personal computers—have helped Exabyte anticipate problems far more than other companies of its size, says Steven Ossad, an industry analyst with Montgomery Securities in San Francisco. In early August, Exabyte alerted investors that it was seeing a softening demand from its European customers and shifts in other demand patterns as well. "It showed really good controls in place. It also enabled the company to adjust costs to match the temporary slowdown," says Mr. Ossad. But the early warning also had its dark side: Investors bailed out and drove the stock price down 38% in less than a month.(9)

#### **The German Model**

At this time, it would be worthwhile to briefly review the German and Japanese models in comparison with the American model. After all, these two countries, among others, have become formidable competitors of the United States in recent years. The question is, did we make it easy for them?

Despite the fact that Deutsche Bank represents only 8% of the banking market in Germany, it leads consortiums that account for three-fourths of all new corporate issues in Germany's securities market. Deutsche Bank also owns 26% of Daimler Benz, the largest and most successful company in Germany. It is ironic that the German banking system operates quite similarly to the way American banks did prior to the Glass-Steagall Act of 1933. German banks sell securities to their customers but actually vote the rights to these securities with the approval of the investors. The supervisory board (*aufsichtsrat*) of the company is appointed by the shareholders for five years. They in turn select the management (*vorstand*) of the company, who are elected for four years. It is possible for them to take a longer term perspective.

The securities market in Germany, while slow and inefficient from a trading standpoint, is very stable and features no corporate takeovers. However, a German bank will take appropriate action if a German corporation gets in trouble. For example, several years ago AEG was on the verge of bankruptcy. Deutsche Bank stepped in, changed management, and merged the company with Daimler Benz. This is remarkably similar to the way the Japanese model worked in regard to the Mazda example described later. Unlike American companies, German corporations are market-driven, emphasize quality products, and take the long view. They are definitely not securities' market-driven, although recent moves by the Deutsche Bank suggest that it, too, is interested in the international mergers and acquisition business.

### The Japanese Model

During the U.S. occupation of Japan, General MacArthur superimposed many American institutions on Japan, including an organization similar to the SEC to control the securities market. However, the emphasis is on disclosure, not regulation.

In addition, Japanese corporations differ greatly from their U.S. counterparts in terms of management. For example, the boards of directors of large corporations in Japan usually consist of company employees who manage important operational units. While Japanese code requires a two-thirds majority vote by stockholders on major questions, Japanese stockholders' rights are rather dormant in Japanese corporations.

The protection of stockholder rights evokes little interest in the Japanese securities market because the majority of stockholders are major Japanese corporations or financial institutions that own stock in each other's companies. As a result—like the Germans but unlike the Americans—the Japanese can take a customer-market view of what is best for a company.

An article in *The Brookings Review* by Shin'ichi Yamamoto concludes, "Too much pressure has been placed on U.S. managers to achieve a high return on stockholders' equity. Stockholders' rights are very powerful in the U.S. and, unlike Japan, managers are expected to provide high earnings and dividends per share."<sup>(10)</sup>

Studies show that Japanese management puts the quality of products and new product introductions at the top of their priority lists, with market share being second and higher stock prices coming in last. Obviously, they are customer-market-oriented. In contrast, American companies focus on ROI and value of the stock as the two most important criteria for corporate success. This survey, in my opinion, clearly illustrates the difference between the American investor-market model and the Japanese customer-market model.

What happens when a Japanese company neglects the customer? One only has to review the Mazda experience as an excellent example of the Japanese system at work when a company gets into trouble.

For years, Mazda made cars with the Wankel engine, which had the worst fuel economy of any automobile engine. This was a fatal problem because of the fuel shortage. However, Mazda kept making cars that were not responsive to customer needs and was thus losing vast amounts of Sumitomo's money. Sumitomo Bank got fed up and showed up one morning with an "army of occupation."<sup>(12)</sup> The bank took over management and performed massive surgery on the company. They also comforted suppliers and buyers by arranging additional financing. This resulted in a very successful car company. In contrast, the management of many troubled companies in the United States are allowed to stay in place long after it becomes obvious that radical changes are necessary. In addition, American banks would probably withdraw from the company at its most critical period, further exacerbating the problem.

COMPARISONS OF JAPANESE AND U.S. CORPORATE OBJECTIVES (11)			
JAPAN	Score	U.S.	Score
1. Improving products and introducing new products	1.54	1. Return on investment	2.43
2. Market share	1.43	2. Higher stock prices	1.14
3. Return on investment	1.24	3. Market share	0.73
4. Streamlining production & distribution systems	0.71	4. Improving products and introducing new products	0.71
5. Net worth ratio	0.59	5. Streamlining production & distribution systems	0.46
6. Improvement of social image	0.20	6. Net worth ratio	0.38
7. Improvement of working conditions	0.09	7. Improvement of social image	0.05
8. Higher stock prices	0.02	8. Improvement of working conditions	0.04

Source: Tadao Kagawa, Ikujiro Nonaka, Kiyoneri Sakakkibara, and Akihiro Olumura, *Strategy and Organization of Japanese and American Corporations*, reported in the Economic Planning Agency, Japanese Government, *Economic Survey of Japan 1980-81* (Tokyo: Economic Planning Agency, Japanese Government, 1981), p. 155. The 1980 survey included 1,031 manufacturing firms listed in Sections 1 and 2 of the Tokyo Stock Exchange and the top 1,000 firms in Fortune's list of mining and industrial firms. The scores reported were the mean value of each item, giving 3 points to those ranked first, 2 to those ranked second, 1 point to those ranked third, and zero to those ranked lower.

### The American Model

The paradox surrounding the American financial system is that while investor rights in America are greatly protected, individual investors, like those in Japan and Germany, exercise little influence on the corporations they own. However, unlike major banks in Japan and Germany, most major American institutional investors, including pension funds, also exercise little influence over American corporations. They see themselves as traders, not investors. If there is a problem, they sell and get out. Thus, American publicly held corporations suffer from a form of corporate absentee ownership.

This permits professional managers in America, who often hold very modest if any equity positions in their respective corporations, to operate under compensation packages that encourage them to manage to short-term goals. Most astute and self-interested executives do just that. They also introduce, with the help



of friendly and acquiescent boards of directors, self-protective measures such as poison pills, staggered boards and golden parachutes—just in case they do not meet these goals or the company is taken over and they find themselves out of a job. Too often, both the customer and individual investor—the orphan and widow—can be lost in this process.

Proponents of the "active" investor model claim to have a solution that copes with this situation. For example, in "Eclipse of the Public Corporation," Professor Michael Jensen singles out Carl Icahn, Ronald Perelman, and Kohlberg Kravis Roberts as "active" investors, people or organizations that "hold large equity or debt positions, sit on boards of directors, monitor and sometimes dismiss management, are involved with the long-term strategic direction of the companies they invest in, and sometimes manage the companies themselves."<sup>13</sup> These individuals are sometimes viewed as the new corporate heroes whose Wall Street ancestors were put out of business by legislation introduced by a "populist" movement in the wake of The Great Depression. However, in fairness, investors like Warren Buffett have created very favorable records as "active" investors.

### **Conclusion and Recommendations**

Protecting the American investor, like protecting gamblers in Las Vegas or Atlantic City, is a necessary and worthy undertaking based on the history of the abuses in the stock market and gambling casinos.

Yet the regulation created in the 1930s to afford that protection has serious flaws that are critical to America's weak competitive position in a global economy. The legislation's intent to shift the burden of "beware" from the buyer to the seller created the very efficient, powerful, and feared SEC to make sure that the seller adhered to the rules and that, consequently, the investor would be protected.

One result, the record clearly shows, is that the CEO of a corporation, or others that fraudulently deal with investors, can and do go to jail. However, faulty products from the same company could kill or maim a customer and nothing remotely as serious would happen to management.

We have illustrated that the well-intended regulation of the 1930s has made me customer an "orphan" in the American financial system, while not doing much for the unsophisticated investor or "widow." Regulations that encourage short-term focus, absentee ownership, self-serving professional managers, and acquiescent boards of directors serve only to institutionalize this second-class status for customers and individual investors.

Nevertheless, the system worked reasonably well as long as the United States was the dominant economic force in the world. But now, dissatisfied customers of American corporations can buy new products or services from global competitors that demonstrate more interest in their needs than do American corporations.

The government could do much in its regulatory and tax practices to solve this problem, including requiring audited information on gain or loss in market share and customer- satisfaction levels in annual reports. This information would be far more meaningful to all investors, including widows, than the often worthless information contained in most quarterly and annual reports. Such changes in SEC regulations would send a clear message to management and investors that the customer is important.

Executive compensation plans should include recognition for progress in these all-important measures of management performance. Changes in the tax code that make golden parachutes less beneficial to corporate management would be another important area for change. (14)

One way to eliminate quarterly reporting would be to have American corporate executives file monthly and yearly forecasts of sales, earnings, and customer-satisfaction levels with the SEC, as much as they might dislike to. (15) If actual results are within plus or minus 10% of the monthly targets, executives would not have to issue any interim report. Otherwise, they would have to simultaneously inform all interested parties of any variations from these ranges via the wire, as they currently do for any unusual and significant corporate information affecting investors. This would help give management a longer-term focus while providing investors with more valuable investing information than the current historical data included in quarterly and annual reports.

Pension funds representing school teachers, state and municipal employees, and other institutional investors are on the way to owning most of corporate America and could be a very positive force in protecting all investors by regaining investor control over American corporations. (16) These institutional investors should be represented on the boards of American corporations by experienced CEOs. Such CEOs could be drawn from the retired ranks and, with their time and knowledge, could be extremely helpful to existing management in times of trouble. Pension funds could also be a positive factor in filling the capital gap caused by the lack of available capital from American banks.

Most pension funds and other institutions have been traditionally traders and not investors in corporate America because securities laws currently impede discussions among institutional shareholders and can be used to the benefit of management. (17) As a result, when a problem occurs, institutions sell and get out. These regulations should be changed.

We have argued that the well-intentioned but often misguided regulation of the 1930s — designed to protect the investor— needs to be updated for America to be competitive in a global economy. Establishing the customer as king in the American financial system is the single most important move America could make to improve its competitive position in the world. Encouraging CEO's to focus on the customers rather than quarterly reporting would be an important development in balancing the needs of customers and investors. Recognizing that current regulation is an impediment to these goals would be a major step in rectifying the problem.

## ENDNOTES

1. Professor John Dunlop, Director of The Center for Business and Government, and Professor Malcolm Salter of The Harvard Business School felt that the first-hand experiences of a CEO with the American financial system would offer a unique view of how the system works. Professor Jack Donahue of The Kennedy School was particularly helpful in forming the issues related to views of many economists.
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In 1982, 1984, and 1985, Mr. Cullinane was named as The Wall Street Transcript's CEO of the Year in the computer software products industry. Cullinane has been inducted into the Babson College Academy of Distinguished Entrepreneurs and INFOMART's Information Processing Hall of Fame.

Cullinane was founding chairman of the board of directors of the John F. Kennedy Library Foundation, the Massachusetts Technology Leaders Council, and the Boston Public Library Foundation.

Cullinane has been the recipient of many honors including honorary degrees from Northeastern University, his alma mater, University of Massachusetts - Boston and Lowell, Suffolk University, and the University of Ulster, the first it ever awarded outside the island of Ireland. He, along with his wife, Diddy, was elected to the Greater Boston Chamber of Commerce's Academy of Distinguished Bostonians. In 2009 they will Co-chair Opening Night at the BSO with a world wide focus featuring Maestro James Levine and Russian pianist prodigy Evgeny Kissin.

While Cullinane was a fellow in the Center for Business and Government, John F. Kennedy School of Government at Harvard University, he authored a paper on the short term focus of American corporations entitled, "Widows and Orphans". Widows are investors in American companies, and Orphans are their customers. He also authored "The Entrepreneurs Survival Guide-101 tips for managing in good times and Bad". Ironically, both publications are even more applicable to today's economic problems than when they were first written.