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Chapter 1

Introduction

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Derivation of Risk Arbitrage

The simple definition of "arbitrage"—buying an article in one market and selling it in another—has undergone considerable refinement over the decades. Arbitrage had its origin in the late Medieval period when Venetian merchants traded interchangeable currencies in order to profit from price differentials. This "classic" arbitrage, as it was and continues to be carried on, is a practically riskless venture in that the profit, or spread, is assured by the convertibility of the instruments involved.

Communications, rudimentary as they were, assumed strategic importance on the European financial scene. The notable London merchant bank of Rothschild, as the story goes, staged an unprecedented "coup de bourse" by use of carrier pigeons to receive advance notice of Wellington's victory at Waterloo. Upon learning the news, Rothschild began, with much ado, selling various

securities, particularly British Government Bonds, on the London Stock Exchange. This was naturally interpreted as a Wellington defeat, thereby precipitating a panicky selling wave. The astute—and informed—Rothschild then began quietly purchasing, through stooges, all the Government Bonds that were for sale. When an earthbound messenger finally brought the news of an allied victory, Rothschild had a handsome profit.

As identical securities began to be traded on the different European exchanges, and as communications evolved from the pigeon to the wireless, simultaneous transactions in securities arbitrage gave way to "tendency" arbitrage. Thus, if for example one had good wire communications with London and Paris, where an identical security was being traded, one would try to detect a general market tendency in both markets. Should there prove to be sellers in London and buyers in Paris, an arbitrageur would sell into the buying in Paris, and try to cover his short position somewhat later when the selling tendency bottomed out in London; or vice versa. In any event, improved market liquidity and more advanced communications were providing the opportunity for "tendency" as well as "simultaneous" transactions.[1]

Riskless arbitrage found its way into the American securities market by way of instruments that are convertible into common stock (i.e., convertible bonds and convertible preferred stocks, rights, and warrants). This kind of arbitrage, according to Morgan Evans, ". . . is not a wild scramble of buying X common in New York, then selling it in San Francisco in a matter of moments, like the international arbitrageur who buys Shell Trading in Amsterdam and sells it in New York. Instead it is chiefly concerned with the buying of a security at one price and the selling of its equivalent (security) at a higher price, usually in the same market. . . . Convertibility of exchangeability lies solely in one direction. In this respect it differs from . . . two-way convertibility or exchangeability, which is associated with the foreign exchange markets."[2]

There were two distinct developments in the 1930s that had a profound influence on the evolution of arbitrage in the United States. First, many railroads in the late thirties were coming out

of bankruptcy. In order to remove their heavy debt burdens and improve their capital structures, many of them were reorganized, (i.e., recapitalized). These reorganization plans, which had to be approved by the various classes of security holders, often required the issuance of new securities to be exchanged for the old debt and preferred issues. Arbitrageurs, finding that they could sell such new securities on a "when-issued" basis, would buy the shares being recapitalized at prices lower than, or below the parity of, these "when-issued" securities. These price discrepancies, or spreads, were available because of the inherent risk that the reorganization plan might not be consummated, thereby precluding the requisite one-way convertibility. The arbitrageur was able to take advantage of the spread and willing to incur the risk. Arbitrage was now moving, in fact, from riskless to risk operations.

The second and equally important development in this period was the 1935 Public Utility Holding Company Act, requiring many public utilities to divest themselves of their holdings of subsidiaries. As the parent companies formulated divestiture plans, "when-issued" markets developed not only in the shares of their subsidiaries, but also in the stock of the parent ex-distributions. Arbitrage was thus possible when the sum of the prices of these "when-issued" securities (i.e., the sum of the parts) was greater than the market price of the parent company (the whole) cum-distributions.

"The profits realized from these recapitalizations and reorganizations led the arbitrageur ultimately to exploit the stock price differentials, or spreads, available in mergers, liquidations, and tender offers."[3] The spreads were, however, only turned into profit when the necessary one-way convertibility of the riskless arbitrage became a legal fact through consummation.

The expansion of risk arbitrage on Wall Street is directly attributable to the great corporate merger wave of the 1960s when a surging supply of selling candidates was matched by an equally impressive list of buyers. The new notion of "synergy," that one plus one equals three, gained acceptability; inflated stock prices provided cheap financing in an ever-tightening money market; accounting

for acquisitions on a "pooling of interests" basis permitted seductive proforma earnings calculations for acquisition-minded companies; and most important, a variety of tax savings was intensively exploited via a variety of security-exchange packages.

While this 1960s merger wave enabled the arbitrageur to develop expertise in the realm of risk arbitrage, the trade itself continued to generate new types of situations where the professional could apply a sharp pencil. In addition to mergers and recapitalizations, then, risk arbitrage, came to encompass stock tender offers, cash tender bids, stub situations, and spinoffs. As the number of synergistic mergers declines in weak securities and tight monetary markets, liquidity or necessitous mergers and un-merging activities are providing work for the enlarged arbitrage community.

The Arbitrage Community

"The big money makers of Wall Street often mask their expertise in mystery, and among them the most mysterious is a cliquish band of specialists known as arbitrageurs. On the Street, they are a peculiar group apart, noted for their ability to spot instantly tiny profits that can be jockeyed into big ones. 'It would take me an hour of paperwork to see that profit,' says one member of the New York Stock Exchange, 'and in that hour the chance would be gone.' Says another: 'I think of them as vague shadows with European backgrounds. I don't even know who they are.'"[4] Arbitrageurs love it that way.

The financial press has increasingly tried to explore the activities of the risk arbitrageurs over the past few years, yet has been unable to delve with any depth into their operations. Many arbitrageurs have been approached, but have been generally unhelpful, though congenial. "Arbitrageurs tend to keep their operations to themselves. 'Frankly, I'd prefer the average person didn't know how to accomplish arbitrage,' says one. 'Therefore, the less I say about it, the better.'"[5] Even Morgan Evans, whose *Arbitrage In Domestic Securities In The United States* surpasses anything yet published

on the subjects of both riskless and risk arbitrage, falls short in explaining the modus operandi of these professionals.

The Arbitrage Community, then, consists of a dozen-plus Wall Street firms, who commit house capital as one of their primary functions, in the various forms of arbitrage. The list includes such outstanding firms as Lehman Brothers-Kuhn Loeb, Goldman Sachs, L.F. Rothschild, Morgan Stanley, and Salomon Brothers.

Many of the arbitrage firms will engage the capital of foreign banks in risk arbitrage situations. Most are reluctant to do so for domestic clients, as the latter are thought to be somewhat less discreet than their European counterparts. Some, in order to avoid conflicts of interest, will avoid arbitrage for client accounts altogether.

The Community is extremely cliquish. Each member of the club has his own particular set of friends within the Community with whom he will freely exchange ideas and information, often via direct private wires. Sometimes good friends will even work on a joint account for a particular deal. But to all others, both within and without the Community, the member will turn a cold shoulder.

Many Wall Street firms and many private investors have tried, at one time or another, to participate in risk arbitrage activity. Having neither (a) schooling or experience in the finer points of the trade, (b) the requisite expert staffs, or (c) membership in the Community, they tend to fall by the wayside. The cancellation of a few proposed mergers always singles out the amateurs and sends them scurrying back to the good old-fashioned business of investing in securities.

Any proper discussion of the Wall Street arbitrage community's changing dynamics over recent decades would be incomplete without some consideration of the context in which these professional traders were operating. For it has always been the talent of the skilled arbitrageur to distill from a complex and ever-changing marketplace, those opportunities that others fail to capture. As the most popular, or, as some might say, "notorious" community of arbs operated primarily in the field of mergers and acquisitions, a brief synopsis of the developments of the structure of the M&A business is essential for any student in assessing the challenges that confronted arbs as they adapted and thrived in the growing world of

risk arbitrage. The mergers and acquisitions business as it existed in the late 1960s may seem like a foreign landscape to today's student of Wall Street practices. While each passing decade has brought new developments in the structure and pace of the deal market, the 1970s and 1980s were particularly formative years in laying the groundwork for the modern deal structure. Indeed, few developments in recent years match the pace of innovation seen during this critical period. The arbitrageur who ventured into these markets needed to be both agile and somewhat innovative in his own right. With the public face of the arbitrageurs, as well as the banker, and other participants, in the deal community becoming clearer, their activities gained a notoriety not seen before on Wall Street. The takeover battles of the 1970s assumed a "spectator sport" appeal to the rest of the financial and business community. Amid the growing deal frenzy, arbitrageurs grappled with an ever-changing terrain, formed by the ebb and flow of the economic, political, financial, and legislative conditions that were all refocused during this profound reshaping of corporate America.

A Changing Community from the 1970s to 2000

1970s

The 1970s saw the initial deal wave of the late sixties gather considerable momentum and, in the process, broaden the variety and the style of acquisition structure available to the corporate buyer. With mixed reactions from within the community, it also introduced the arbitrageur to the public. As could be expected, attention begets even greater attention and by the end of the decade the arbitrageur might be said to be swimming in a sea of deals . . . and arbitrageurs!

The 1970s could best be characterized as the years that propelled the M&A business toward increasingly novel and flexible deal structures. The unfolding techniques were more aggressive, the press more inquisitive, and the once congenial club of arbitrageurs

who plied their expertise out of only a handful of firms found themselves in a market crowded by newer players.

One of the more significant developments, foreshadowed by the 1969 hostile takeover bid for BF Goodrich by Northwest Industries, was the first truly large-scale hostile cash tender offer. Launched in 1974 by Inco for ESB Corporation, the offer was significant not only for this new currency of the hostile offer, but also for what it represented: a bold new dimension in the world of deal making. The significance to the arb community was in the additional arrow it placed in the quiver of the would-be corporate buyer and, of course, the modification of the risk/reward considerations for those who assumed positions in such deals. Any expansion in the options available to bidder corporations expands in equal measure the profitable opportunities for the arbitrageur. In taking an offer directly to the shareholders, the debate over the appropriate balance between a board's fiduciary obligations, and shareholder's rights, began inching toward center stage—a position it would firmly occupy decades later. As "shareholder-friendly" generally equated to "arb-friendly," the new hostile tenders were, of course, greeted with open arms.

The decade was not finished with innovation, however, and the next change to come would involve the allocation of payment that the arbitrageur received. Typically, a tender offer for control is followed by a squeeze-out merger to bring the bidder to 100 percent control. Conventional expectations at this time were that an owner of stock acquired in a deal, whether hostile or friendly, would receive equal monetary consideration on both the front and back ends. The value of cash or non-cash consideration paid in the first stage tender offer would equal the consideration on the back end. The first significant departure from this assumption took place in the takeover fight for Pullman between McDermott and Wheelabrator Frye. McDermott offered a package that featured cash on the front end, with back-end securities that were markedly lower in value than the front. Ultimately, Pullman was acquired by Wheelabrator in a white knight rescue, but the "two-tiered" offer had arrived. It altered some of the financial constraints normally

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associated with the structure and financing of a bid, adding to the deal frenzy by allowing for more creatively structured deals and a reduced reliance on cash in a hostile approach.

The arbitrage community, while enjoying the increase in deal volume, was less excited by the new entrants it attracted to the business. The arb's return on investment is a direct function of the demand for that particular spread. With five or six arbs willing to trade a deal for no less than a 25 percent annualized return, the arrival of a new player who is willing to accept 20 percent compresses the profit available to the others. The new player will bid up the target's price while selling down the acquirer's price, leaving those who require a higher return outside or "away" from the market. This new crowding of the arb market can best be described in the words of the arbs themselves during this period as printed in a story run by Barron's.

"By the seventies . . . the arbitrage community was having difficulty hiding its role in the mounting volume of corporate takeovers. In 1975, Ivan Boesky, lawyer, accountant, and securities analyst, established what probably was the first large limited partnership specializing in risk arbitrage. Boesky, to attract capital and much to the disgust of the rest of the community, stomped all over the unwritten rule proscribing publicity. "Boesky was the first of the queens to come out of the closet," says Alan Slifka, a partner in L.F. Rothschild Unterberg Towbin's arbitrage division. In 1977, Boesky was spread across two pages of *Fortune*, wreathed in smiles over the $30 million he and a handful of other arbitrageurs had picked up in the takeover of Babcock & Wilcox by United Technologies. The jig was up!

Money poured into risk arbitrage. Merrill Lynch and Morgan Stanley quickly set up arbitrage departments. Many experienced arbitrageurs formed their own limited partnerships, and a whole slate of smaller firms joined the act.

With quality firms selling for bargain-basement multiples, it had become cheaper for a company to acquire another than to make a capital investment itself. But the flat equity markets also meant that takeover stocks became "the only game in town"—a game

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in which hungry registered representatives were eager to interest equity-shy clients. At least two large brokerages, Oppenheimer & Co. and Bear Stearns, launched an organized assault publishing research for retail and institutional clients. No figures are available, but the guesstimate is that as much as half the arbitrage activity in some deals was "non-professional."

"A shakeout is the best thing that could happen in this business," says John Monk, an arbitrageur at Cohn, Delaire and Kaufman. Chief among Monk's beefs is the narrowed spreads brought about by too many players jockeying for a piece of the same action. "The single greatest complaint I hear these days is the spreads," Monk says. "A few years ago, if $25 was bid for a company, you might see it open up at $19 or $20. Everybody was reasonable. Today, spreads are nothing."

Disorderly markets are another problem. "There are 33,000 registered reps out there," continues Monk, "and they can cause severe dislocation in the market. The non-professionals tend to get out at the first sign of trouble, dumping all their stock back into the market."

Complains Steve Hahn of Easton & Co.: "There never used to be any problem of getting as much stock as you wanted. Now I find sometimes I'll go after 5,000 shares of something and only be able to get, say, 3,000." But arbitrageurs used to dealing in blocks ten or a hundred times larger scoff at such squawks. Their sanguine philosophy is that "when the going gets tough, the tough get going." Says one whose firm is believed to put some $100 million at the disposal of its arbitrage department: "Markets have a magnificent way of correcting themselves. For example, if you take a situation like we saw with Marathon, where the stock was quickly run up to $90 after the Mobil bid of $85, you'll find that most of that was non-professional or inexperienced money. Not till the stock came down again to the low eighties did you find the arb money coming in a significant way."

Certainly, the year was trying for professionals and non-professionals alike. Stratospheric interest rates dampened most investment sectors. High rates cut two ways in arbitrage. On the one

hand, the carrying costs must be factored into the spreads on any given deal, although one arbitrageur declares: "If the difference between 15 percent and 20 percent interest rates is the deciding factor in whether you do a deal, you probably shouldn't be even considering it in the first place."

It is the author's contention that the private as well as the institutional investor should be more conversant with risk arbitrage, for it often appears as though one-half of the list on the New York Stock Exchange would like to swallow the other half. Thus, stocks involved in mergers and other forms of risk arbitrage will often perform in accordance with other than their fundamental or technical characteristics. In addition, the average investor should know how to evaluate a particular package of securities offered in exchange for those securities that he is holding. The answers to some of these problems will enable the investor to make an important investment decision: whether to hold his position in the security, or dispose of it. It is thus the author's intention to explain and describe these market reactions by discussing the various activities in which the arbitrageur gets involved.

Whereas in the first edition of *Risk Arbitrage* there was extensive coverage of merger arbitrage reflecting the emphasis of the 1960s, cash tender offers became much more important in the 1970s and 1980s and are given greater coverage in later sections. Indeed, cash tenders became the favorite vehicle for effecting what were called "Saturday Night Specials," or hostile tender offers. It will be shown in the examples that follow that participation in these cash tender offers was far more profitable for the arbitrage community than participation in mergers, in that the former usually forced the target brides to seek competitive bids.

1980s

The eighties brought the arbitrage business to new heights on the back of the largest takeover boom to date. Propelling the expansion in deals was the introduction of high-yield-bond or "junk" financing for hostile takeovers. The concept of purchasing

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a corporation using its own assets as the collateral had been long pondered but not put to significant use with public companies. This decade brought such action and did so on a scale never before imagined. The prowess of Michael Milken's junk bond desk at Drexel Burnham Lambert was such that, at times, it seemed that no deal was too big or too bold to be launched. The unbridled success, or some may say, excess of Drexel financing and those who profited from it would ultimately end in the indictment of arbitrageur Ivan Boesky, and later Milken, in a widespread insider trading scandal. Alongside these developments came the beginnings of the collapse of the junk bond market and Drexel itself. But not before this financing machine and the man who ran it left an indelible mark on both M&A and the arbitrage business.

What Milken created was a market for corporate raider debt obligations. Milken's new debt instruments stood on their own, requiring no convertibility to equity. They allowed the corporate raider to, among other things, finance a bid entirely in cash and work around the Mill's Bill, which had disallowed the deduction of interest on takeover debt linked to equity. A raider needed only a "highly confident" letter from Drexel that it could raise the necessary financing and it could be assured that its intentions would be taken seriously by the Street and a target's board.

The eighties also brought an increase in the frequency of "white knight" rescues. Among some notable examples were DuPont's 1981 winning bid for Conoco following an initial bid from Seagrams and Occidental Petroleum's 1982 rescue of Cities Service from T. Boone Pickens' Mesa Petroleum. That year also brought a new term to the deal lexicon: PacMan defense—used to describe a defensive tactic where the target of a hostile offer bids for its suitor. Bendix found itself the victim of such a defense by Martin-Marietta after it had launched its own hostile bid for the latter. In the end, Bendix was acquired in a white knight rescue by Allied Corporation. All of these situations meant one thing for the arbitrageur: opportunity. The frequency of bidding wars was obviously a boon to the community. As the decade progressed both the risk arbitrage and M&A businesses would be shaped by the

opposing forces of the Drexel money machine and, on the legislative side, the counterweight of antitakeover legislation.

One of the more onerous developments of the 1980s was the widespread adoption of the "poison pill" takeover defense. In upholding the pill, the Delaware Superior Court essentially sanctioned a device that would for years impair the rights of shareholders to receive a fair price from a suitor deemed unfriendly by a sitting management. The obvious conflict between this new antitakeover defense and the basic rights of shareholders was, and is to this day, inexplicably lost on the Delaware courts. Adopted by a simple board resolution, the poison pill had the effect of a charter amendment without shareholder approval. The basic concept behind a poison pill was to dilute the voting power of a hostile shareholder by disallowing its shareholder's equal participation in a discount stock issue that would be triggered by the raider crossing a stated percentage shareholding threshold. In the 1985 case of Moran vs. Household International the Delaware Supreme Court rejected a request by Moran to strike down Household's poison pill. This historic decision solidified the presence of an antidemocratic takeover device that, regrettably, continues to undermine shareholder rights.

The stock market crash of 1987 was the defining event of the decade and brought the first major macroeconomic shock to the arb community. Since, at the time, most of the high-profile announced deals were for cash consideration, the arbitrageur lacked the short side which, when moving in tandem with the long, insulates a position from day-to-day market movements. Spreads widened so sharply on that historic day that the entire arb community suffered significant losses. The question in the immediate aftermath of the crash was: What's next? Opinions varied on the future of the risk arbitrage business as the financing of mergers and acquisitions business itself hinges on investors' appetite for risk. Some firms elected to close their arbitrage operations entirely, while others, seeing a quick end to what they believed was simply an index arbitrage meltdown, elected to extend additional credit lines to their arb desks. The idea was to capitalize on the drastically oversold market conditions and mispriced spreads brought on by the panic selling. Those

firms that withstood the panic profited handsomely, as the market stabilized under the watchful eye of the Federal Reserve, spreads narrowed, and the naysayers were proven wrong. Only one year late in fact, KKR, armed with Drexel's war chest, won a bidding war and acquired RJR for $25 billion in the largest LBO to date.

A two-year respite from the 1987 turmoil was shattered in 1989 with the catastrophic collapse of the $300-per-share, union-led buyout of UAL. If the 1987 crash was the seminal event of the decade for the larger financial community, the UAL deal collapse was its counterpart to the arbitrageurs. Referred to in gallows humor as "United Arbitrage Liquidation" the UAL deal made tragically clear the meaning of "risk" in the risk arbitrage game. The one-day plunge in UAL's share price and the collateral damage from arb desks dumping positions to raise capital for margin calls sent the DJIA down a then-significant 190 points. UAL was a shining example of one of the many perils of an overheated market: the phenomenon of confidence overtaking caution, a time-tested recipe for disaster. With the benefit of hindsight, many an arb looked longingly at the prices of the out-of-the-money put options on UAL common stock just prior to the collapse. A simple married put strategy would have insulated every arb from the damage to their long positions. Instead, some arbs found themselves setting up their own shops as their benefactors shied away from the risk arb business entirely. The UAL deal, while a calamity in its own right, was also a symptom of a larger problem. The overleveraging and general excess that had for the better part of the decade consumed Wall Street was finally coming home to roost.

The decade that had brought so much innovation to the arbitrage community and M&A business, as well as to corporate America, was ending on a decidedly sour note. Suspicions that the junk bond market was beginning to live up to its name were exerting enormous pressure on Drexel's ability to sell new debt. The firm was suddenly rudderless without the presence of Michael Milken, who in 1988 had been indicted on 98 counts of fraud and racketeering. Drexel itself was busy fending off its own indictment from then New York Attorney General Rudy Giuliani, and

the earlier insider-trading scandals involving Ivan Boesky, Dennis Levine, and John Mulheren had begun to shape a somewhat villainous image of the arbitrageur. The predictions at the time were dire. Risk arbitrage itself appeared to be imperiled by the tribulations of its host, the M&A business and, with a slowing economy raising fears of a recession, lighthearted Wall Street discussions of bidding wars gave way to more somber discussions of defaults and bankruptcies.

1990s

The early part of the next decade was a quiet period for the risk arbitrage business. The country was experiencing its first recession since 1982 and the job cuts and retrenchment within corporate America had all but extinguished the heady feel of the "go-go" eighties. Drexel Burnham in 1990 officially ended its reign as the premiere bond house on Wall Street when a series of credit rating downgrades forced it from the commercial paper market and into bankruptcy proceedings. The speed with which the junk bond powerhouse had risen to prominence and then vanished was stunning. The rest of corporate America was coping with the debt hangover of the eighties and the junk bond market, which once dominated conversation on Wall Street, was in ruins.

With the absence of an active deal market, spreads on announced deals suffered. The thinning of the arbitrage community had been more than offset by the scarcity of deals. This left the remaining arbs chasing few opportunities and doing so for lower returns. What followed was a movement by some firms into distressed arbitrage. In an attempt to capitalize on the rash of defaults and bankruptcies, some arbitrage departments turned their attention to valuing the outstanding debt of those companies that were facing restructuring. The idea was to then position their firm's capital in the debt of those companies in the hope of recovering a larger payout than a panicky bond market was anticipating. While this business was popular with some in the community, many arbs

stood their ground, concerned by the lack of liquidity in some of the debt issues, and viewing the heavy component of bankruptcy law as well as the new structure of analysis as an imprudent stretch from their classical training. As the economy recovered, the risk arb business was again given life by the new catch phrases of corporate America: scale and global positioning. Corporations were finding that the needs for scale within industries and indeed across continents were again pushing them toward the consolidation game.

After the drought the arbs were ready. The mid and late nineties saw a wave of consolidation amid a tech boom that transformed the productivity of corporations on a scale not seen since the industrial revolution. It appeared that American CEOs had concluded that it was simply easier to purchase market share than to grow it organically, and they had at their disposal the perfect currency: their own stock. The rise in equity prices throughout the nineties was the same boon to stock deals as the availability of junk bond financing was to the cash deals of the eighties. As in most economic rebounds, CEOs were finding that out of the wreckage of recession they and their competitors were emerging with leaner balance sheets and attractive stock valuations. The newly expanding economy provided the impetus to adjust to a more aggressive growth focus and the deal machine was once again in high gear.

One of the notable developments of the decade involved the resilience of the poison pill and its ability to shelter boards using the "just say no" defense. The development was the increasing objection to the device by shareholders. The targets of two closely followed hostile deals faced a new element . . . organized shareholder resistance. In 1995 Moore Corp launched a hostile offer for Wallace Computer. Wallace adopted the standard "just say no" defense and relied on its poison pill for protection. Moore Corp petitioned the Delaware Federal court to strike down Wallace's antitakeover defenses, namely the pill. Moore withdrew its offer after its petition failed and the pill was upheld, but not before Wallace found itself the target of a shareholder proposal to amend the company's bylaws so that its takeover defenses would terminate

90 days after a qualified offer had been received by the company. This event was one step in what became a turning point in the attitudes of shareholders toward recalcitrant boards. The "just say no" defense was now being reconsidered as an acceptable measure. What had been sanctioned by the Delaware courts was now coming under fire by popular revolt. The issue was again in focus in 1997 when the board of Pennzoil rejected a cash and stock offer from UPR. While the board consistently argued that the offer was too low, the real impediment was the company's poison pill and the prospect of costly litigation that it promised. After failing to bring Pennzoil's board to the negotiating table, UPR did in fact withdraw its offer, citing a deterioration in the value of Pennzoil's assets. To the arb it appeared more likely that the poison pill was the real culprit. While victorious in the end, Pennzoil, too, found itself the target of a shareholder revolt in the form of a proposal to elect a dissident director to the board and a demand for sweeping changes to the company's governance of change of control situations. It was becoming clear that by the late nineties, shareholders were no longer willing to accept a board's refusal to allow them to judge the fairness of an offer. Shareholders wanted their say as owners and their relationship to a board of directors was changing forever.

The arbitrage business continued to feel the influx of new players as it was being seen by increasing numbers of people as an attractive use of capital. The compression of spreads continued but by the late nineties the proliferation of derivatives was bringing pressure from a new direction. Spreads were being compressed not only by the volume of players but also by the margin that they employed. Arbitrage positions were now being taken by way of simple collateral deposits on derivative contracts, rather than through the actual purchase of common stock. The result was an amount of leverage that allowed arbs who were using these methods to profitably play spreads that appeared too thin for a profitable return. This action further squeezed the profit that was available by playing the deals through the common stock and began to raise the issue of whether the "risk" in risk arbitrage was being mis-priced.

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2000

The current decade began in a manner reminiscent of some of the difficulties faced in the early nineties. In this instance, the aftermath of a speculative boom in Internet and technology stocks that had distorted both the traditional risk/reward expectations of investors, as well as the historical price to earnings multiples of entire sectors of the market, had utterly poisoned market sentiment. It was a period marked by the brutal and seemingly endless destruction of wealth that had been created in the dotcom boom of the late nineties. A new distrust of corporate management, sown by the accounting scandals at Enron and Worldcom, as well as by the complete collapse of the Internet stocks, was now deeply rooted in both Wall and Main streets. CEOs were now being required, for the first time, to certify their company's financial reports in writing. The performance of the equity markets reflected a nation of investors disenchanted by corporate malfeasance. The revelations were beginning to make the explosive equity returns of the nineties look, in hindsight, like nothing more than a shell game. Gone were the days when a technology company's CEO could entice the shareholders of a target company with the implied promise of two- or three-fold gains in the combined company's stock price. The folly of Internet stocks was being driven home even at staid, blue chip corporations like Time Warner which, in one of the most glaring examples of poor judgment in corporate history, had accepted AOL common stock in the two companies' much touted 2001 merger. The arbitrageur in these days was wise to maintain a full hedge, for while the deals were still being churned out by optimistic investment bankers, the risk of a collapse in an acquirer's stock price could have been lethal. What has defined the current decade more than any development in the arbitrage or investment banking field, are the changes in the relationship of shareholders to their fiduciaries at publicly traded corporations.

What in the 1970s and 1980s might have been described as a "rogue shareholder," was now operating under the label "activist." What started in the nineties as revolts against entrenched

managements that had ignored their shareholders in rejecting high premium offers from unwanted suitors, was now an institution. Funds designed specifically for the purpose of engaging managements to enhance shareholder value were raising capital at an astonishing pace. The new idea was to establish a position in shares of an underperforming company and then present a solution, in the form of a new business plan, to management. In prior years, resistance had been common; the old "just say no" defense was still prevalent in boardrooms and the spirit of it had been used successfully against shareholders who wished to voice their concerns. The current decade brought a widespread change to attitudes regarding a shareholder's voice. Perhaps the distrust of managements had given way to a new willingness to demand, publicly, better performance from management. Activists, although still not genuinely welcome in the boardroom, were now warmly greeted by both the press and the investment community. Hedge funds, unencumbered by the investment banking ties of their larger competitors, were free to voice their opinions without the fear of a backlash from a parent company or an investment banking division fearful of losing its next underwriting fee. Activist funds were, in increasing numbers, succeeding in gaining board seats, and pushing agendas that ranged from changes to administrative governance frameworks, to more aggressive plans such as restructurings and even mergers. The age of the activist had clearly arrived. Once the low-hanging fruit at poorly managed U.S. corporations had been picked, activists turned their attention to Continental Europe. European companies were, by comparison, decades behind their western counterparts in the area of corporate governance. Equally archaic, however, were their attitudes toward shareholder's rights. The specter of a fund manager challenging a board of directors at a shareholder meeting was appalling to European managements and even to some of their large shareholders. The activist needed to plan a careful approach to avoid losing a public relations battle before his ideas were even on the table. As the decade progressed, even European managements began to adopt a more shareholder-friendly posture. European CEOs were recognizing that without reforms, their markets might be

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viewed as less efficient and therefore less competitive. Without efficiency, they might fail to attract capital from the international community. While the European business community has begun to change its attitudes toward active shareholders, the political establishment, particularly in Germany and France, continues to object to the participation of these funds in the management of public companies, on the grounds that they have no long-term interest in the companies themselves, or in the economies of the countries in which they invest. During the recent political season in Germany, for example, activists were labeled as "locusts" in an attempt to paint them, for political purposes of course, as the enemy of the German worker. The absurdity of this argument has not been lost on business leaders, and many have publicly cautioned their elected officials about the economic perils of appearing unwilling to embrace a more modern management philosophy that is inclusive of all ideas to enhance value. The activist battles between shareholders and managements in both the United States and Europe will undoubtedly continue for years to come. Any movement within the business community that has as its purpose the efficient management of a corporation's assets is unlikely to be derailed. Surely there will be mistakes and periods of backlash against aggressive shareholders, but the essential elements of the activist movement are here to stay.

One can examine the field of active value investing in terms that are quite familiar to the arbitrageur. It is possible to identify what is, in a sense, the spread in these situations. For each activist target there is a current market price, which can be seen as reflecting the performance of the current management. A research department may then analyze the potential values of the corporation's assets under an array of restructuring scenarios and arrive at a target price which, to a classically trained arbitrageur, might be the activist equivalent of a bid price under a traditional takeover scenario. The difference between the current market price and the anticipated values under each restructuring scenario can be considered "the spread." The spread could be captured in the event that the restructuring succeeds. An arbitrageur who commits capital to

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such a situation is taking both the risk that the proposal is accepted and that the proposal is sound. The time frame is of course considerably longer than the traditional risk arbitrage scenario, as it may require a full meeting cycle or longer for even the successful activist to implement a new agenda. What might be called "active arbitrage" is a demanding endeavor. Some investors from the arbitrage community elect to participate silently in the projects of other activists, while others are using their expertise in valuing corporations under restructuring scenarios, as well as their extensive knowledge of change-of-control scenarios and the attendant tactics associated with them, to initiate activist agendas themselves. Few professional investors, in fact, are better qualified to navigate the unique obstacles of corporate activism than the classically trained risk arbitrageur. The still-developing field of activism may hold great promise for those who honed their skills during the takeover wars of past decades.