

# 1

## THE SHOWDOWN



*Thank God for her.*

—ANONYMOUS HP INVESTOR, LEAVING THE  
COURTROOM AFTER CARLY FIORINA'S TESTIMONY

**T**he line started forming outside of the Court of Chancery in Wilmington, Delaware, at 3:00 A.M. Scruffy college students in parkas and heavy blankets set up lawn chairs to hunker down for the long wait. For \$60 an hour, they held spots for the high-priced lawyers involved in the landmark case that was set to start that day. Soon after sunrise, dapper stock traders, hoping for some big courtroom news, stood sipping coffee to shake off the chill of the morning air. Law professors waited patiently to witness a chapter of corporate law history. Business reporters from around the country stood sharing war stories and speculating about who would be the day's winner. By the time a security guard opened the heavy courthouse doors, more than 200 people snaked down the side of the massive building.

They were all waiting for what was expected to be corporate theatre at its best. At the start of the working day on April 23, 2002, Judge William B. Chandler III would open the trial to consider Walter Hewlett's lawsuit against the company that bore his name.

## ◆ BACKFIRE ◆

Like most companies, HP is technically incorporated in the state of Delaware for tax purposes, so the case had ended up here. Neither civil nor criminal, the court's sole purpose is to resolve internal corporate disputes. Hewlett's suit, filed less than a month before, made one simple yet monumental request of the court: Throw out the shareholder vote taken on March 19 that had narrowly cleared the way for HP's merger with Compaq.

Like all great dramas, this one was filled with rich characters and timeless themes. Here was Walter Hewlett, the intensely private son of one of the company's cofounders, coming out of the shadows to defend his father's traditional values. Rather than pursue risky blockbuster deals, he believed HP should return to operational discipline and the hard work of inventing great products. To some, he was a courageous corporate governance hero, daring to stand up to management and its rubber-stamp board. To others, he was a meddling, spoiled scion longing for a simpler time.

His foe, Carly Fiorina, was as different from him—and from that old HP—as she could be. She was stylish, where HP was stodgy. She preferred bold moves and “transformational” management philosophies to HP's watchful, steady-as-she-goes approach. She was a marketer in a company of hard-core engineers. And she had earned her stripes at AT&T, a hierarchical world of pinstripe suits and power lunches—not the egalitarian, Western ways of HP, where the dress code was khaki and the preferred lunch spots served burgers or burritos.

Although the monetary stakes were high, this was not just another greedy corporate imbroglio. This was a fight for the soul of a company. HP had been wildly successful. It had never suffered so much as one annual loss in 63 years. But what made HP a management icon was *how* it achieved those results. For decades, the company had balanced stellar financial performance with unquestioned integrity, from how it kept the books to how it treated its employees and customers. It had plowed millions into the communities in which it did business, not only out of charity but out of a progressive self-interest in keeping them strong. Put simply, it seemed HP had figured out the magic formula for how to run a company. Everyone won—investors, customers, managers, and employees. A frequent

## ◆ The Showdown ◆

member of *Fortune* magazine's "Most Admired" companies list, HP had been a shining example of the best that Big Business could be.

But that was a different time. During the late 1990s, HP had descended into mediocrity. Badly outpaced by rivals, the company's sales growth and morale had plummeted, and its reputation as an innovator had languished. After almost three years on the job, Fiorina certainly hadn't reversed HP's decline. In fact, some thought she had only accelerated it. Now, she would probably lose her job if the Compaq deal was voted down. This trial would determine not only the future of this powerful woman, but also how HP would try to regain that magical formula.

Well before 9 o'clock, the sweeping, spiral stairway leading up to the third-floor courtroom was jam-packed as the principals began to arrive. Hewlett's group turned up first, at 8:50. Hewlett's lawyer, Stephen Neal, led the clan, nodding gregariously as he cleared a path for his client. With his wife Esther walking calmly by his side, the slightly stooped Hewlett shuffled nervously, wearing an uncomfortable smile. An unlikely and reluctant media star, he would have preferred to be practicing his cello or working in his computer lab. He stopped to quickly shake a reporter's hand before moving into the courtroom.

It would take another 15 minutes, long after most of HP's lawyers and handlers had arrived, for Fiorina to show. Her entrance befitted one of the business world's newest superstars, one used to traveling with the accoutrements of a wealthy jet-setter. Like Hewlett, she was coming from the luxurious, \$320-a-night Hotel du Pont, just three blocks from the court. Unlike Hewlett, who walked to court, she arrived in a limousine to avoid the gaggle of photographers lurking en route. She walked with a regal calm into the courtroom, flanked by her husband Frank and her lawyer Larry Sonsini. Just five weeks before, she'd presided over the shareholder meeting looking embattled and exhausted. Now, the bags under her eyes had disappeared. Despite working her typical long hours—she could go for months on four or five hours of sleep a night—she appeared well rested. A slightly clenched jaw was the only visible sign of the fierce determination that had brought her to this courtroom. It was time to give the performance of her life, and she was ready.

## ◆ BACKFIRE ◆

Neal was ready, too. It had been seven months since Hewlett had come to his office seeking counsel. From the start, Neal had been pleased with the case. Hewlett was a wealthy client from a legendary family—never a bad thing, particularly in a terrible year for business. And while Hewlett was no doubt an underdog, he was far from alone in his fears about the deal. Wall Street hated it, too. HP's shares had plunged by nearly 35 percent from the time the deal was announced to the day Hewlett visited Neal's office. Since then, the attorney had served as Hewlett's field general on the case—plotting strategy, wooing reporters, and coordinating the efforts of Hewlett's other advisors.

The case was a huge opportunity for Neal in personal terms, as well. He was the CEO of Cooley Godward, and he would like nothing better than a victory over the prestigious firm of Wilson Sonsini Goodrich & Rosati across the street from his office. The trial would pit Neal against rival Larry Sonsini, *the* "it" lawyer of Silicon Valley—advisor to stars such as Apple's Steve Jobs and Sun Microsystems' Scott McNealy. The case also appealed to Neal's love of fighting high-stakes battles, even when the deck was stacked against him. For eight years, he had defended Charles Keating, the poster child of white-collar crooks for his role in the savings and loan scandals of the 1980s. Neal had stuck by Keating, and ultimately got his 10-year sentence dismissed, after Keating had spent 4 years behind bars waiting for appeals.

Legally speaking, Hewlett's case was not much rosier than Keating's had been. Filed nine days after the March 19 shareholder vote, it hung on two allegations, neither of which would be easy to prove. The first centered on whether Fiorina had muscled Deutsche Bank, one of HP's top 20 investors with more than 17 million shares, into voting for the acquisition on the morning of the vote. The evidence was certainly intriguing. Just days before the vote, the bank had decided to vote all its shares against the deal and contemplated publicly declaring its opposition.<sup>1</sup> But suddenly, after a phone conversation with Fiorina and HP chief financial officer Bob Wayman at 7 o'clock that morning, the bank had thrown its shares—possibly enough of them to swing the entire vote—in support of the acquisition. But how had she done it? Was it just through the force of

## ◆ The Showdown ◆

salesmanship? Or had HP offered big banking contracts in the future? Had she threatened to cancel existing banking work? Making matters more interesting was a phone message Fiorina had left for Wayman on March 17, which was intercepted and leaked to the *San Jose Mercury News* on April 10.<sup>2</sup> In it, Fiorina said that she or Wayman might have to do “something extraordinary” to win the support of Deutsche Bank and another big shareholder, Northern Trust. Just how Fiorina defined *extraordinary* was the question.

It was delicious cloak-and-dagger stuff—and very likely worthless in court. So far, there was no actual evidence of wrongdoing. Neal would need a smoking gun—a contract, a witness, or some document that confirmed that HP actually bought Deutsche Bank’s votes. Many observers were convinced something fishy had occurred, but proving it was another thing. Fiorina could have delivered a promise or threat with nods and winks, without putting pen to paper. But would a judge really undo one of the biggest mergers in history on the basis of such flimsy evidence?

The second allegation had grabbed fewer headlines, but held more promise of standing up in court. It alleged a cover-up of sorts—that HP’s management had withheld damning information about the merger from investors. Fiorina had persuaded many investors that this merger would be different from other failed deals, because a crackerjack integration team of top HP and Compaq staffers had spent almost 1 million hours planning every detail of how to bring the companies together.

Neal had evidence that challenged Fiorina’s rosy outlook. In the weeks prior to the trial, the Hewlett camp had received a stream of information from HP insiders that told a different story, including anonymous phone calls from senior executives and unsigned letters slipped under doors in unaddressed manila envelopes. Among the 40,000 memos, e-mails, and other documents HP had been forced to hand over after the lawsuit was filed were so-called value capture updates. Prepared by members of that much-lauded integration team, these documents suggested the company was not going to hit the targets Fiorina had promised Wall Street. These reports seemed to be the smoking gun Neal needed. Fiorina had seen these documents, yet decided they were not something investors also needed

## ◆ BACKFIRE ◆

to know about. Still, it wasn't enough that the documents existed. To win, Neal had to prove that Fiorina knew the reports spoke the truth. In other words, Neal wouldn't win just by proving the Compaq purchase would be a disaster for HP. He had to prove that Fiorina knew it, too. He had to prove that she was a liar.

**A**s Neal rose to make his opening argument, he knew everyone in the courtroom was wondering the same thing: What does he have? Hewlett sat hunched at a table behind his attorney. Soncini, the man who had advised Hewlett to vote with the board, sat just feet away from Hewlett, across the center aisle that separated the two camps. Fiorina sat against the wall at the far left of the courtroom, as if trying to get as far away as possible from Hewlett.<sup>3</sup>

Neal, impressive at six-foot-four with a low, resonant voice, played his best card first: the claim that HP had withheld vital information from investors that would have cast major doubts on the merger. He first needed to establish for the court what HP had promised investors, in its presentations to Wall Street, in Fiorina's speeches, and in government filings such as the S-4, the document companies use to register new merger-related shares.

Most everyone in the courtroom knew the basics. For starters, Fiorina promised huge cost savings—\$2 billion in fiscal 2003, and \$2.5 billion every year afterwards—but she said HP would make these cuts without sacrificing too much in the way of sales. Most analysts figured HP would take a 10 percent hit to its top line as a result of the merger, but Fiorina argued it would be no more than 4.9 percent. Then there was the question of profitability. Walter Hewlett's advisors believed the new HP would lose many high-end, lucrative computer contracts. All told, it would lose roughly \$0.26 of profit per every dollar of lost sales. But Fiorina believed most of the lost sales would be in the cutthroat PC business, where margins were negligible. As such, HP figured it would lose only \$0.12 per dollar of lost revenue. The bottom line: HP shareholders could expect a 12 to 13 percent increase in the value of their shares in 2003, the company had predicted. Although the math worked, Neal argued that Fiorina knew the reality was different. It all came down to how you interpreted the value capture updates. Of all the documents

## ◆ The Showdown ◆

collected before the trial, these were the only ones that seemed to summarize how the merger was faring. A key page of each showed three columns of data.<sup>4</sup> One column showed the earnings per share the integration team believed HP was on track to hit for 2003 and 2004. Another showed the consensus estimates on Wall Street for those years. A third was the so-called S-4 case. HP did not include an earnings per share estimate in the actual S-4 filing sent to investors, but Neal argued that this S-4 column was what the company believed it had promised to investors in that document. And as of mid-February, HP was not on target to hit it, he argued. Even Compaq chief financial officer Jeffrey Clarke, who ran the value capture effort and was cochief of the entire integration effort, seemed to have his doubts. According to the minutes of a February 20 integration team meeting, he said “We have a mile to go on this.”

Now firmly in command of the courtroom, Neal moved confidently and theatrically as he dropped his next juicy bit of evidence. It came from the personal journal of none other than Michael Capellas, Compaq’s chief executive and a loud proponent of the deal. “Sobering thought,” Capellas had written. “We are about to really start one of the most historic periods in U.S. business history. Case study for years. At current course and speed we will fail.”

Neal then read an e-mail that Clarke had sent to Wayman on March 12, just a week before the crucial merger vote. Referring to the latest value capture update, Clarke wrote: “It is uglee [sic]. . . . Both companies are deteriorating in this slowing market and due to merger ‘noise.’” Neal’s case was gathering momentum. Members of the gallery exchanged glances as if to say, “This might be a lot more interesting than we thought.” Investors, who had been required to drop their cell phones in a cardboard box at the door to the courtroom, began slipping out to call in trades. And Neal wasn’t done. Next, he offered a study done by HP veteran Ken Wach, who had just been named financial chief of the new HP’s \$20-billion high-end computer business. Wach, who had just joined the integration team itself, was even more pessimistic about that part of the company than the value capture updates indicated. He sent his report to Wayman on March 10, along with a note that said: “The attached is a frightening reality check . . . I see little realistic upside

## ◆ BACKFIRE ◆

and I am not alone. . . . Sure, this may be overly pessimistic, since the [salespeople are] very down right now, but I sincerely hope that we all start acknowledging the realities soon.”

The reality, Neal argued, was that Fiorina knew HP’s merger plan was falling off course fast. According to the February value capture update, the company was on track to deliver earnings of just \$1.30 per share, versus an S-4 case of \$1.65. By March 12, the internal projection had fallen to just \$1.23, according to the Clarke e-mail. That was far less than the \$1.37 most analysts figured HP could have posted that year *without* buying Compaq. Putting it plainly for Judge Chandler, Neal said “It hadn’t gotten any better, Your Honor. . . . This was a consistent and a persistent and a declining situation throughout 2002.”

Indeed, Neal continued, Fiorina hadn’t even disclosed this troubling information to her own board. The directors, by then embroiled in a public fight for shareholder support with Hewlett, had not been diligent enough to ask for proof that Fiorina’s plan was working. Instead, they joined Fiorina’s crusade for the deal, turning a blind eye to their responsibilities as investors’ watchdogs, he argued. “Your Honor, I think the board abdicated its responsibilities both to make sure it was fully informed and in turn to make sure that all complete material information was being turned over to shareholders.”

Neal had masterfully played his best cards. Having done so, he quickly recounted what many had believed would be the high point of the proceedings: the Deutsche Bank allegations. There were some juicy new morsels. Deutsche Bank, for example, had a \$1-million contract to help HP win its proxy fight, with a \$1-million success fee if HP prevailed. But truth be told, there didn’t seem to be that smoking gun to make this charge stick. Still, it was time for Fiorina’s lawyers to come up with some answers.

Steve Schatz did little to defuse the sparks that Neal had set off. A member of Wilson Sonsini’s top brass, he was one of the firm’s top litigators. Despite his Ivy League education, Schatz stood out among the slick Silicon Valley power brokers with his thick New York accent and nervous delivery. In this case, he had slept just three hours a night for the past week as the case was being prepared, he said, and his delivery sounded more edgy than usual. He



## ◆ The Showdown ◆

repeatedly strayed from the microphone, making himself barely audible to the gallery.

He did have plenty to work with. First, Schatz attacked the Deutsche Bank allegations, quickly stripping them of much of their remaining validity. The bank had made its own choices. There was no concrete proof that HP had crossed the line. Then he quickly moved to the allegation that HP withheld damning information from investors about the integration effort. For starters, he said, HP had never promised investors \$1.65 in earnings per share in the S-4—regardless of what the heading on an obscure set of internal presentations said. No one from HP had told investors to expect such earnings. Rather, HP had told investors to focus on two key things: The new HP would cut costs by \$2.5 billion a year by 2004, and it would limit revenue losses related to the merger to less than 4.9 percent. The economy might rise or fall, impacting sales and profits, but that couldn't all be attributed to the merger. As for Capellas' journal and Clarke's comments and e-mails, they were taken out of context, Schatz argued. Capellas had been jotting down notes for a motivational speech he was preparing for Compaq staffers. He knew the companies were right on course, but he didn't want employees to know it for fear that they'd ease up. As for CFO Clarke, he was frustrated that midlevel managers were unwilling to sign up for the revenue targets management had publicly promised.

Indeed, Schatz argued, the truth was that HP was far ahead of plan. Rather than \$2.5 billion, management actually thought it would be able to cut expenses by as much as \$3.9 billion a year by 2004. And what about the damning value capture updates? Well, the executives who wrote them didn't have the whole picture. They didn't know what staffers in other corners of the integration effort were up to. For example, a team that focused on supplier contracts had determined that volume discounts on parts and supplies would be three times greater than initially expected. Plus, Schatz argued, these managers, like managers at all companies, preferred to set nice low sales targets that could easily be achieved, ensuring big end-of-quarter bonuses. It was sandbagging, pure and simple. The full picture was that management's plan was doable, even conservative. In fact, Schatz pointed out that management had decided not to

## ◆ BACKFIRE ◆

include areas in which the merger might *increase* sales—say, by selling HP printers to buyers of Compaq PC products.

Now it was Schatz's turn for moral outrage. It wasn't enough for Judge Chandler to throw out Walter Hewlett's baseless case. He had to do so in a way that would clear the good name of Fiorina and her board: "[Hewlett] has unfairly cast aspersions on HP's management, and the shareholders' will should be honored."

It all sounded conceivable, if a bit too convenient. Who really believed that Deutsche Bank had switched those votes without some kind of pressure from HP? And didn't those value capture reports speak for themselves? HP could argue that they didn't mean what they said, but where were the documents that proved HP *was* on track to hit its goals? There weren't any. In effect, HP's managers were asking the court to just trust them. Now, Fiorina was going to have to earn that trust.

**W**hen the trial schedule came over the fax machine at the Hotel du Pont on the weekend before the trial began, high fives broke out among the army of Wilson Sonsini lawyers working with HP. Steve Neal was calling Carly Fiorina as his first witness. She might be controversial as a CEO, but she was going to make a terrific witness. She was a brilliant communicator, capable of Clintonesque persuasiveness. An unbelievably quick thinker, she would understand the intent of a question before she answered. She was not going to fall into any of Neal's traps.

Fiorina was extremely well-prepped. Almost from the minute the suit had been filed, Wilson Sonsini partner Boris Feldman had been working with her to prepare for this day. Widely rumored to covet a federal judgeship, the bow-tied Feldman's erudite delivery would make him the perfect courtroom dance partner for Fiorina. And Fiorina understood the stakes. "She got it from the start," says Feldman, who spent 30 hours face-to-face with Fiorina, going over her testimony and likely questions. He describes it as a "two-week Vulcan Mind Meld." "As busy as she was, she understood that she was going to have to deliver on the stand," Feldman says.

Neal figured calling Fiorina first was his best shot. He certainly wasn't going to let Feldman call her as his witness; he would just lob

## ◆ The Showdown ◆

softballs that Fiorina would hit out of the park. Neal had considered calling Chief Financial Officer Bob Wayman to the stand first. He had been in on the call with Deutsche Bank and was intimately aware of the financial data. But Wayman was smart and squeaky clean. After 33 years at HP without an ethical blemish, it would be hard to cast doubt on him. So Fiorina was it. Neal was convinced he could, and had to, crack Fiorina's Teflon exterior. He had the documents to prove she'd been told all was not well with the merger. If she came off as a reasonable executive who had objectively considered the documents, Judge Chandler would likely accept her explanations. But if Neal could get her to become evasive or indignant, or get her to admit she'd had concerns, Chandler might start to wonder. All Neal had to do was expose her for what her critics claimed she was: a super salesperson who would do *anything* to land the deal.

**S**econds after Fiorina was sworn in, Neal went on the attack. "I have to ask you. Did you see the *Financial Times* piece over the weekend that suggested they are going to rename the Compaq Center the Carly Fee-Arena," he said, referring to the San Jose-based hockey stadium. The dig worked on many levels. It played on criticisms that Fiorina was egotistical. It might even have made Fiorina pause to think about the mostly negative press coverage, a hurtful thorn in her side considering the glowing treatment she'd enjoyed in the past. It certainly sent the message that she was not in for any walk in the park on the witness stand.

"I missed that one," she responded, with a cool, insincere smile.

To get started, Neal set out to establish what HP had promised investors in its financial filings. He held up a page from one of the value capture updates.

"You would agree, would you not, Ms. Fiorina, that the value capture team at the Hewlett-Packard/Compaq [company] . . . said that the 2003 earnings per share implied in the S-4 filing was in the range of \$1.60 to \$1.65 a share?" Neal asked. "I certainly would agree that that is the title of the document that the value capture team produced, yes," Fiorina said mildly, settling in.

"And the value capture document . . . stated that the earnings per share . . . for 2003 was \$1.65. Correct?" Neal repeated.

## ◆ BACKFIRE ◆

Normally, witnesses are trained to give the briefest answers, to avoid offering any unexpected avenues for a smart litigator to explore. But Fiorina wasn't just any witness. Her counsel had advised her to use her own discretion.

"That is what that document says," she answered. "I don't believe you can find anywhere in the S-4 [where it says] \$1.65. Nor is it what we talked to investors about for six months on the road."

Neal was not expecting a fight so soon. "But my question was more limited than that," he said, trying to get her to just answer the question. "The statement that the S-4 filing implied an EPS of \$1.65 a share was a statement that came from the Hewlett-Packard/Compaq value capture team, not from the plaintiffs in this case. Correct?" Fiorina, who had been listening with her head tilted, wearing a slightly impatient stare, blinked with disdain. "Yes, that is a document that was produced, and that is the title of the document," she said.

This cat and mouse would continue for what seemed like an eternity, as Fiorina refused to be drawn into Neal's trap. Over and over, she refused to give him the easy answers he could later use against her. Before long, it was unclear who was flustering whom. Fiorina grew more confident, even comfortable enough to make jokes. When the judge asked her to pull her microphone closer, she struggled to make room, given the computer monitor that was perched next to the mike. "We wanted to make you feel at home with computers all around," Chandler offered with a smile.

Ever the salesperson, Fiorina replied without missing a beat, "You clearly need some new ones, Your Honor."

Neal refused to back off. The questioning went on endlessly. Didn't page such and such of the December 19 presentation to shareholders say the new HP would enjoy operating margins of between 8 and 10 percent—much better than those the company achieved in 2001?

Yes, she said. But the footnote at the bottom of that page said those margins depended on overall economic activity. Good enough. But didn't that presentation say that combined revenue for the companies was \$85.1 billion, before the 4.9 percent revenue loss? Didn't that imply a \$4.1-billion drop in revenue? If he could

## ◆ The Showdown ◆

get her to confirm an actual revenue figure rather than a percentage dip, HP could be held accountable if it came up short. So what if it did? she argued. There was no way of knowing what portion of the revenue loss was due to the merger or to the economy. Any dolt understood that the economy had taken a nosedive after the September 11 terrorist attacks and knew to toss aside projections made before that infamous date. More than 10 times in a row, Neal asked her to confirm that HP had projected a \$4.1-billion revenue loss in its filings. Her answer: The \$4.1 billion was just the result of applying a 4.9 percent drop to Wall Street's revenue estimates as of that date. Because those estimates change over time, it was no longer a relevant number. "Mr. Neal, you and I can agree there is a page that says \$4.1 billion. I'm not disputing the math."

With that, Fiorina had hit on her theme for the day. For the remainder of the marathon three-hour-plus session, she would spin variations on "Your math is correct," like Mozart exploring a musical theme.

When Chandler called for a recess at 1:00 P.M., it was clear Fiorina was winning. As the packed courtroom emptied, one Wall Street investor—obviously, one with a stake in the merger passing—said simply, "Thank God for her."

Looking back, Neal said he had no regrets about his approach. But the longer he kept at it, the more gleeful the rival camp became.

"I think Steve thought he could break her," Feldman said later. "But she broke him."

